The Impact of the Recently-Enacted JOBS Act: Helping Banks and Bank Holding Companies Stay Private

Apr 17 2012

Practice Area: Banking and Commercial Finance

On April 5, President Obama signed into law the Jumpstart Our Business Startups Act ("*JOBS Act*"[1]). The JOBS Act provides new exemptive and other relief under the federal securities laws for smaller businesses trying to raise capital and substantially eases the regulatory burden on banks and bank holding companies by increasing the thresholds for registration and deregistration under the Securities Exchange Act of 1934 ("*Exchange Act*").

Section 12 of the Exchange Act requires a company with more than $10 million in assets and any class of securities held by more than 500 record shareholders to register with the SEC and thereby become a "public company" subject to the periodic reporting and proxy requirements, as well as a variety of other obligations and limitations, under the Exchange Act. Further, companies cannot "deregister" until they fall below the assets test or have fewer than 300 (not 500) shareholders of record. The JOBS Act does not eliminate the Exchange Act registration requirement for banks and bank holding companies, but increases the registration thresholds to 2,000 record shareholders for initial registration and 1,200 for deregistration.[2]

For banks and bank holding companies, the $10 million assets threshold is, of course, meaningless. But many small to medium-sized banks have historically struggled with the 500-shareholder limit. In contrast to most non-financial institution companies, when a bank is first organized, it often seeks to have broad participation of the local community, which also represents their potential customer base. Thus, it is common for even small banks/holding companies with hundreds of shareholders of record.

The former thresholds presented some difficulties that are largely obviated for community banks by the JOBS Act changes.

Bank M&A Activity
First, and perhaps most important, the 500-holder registration threshold has historically had a chilling effect on mergers and other business combinations in the banking industry. For example, if two banks wanted to merge and each had 300 shareholders, on the day of closing, the surviving bank would have 600 shareholders and, under the former threshold, would have to register under the Exchange Act. In my career I have seen at least three potentially viable privately – held bank/holding company mergers get put on indefinite hold due at least in part to the desire not to have the survivor become a public company. The reasons for this aversion to public company status were the added liability of directors and officers that public company status would entail, significantly increased compliance costs, and the fear that too much information (especially management compensation) would become public.

Increased compliance cost was cited as the most significant factor Estimates ranged from $100,000 to $200,000 in added expense in the first year, and about half that every year thereafter, which did not include management and staff time. These newly-added costs often had the potential to erase much of the synergistic savings associated with the merger.

The desire to avoid disclosure of management compensation was also an important concern, but for a less obvious reason. Although "transparency" is generally seen as a positive thing, it can involve costs at the community bank that are different from larger financial companies. It is one thing to be the CEO of a $50 billion bank in far off New York or California and have the world know that you made $5 million last year, because you have little if any contact with bank customers and you travel in circles where many of your contemporaries are in much the same position. It is quite another to be the president of a local bank making, say, $150,000 per year and having your friends, neighbors, customers and employees – the people you see every day – know exactly what your salary, bonus, perks and stock-based awards are. A bank president once told me that having his compensation "public" (i.e., known to his shareholders and, therefore, to practically everyone in the local community) made him uncomfortable when he had to take a hard line in negotiating loan workouts with borrowers facing financial difficulties.

Under the JOBS Act, while these concerns do not disappear altogether, the number of banks and holding companies subject to Exchange Act registration affected drops dramatically. It is likely that, as the impact of these changes is recognized, small and mid-sized banking organizations will have renewed interest in the possibility of business combination transactions with the SEC registration impediments effectively gone.

Complex Capital Structures
Historically, some bank mergers became unnecessarily complicated by the desire to avoid public company registration. In addition, I have represented more than one institution that changed its capital structure to remain a private company. This was usually accomplished by introducing a second class of stock[3]or engaging in some sort of stock repurchase program. While these restructurings gave me the opportunity to be creative, the added complexity – and added cost – did represent a burden to the bank/holding company. Other banks have opted for having transfer restrictions and rights-of-first refusal built into their Bylaws to prevent the 500-shareholder threshold from being crossed.

Shareholder Liquidity
One problem facing many smaller organizations is having a highly illiquid stock (although there are many larger banks and holding companies that suffer this same affliction). While there are various ways to address this concern, one of the most obvious is being able to substantially increase the number of potential shareholders – a shareholder of a local bank that already has 400 shareholders is much more "liquid" having an audience of nearly 1,600 (1,599 to be precise) potential buyers than be limited to 99 potential buyers under the old registration threshold. Thus, banks and holding companies that are now artificially restricting the number of shareholders (through, for example, Company rights-of-first-refusal) may be able to remove these restrictions and make their shareholders "feel" that they could liquidate their investment if they had to. Even though an actual market for the stock may take some time to develop.

Capital Formation
Under the old rule, established banks and holding companies that sought additional capital through a "secondary" stock offering would also have to be concerned about crossing the 500-shareholder threshold and in some cases may have been artificially limited by this constraint. Consider a holding company with 375 shareholders knowing it could sell additional stock to no more than 124 new shareholders in a secondary offering. Now consider that same company with the freedom to offer and sell its stock to up to an additional 1,624 potential buyers.

Of course, any stock sale will have to be structured to avoid the requirement to register the offering under the Securities Act of 1933. Banks, of course, already enjoy an exemption from the registration requirements under the Securities Act. For holding companies, while there are a variety of registration exemptions available, many would be inconsistent with a broad-based offering of the kind that would be implied by the new 2,000 shareholder Exchange Act registration threshold. The JOBS Act does create a new registration exemption under Section 3(b)(2) of the Securities Act that is similar to the existing Regulation A exemption but has a substantially higher dollar limit ($50 million compared to the Regulation A limit of $5 million). Neither exemption imposes restrictions on the number of or qualifications of purchasers, which is consistent with the expanded exemption from Exchange Act registration. The Section 3(b)(2) exemption, like Regulation A, can be thought of as "public company light" as it still involves some filings with the SEC and requires periodic information to be provided to shareholders. The Section 3(b)(2) exemption is subject to SEC rulemaking to implement its provisions and the JOBS Act imposes no deadline for this to occur.

Deregistration
Many banks/holding companies are already registered with the SEC because at one time or another they had more than 500 shareholders – now they have between 300 (the old deregistration threshold) and 1,199 (the new threshold). The American Bankers Association estimates that there are 500 such institutions nationwide. Subject to a deregistration process that is still undergoing SEC rulemaking, these organizations will be able to "go private" and avoid the concerns that made many of their peers remain private in the first instance.

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In summary, the changed SEC registration and deregistration thresholds for banking organizations under the JOBS Act should have significant positive impact on community banks, freeing business combinations and capital formation from significant restrictions that hampered these activities in the past. As a result, we may see a noticeable increase in community bank M&A transactions and securities offerings over the next few years.
About the Author Andy Guzikowski is a shareholder in the Milwaukee office of von Briesen & Roper, s.c. During his 30 years of practice, Andy has been involved in numerous bank mergers and acquisitions, has helped form new banks, has handled many primary and secondary stock offerings by financial institutions and counseled banks and bank holding companies on business combinations, capital, financing, regulatory and corporate governance matters.

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[1] Not to be confused with the American Jobs Act that was proposed by the President in September 2011 and is, for the most part, yet to be enacted.
[2] This change is applicable only to banks and bank holding companies – other companies will still be under the 500/300 thresholds. While bank holding companies are subject to SEC jurisdiction, banks would be required to register under the Exchange Act with their primary federal regulators.
[3] The shareholder threshold applies on a class by class basis, and thus a company with 499 "Class A" shareholders and 499 "Class B" shareholders would not have to register with the SEC.
