

Taking the “Private” Out of “Private Placement”

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Mark Twain once wrote, “Many a small thing has been made large by the right kind of advertising.” In the context of raising capital, this may mean that general advertising and solicitations made in conjunction with stock offerings result in larger capital raises, which, in the minds of many bank executives, directors and regulators, translates into better financial health, capital ratios and prolonged success. The SEC recently relaxed the prohibitions on general solicitations by amending Rule 506 to include an additional exemption, a change of course that will no doubt increase both the right and wrong kind of advertising.

Effective September 23, 2013, the SEC adopted amendments to Rule 506 under the Securities Act of 1933, as amended by creating Rule 506(c) that permits general solicitation and general advertising in securities offerings under this exemption from securities registration, provided all purchasers are accredited investors and that the issuer complies with other requirements. The rule fundamentally changes how private placements may be conducted, by providing bank holding companies and national banks with a means in which to engage in general solicitation and advertising of their stock offerings. The general solicitation amendments were required by the Jumpstart Our Business Startups Act of 2012 (JOBS Act) and the exemption from registration under Rule 506(c) is available to both publicly traded and private companies, both domestic and foreign.

Overview of Regulation D

A basic principle of securities regulation laws is that every offer and sale of securities must either be registered under the Securities Act or be conducted pursuant to an exemption to registration requirements. Many bank holding companies used the “private placement” exemption under Section 4(2) in the last economic downturn. Regulation D is a statutory safe harbor for the private offering exemption of Section (4)(2). Within Regulation D, Rules 504, 505 and 506 provide exemptions from registration so long as specific requirements are met, with each rule having its own requirements and limitations. Rule 506, which has no limit on the size of the stock offering, is the subject of the SEC’s recent rule amendment and a widely used exemption.

Prior to the enactment of Rule 506(c), an issuer of securities in a Rule 506 offering was permitted to sell stock to an unlimited number of accredited investors and up to 35 non-accredited investors, so long as each non-accredited investor is experienced in financial and business matters and understands the nature of the investment opportunity. As it relates to offerings under the newly enacted Rule 506(c), the disallowance of non-accredited investors would be an

area of change following the new amendment.

Additionally, prior to the enactment of Rule 506(c), Rule 506 exempted stock offerings only so long as the “advertising” was conducted in private, i.e., the offering was not publically advertised or connected to a general solicitation to unknown parties, but instead was limited to investors that the issuer shared a pre-existing business relationship with. Accordingly, an issuer that was relying on Rule 506 as an exemption could not, among other things, advertise the stock offering in the newspaper or broadcast it on radio or television commercials. This ban on “general advertising and solicitation” is a fundamental tenet of Rule 506, or at least it was.

Amendment to Rule 506

The SEC amended Rule 506 by creating a new paragraph (c), or Rule 506(c), which allows general advertisings and solicitations of stock offerings, subject to strict compliance with other aspects of the rule. With the addition of Rule 506(c) offerings, traditional Rule 506(b) offerings will remain exempt, i.e., stock offerings up to an unlimited amount that are made to unlimited number of accredited investors and up to 35 non-accredited investors and, like in the past, are made to investors with whom the issuer has a pre-existing business relationship and not by way of general solicitations or advertisements. Thus, Rule 506(c) is an additional path and does not take away the traditional Rule 506 exemption.

In order to generally solicit and advertise to investors in reliance upon Rule 506(c), an issuer must comply with all terms and conditions of Rule 501, 502(a), and 502(d), which set forth definitions, general conditions to be met, and limitations on resale (the securities are “restricted securities” for purposes of Rule 144). Furthermore, pursuant to Rule 506(c), all of the final purchasers of a Rule 506(c) offering must be accredited and the issuing institution must have taken “reasonable steps” to verify the accredited status of purchasers in the offering. If the issuing institution satisfies the aforementioned requirements, then, pursuant to Rule 506(c), general advertisements and solicitations will be permitted. The allowance of general advertisements and solicitations will greatly increase the exposure of heretofore private stock offerings.

Taking “Reasonable Steps” to Verify Accredited Investor Status

In order for issuers to rely on Rule 506(c) to make general solicitations and advertisements in connection with a securities offering, all purchasers must be accredited investors. While a Rule 506(c) offering may be marketed to non-accredited investors, the final purchasers must all be accredited. In addition, Rule 506(c) requires that the issuing institution take “reasonable steps” to verify that all such purchasers are accredited investors. As such, a stand-alone check-the-box investor questionnaire will not suffice for the mandatory Rule 506(c) verification process. Accordingly, it is both the product and the process that matter. The SEC has provided a non-exclusive list of four methods that issuers may use to satisfy the “reasonable steps” requirement. They are as follows:

- Verifying income by reviewing copies of IRS income reports, including W-2 forms and tax documentation
- Verifying net worth by evaluating bank statements, tax assessments, credit reports and appraisal reports, as well as a written representation from the investor that includes a declaration that all of the investor’s liabilities have been disclosed

- Confirming accredited investor status by obtaining a written confirmation from specific professionals, including registered broker-dealers, SEC-registered investment advisers, licensed attorneys, or certified public accountants, that such professional (a) has taken steps to confirm that such investor is accredited, and (b) that the subject investor is indeed accredited
- For accredited investors that participated in a prior Rule 506 offering (that pre-dates the effective date of Rule 506(c)), and continue to hold such previously purchased securities, the issuer may continue to treat such investors as accredited so long as the investors certify his/her accredited status in writing

In addition to the foregoing verification methods, an issuer may also factor in other information. Specifically, factors that may be considered by an issuer in its verification of the accredited status of an investor include, but are not limited to, the following: (i) information about the nature of the purchaser (i.e., whether the purchaser is a natural person or an entity), (ii) publically available information about the purchaser, (iii) information obtained from third parties that is reasonably reliable; (iv) the nature of the offering; and (v) the terms of the offering.

In light of the foregoing, while the end result of a 506(c) offering, i.e., that all purchasers are required to be accredited, is fundamental, the process is also an area of key concern.

Practical Suggestions

Should your institution desire to conduct a general solicitation in connection with a stock offering, in order to ensure that your institution is compliant with Rule 506(c) during its next capital raise, we recommend the following:

- Prepare systematic intake documentation that is designed to verify the accredited investor status of proposed purchasers
- Train bank executives that participate in the mechanics of stock offerings to verify financial information regarding individual investors, including, but not limited to, the reliance on certifications from specified third parties and/or research from publically available information
- Request that purchasers provide IRS income reports and related certifications to substantiate accredited investor status
- Request that all purchasers provide true and correct financial statements and related certifications to substantiate accredited investor status
- To the extent feasible, structure your Rule 506(c) offerings with minimum investment amounts that would reasonably prevent non-accredited investors from participating in such offerings.

The benefits of a Rule 506(c) offering, including the ability to generally solicit and advertise the offering, which will likely increase the success of the raise, are significant. However, the compliance issues, administrative burden and loss of potential non-accredited investors associated with Rule 506(c) offerings should carefully be weighed against any such benefit and we caution our banking clients to evaluate these issues prudently. Put another way,

"sometimes, larger isn't better," and perhaps, Mr. Twain was indicating that problems may also become larger with advertising.

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