BALCH & BINGHAM LLP

B&B REVIEW

Financial Services and Regulation
Corporate Finance and Securities

DODD-FRANK LAW SHRINKS POOL OF INVESTORS FOR BANK SECURITIES OFFERINGS

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INTRODUCTION

Tucked into the 2,300 pages of the recently-enacted Dodd-Frank Wall Street Reform and Consumer Protection Act is a provision that could make it more difficult for banks and bank holding companies to raise capital through securities offerings. Section 413 of Dodd-Frank, which was effective as of July 23, 2010, requires that when determining whether a potential individual investor is an "accredited investor" the company must exclude the value of the investor's primary residence from the calculation of the investor's net worth.

PRIVATE OFFERINGS OF SECURITIES

Many community banks and bank holding companies have historically relied on Rule 506 of Regulation D of the Securities and Exchange Commission when making a private offering of securities. Regulation D provides several exemptions from the normal registration requirements for securities offerings under the federal securities laws, to facilitate private offerings of securities that are limited in dollar size or in the number of potential investors. Usually, it is smaller businesses that take advantage of this exemption, to avoid the expense of a registration with the SEC.

Many issuers limit their Rule 506 offerings to "accredited investors" only, since the rule allows the issuers to avoid providing those investors with the more detailed information that must be provided to non-accredited investors. Prior to Dodd-Frank, many prospective investors satisfied the accredited investor definition by demonstrating that they have an individual or joint net worth with his/her spouse of not less than $1,000,000.

Further, prior to Dodd-Frank, the SEC permitted the value of an investor's primary residence to be included when determining whether the investor satisfied the $1,000,000 net worth requirement. The reasoning behind the "accredited investor" exemption in Rule 506 is that such an investor is not thought to warrant the same protection from the risk of loss from an investment as those who do not have this level of net worth.

DODD-FRANK CHANGES

Congress apparently believed that the better test for establishing an investor's minimum net worth deserving of less protection under the securities laws would be to exclude the value of the investor's principal residence from the test. Perhaps this was due to the relative illiquidity of residential property, coupled with the rise in home values since the $1,000,000 net worth level was set in the 1980s.

Whatever the reason, Section 413 of Dodd-Frank now requires that the value of one's primary residence be excluded from the net worth test. In addition, responding to the passage of the new law, the SEC recently issued an interpretation stating that the related amount of indebtedness secured by

the primary residence "may" also be excluded up to the fair market value of the residence. Moreover, the SEC indicated that indebtedness secured by the residence in excess of the value of the home "should" be considered a liability and deducted from the investor's net worth.

The SEC plans future rulemaking on the definition of "accredited investor." However, Dodd-Frank provides that the SEC may not adjust the $1,000,000 amount until July 2014, and thereafter not more frequently than once every four years. In each case, an adjustment may only be made if done for the protection of investors, in the public interest and in light of the economy.

WHAT TO DO NOW

Banks or holding companies planning to raise capital in Regulation D offerings should immediately revise their subscription and disclosure documents to reflect the new definition of accredited investors. Moreover, prospective issuers should be prepared to verify that any individual investor purchasing securities based on an exemption using the accredited investor standard meets the revised standard. Failure to comply with the new requirement could result in loss of the exemption and could trigger either a costly registration process or equally problematic rescission of a securities offering.

'BAD ACTOR" PROVISIONS

In addition to the new restrictions on accredited investors, Dodd-Frank also directs the SEC to issue rules within the next year disqualifying certain "bad actors" from using Rule 506 in a securities offering. The law requires that the SEC's rules disqualify offerings or sales of securities by any issuer that has been the subject of certain proceedings under federal or state laws, including proceedings that bar the person from engaging in securities, insurance, banking, savings association or credit union activities and certain proceedings involving fraudulent conduct.

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