Published on *The National Law Review* https://natlawreview.com

Washington Delivers Relief to Community Bank Capital Raising Initiatives - Part I

Article By:

Banks & Other Financial Institutions

Many community banks and their holding companies need capital, whether to meet regulatory directives, anticipate BASEL III capital standards or to fund growth opportunities. While many laws, regulations and policies coming out of Washington in recent years have increased burdens on community banks, a recent development actually lifts burdens and facilitates stronger bank balance sheets. In a recent change, Washington has made it easier for community banks and their holding companies to raise capital by relaxing securities laws that apply to capital raising transactions.

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups (or JOBS) Act. The JOBS Act includes a number of dramatic changes to the federal securities laws. It represents the most significant relaxation of initial public offering and public company reporting requirements to be enacted in many years. It also includes revisions intended to facilitate, and reduce the expense of, access to capital through unregistered offerings of securities.

This is the first of two alerts that will discuss those provisions of the JOBS Act of particular importance to community banks and provide some insights into how such institutions may be able to take advantage of these developments. This alert deals specifically with the JOBS Act's impacts on securities registration and de-registration thresholds and its loosening of certain rules concerning public offerings. A subsequent alert will deal specifically with the JOBS Act's provisions on the so-called "crowdfunding" exemption and a new classification of reporting companies — "emerging growth companies."

Changes to Registration and De-Registration Thresholds for Periodic Public Reporting

Prior to the passage of the JOBS Act, banks and bank holding companies with 500 or more shareholders of record had to register as public companies under the Securities Exchange Act of 1934 (the "Exchange Act"). That is, banks and bank holding companies had to file expensive, periodic reports to the Securities and Exchange Commission ("SEC") under the Exchange Act (reports like a 10-K, 10-Q or 8-K), and meet other SEC compliance burdens so long as they had 500 shareholders of record. Furthermore, if a bank or bank holding company was already registered as a public company, it could not deregister and eliminate the substantial costs of disclosure and other compliance as a reporting company until its number of shareholders dropped to below 300. Some of the most significant aspects of the JOBS Act are its changes to registration and de-registration thresholds for banks and bank holding companies. It is important to note that banks without holding companies benefit equally from the provisions of the JOBS Act. For those banks, their primary federal banking regulator administers Exchange Act registration and those banks file their periodic reports with the regulator rather than the SEC. To simplify our discussion here, this alert discusses both bank holding company and bank registration thresholds in the context of registration and filing with the SEC.

The JOBS Act has increased the Exchange Act registration threshold for banks and bank holding companies to 2,000 shareholders of record. This threshold is specific to banks and bank holding companies. This is in contrast to the threshold for non-bank companies, which is now 2,000 total shareholders of record or 500 non-accredited shareholders of record. Furthermore, the JOBS Act resets the threshold for deregistration for banks and bank holding companies (but not other companies) at 1,200 shareholders. Additionally, shareholders obtained through the "crowdfunding" exemption discussed in our next alert will also be excluded from the count of shareholders of record, as will shareholders whose only securities of the company were received under employee compensation plans.

These changes provide enhanced flexibility to banks and bank holding companies around the issue of Exchange Act registration. It will allow banks and bank holding companies that are not registered with the SEC currently to increase their shareholder base without triggering SEC registration. Companies that were at or nearing the 500 shareholder limit and were previously forced to make the difficult decision of rejecting new capital lest they be forced to register will be able to bring in that new money without having to worry about the registration issue. Companies can also breathe easier that they will not unintentionally trip the relatively low 500 shareholder limit through sales of shares by existing shareholders or transfers at death.

Likewise, banks and bank holding companies with greater than 300 shareholders but less than 1,200 will now have the opportunity to de-register from the Exchange Act and significantly reduce their compliance costs. Community banks and their holding companies in this position should consider the pros and cons of deregistration and evaluate whether it makes sense in their particular circumstances. On the positive side, benefits may include:

- A reduction in expenses such as SEC filing, shareholder communications and outside adviser fees, which for an industry under earnings pressure is an obvious advantage;
- Elimination of the requirement to disclose transactions in the company's stock or publicize detailed compensation information in the company's proxy statement, which may in turn reduce negative publicity or pressures from activist shareholders;
- Curtailment of reporting and disclosure obligations that may free up resources of already overburdened management to focus increased attention in other areas, such as business strategy and credit review and enhancement; and
- Elimination of a management priority, whether stated or not, to meet normal capital markets pressures imposed by analysts and others to meet short-term earnings expectations.

On the negative side, depending on a company's circumstances, de-registration may also have some disadvantages that make it less compelling for certain companies, including:

- Reduced access to public equity markets due to less visibility and exposure;
- Inability to list securities on a public stock exchange, which makes it more difficult for shareholders to sell their stock;

- Possible negative reaction of shareholders who have grown accustomed to a certain level of disclosure and the format of such disclosure; and
- Decreased use of stock in reorganization transactions.

It appears that community banks are rushing to take advantage of this deregistration opportunity. According to a recent report of SNL Financial published in late May, 61 institutions have filed the necessary forms to deregister since passage of the Act — that's a number greater than the total bank and bank holding company deregistrations for the prior 16 quarters combined. For banks or bank holding companies that determine that deregistration makes sense, the process is relatively simple. Certain forms will need to be filed with the SEC under Section 12(b) of the Securities Exchange Act to remove the company from any national securities exchange and under Section 12(g) of the Exchange Act to suspend the company's periodic reporting requirements.

Changes to General Solicitation and Advertising Prohibitions and Small Public Offering Exemptions

Many community banks rely on private placements to raise capital either in recapitalization transactions or to stockpile capital to fund growth opportunities. Satisfying SEC private placement standards can be difficult, particularly when capital is scarce as it is today and the bank wants to approach as many potential investors as possible. The JOBS Act makes it easier to conduct private placements of securities through a set of changes relating to certain existing registration exemptions.

First, the JOBS Act requires revisions concerning Rule 506 of Regulation D. Rule 506 exempts from SEC registration sales of securities in any dollar amount to an unlimited number of accredited investors and up to 35 non-accredited investors, *provided there are no general solicitations or advertising used in the offering*. The JOBS Act requires that Rule 506 be revised to permit general solicitations and advertising in offerings pursuant to the rule, provided securities are only sold to accredited investors. Any such rule amendments must include a requirement that issuers must take "reasonable steps" to verify that investors are accredited investors, using such methods as determined by the SEC. Likewise, the JOBS Act requires revisions to Rule 144A(d)(1) to provide that securities sold under that exemption may be offered by means of general solicitation or general advertising, provided that securities are sold only to persons reasonably believed to be qualified institutional buyers (QIBs). In private placements there is always the legal tension as to whether the securities offering gets too close to the "general solicitation" line raising SEC compliance issues. The JOBS Act liberalizes the rules and thus reduces this risk, all of which should benefit the structuring and conduct of securities offerings and capital raising transactions by community banks.

Finally, the JOBS Act amends Section 3(b) of the Securities Act to effect changes to Regulation A. Regulation A provides for small public offerings exempt from registration with the SEC. The JOBS Act increases the current Regulation A cap of $5 million in any 12-month period to a cap of $50 million in any 12-month period. The securities sold pursuant to the exemption may be offered and sold publicly, and such securities will not be restricted securities. An issuer may "test the waters" or solicit interest in its offering prior to filing any offering statement with the SEC, provided any such communications are conducted in accordance with any conditions or requirements established by rules by the SEC. The civil liability provision in Section 12(a)(2) will apply to any person offering or selling securities pursuant to the exemption.

The JOBS Act requires the SEC to adopt rules requiring that issuers taking advantage of this exemption annually file audited financial statements with the SEC. In addition, the SEC is permitted to impose such other terms, conditions or requirements the SEC may determine necessary for investor protection, including a requirement that the issuer prepare and file electronically with the SEC and distribute to prospective investors an offering statement and any related documents. The offering statement or other documents may be required to include audited financial statements, a description of the issuer's business and financial condition, a discussion of the issuer's corporate governance principles, a statement of the issuer's intended use of proceeds from the offering, and other appropriate matters. The SEC also may require an issuer to file periodic disclosures with the SEC in addition to the mandated annual filings. Disqualification provisions applicable for the exemption shall be substantially similar to the disqualification provisions adopted in accordance with Section 926 of the Dodd-Frank Act (which looks to the bad actor disqualification provisions in current Regulation A).

These changes should enhance the ability of banks and bank holding companies to reach a larger pool of potential investors, to raise capital from such a larger pool without having to resort to the costs of a public offering and to increase the efficacy and success of those capital raising efforts through the ability to utilize general advertising and solicitation. Although these changes are promising for community banks and bank holding companies, the exact details and parameters established for taking advantage remains to be seen. The SEC is charged with adopting rules to implement these various revisions. In most cases, the SEC is charged with enacting such rules within 90 days of effectiveness of the Act. But in the case of the amendments to Regulation A, a timeframe by which the SEC must act is not established. In the case of revisions concerning Rule 506, the SEC has already missed the 90-day deadline imposed by the JOBS Act, but an SEC open meeting to consider whether to propose rules has been set for August 29, 2012.

Conclusion

Taken together, the changes brought about by the JOBS Act promise to loosen regulatory burdens on community banks and bank holding companies and thus expand capital raising opportunities for such institutions that remain in desperate need of additional capital for regulatory purposes or to fund growth opportunities. Both the sources of new capital and the means and methods by which such capital can be tapped have the potential for significant expansion for financial institutions. Although the exact parameters of some of the changes brought about by the Act will continue to emerge and evolve, financial institutions have reason to be optimistic about this altered regulatory landscape.

A copy of the Act is available at http://www.govtrack.us/congress/bills/112/hr3606/text#.

National Law Review, Volume II, Number 243