Comptroller of the Currency
Administrator of National Banks

Private Placements

Comptroller's Handbook
(Section 411)

Narrative and Procedures - March 1990

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Private Placements (Section 411)

Introduction

At the time of publication, the Securities and Exchange Commission is in the process of considering substantial changes to its rules regarding "private placements." Examiners reviewing this section and supervising banks engaged in either the purchase of "private placements" as investments, or functioning as placement agent, should consult with the OCC's Investment Securities Division for significant changes in our approach to private placements.

The Securities Act of 1933 (Act) requires that adequate and reliable information be made available about securities being offered or sold to investors. The Act requires that any security that is to be offered for sale to the public be registered with the Securities and Exchange Commission (SEC) unless there is a specific exemption from registration. The Act provides an exemption from the registration requirements for the issuer of securities if the securities are offered only to sophisticated investors in a nonpublic manner. Such transactions are called "nonpublic offerings" or private placements.

Bank as Agent or Advisor

Matching private placement issuers with investors is usually done by an individual or firm, including a bank, acting as either an agent or advisor. In the "as agent" relationship, the bank has authority to commit the issuer. The bank as advisor has no such power. Agents participate in negotiations between issuers and investors and assist in the actual placement of securities sold by the issuer. The agent's fee often is based on a percentage of the securities placed. Advisors, however, generally do not assist in the actual sale of the securities, their role being limited to advising the issuer on the structure and terms of the placement transaction.

Agreements between the bank and all other parties should specifically state the capacity in which the bank is acting, and who the bank represents if it is acting as agent. Regardless of whether the bank is agent or advisor, it must act prudently and disclose all pertinent information to the investor. Furthermore, the bank should avoid possible conflicts of interest and in all cases must disclose any possible conflicts. For example, a bank acting as advisor or as agent assumes the risk of a potential conflict of interest whenever the proceeds from the placement are applied to reduce a loan by the bank to the issuer.

Similarly, a conflict would exist when proceeds of a bank advised or brokered private placement are provided to companies which are owned or controlled by bank insiders. Furthermore, the bank must exercise due diligence to disclose all relevant information, including possible conflicts of interest and whether the issuer is borrowing from the bank or is experiencing financial difficulty. Although the bank does not commit its own funds to acquire securities in a private placement transaction, the potential for loss of funding sources or other business increases greatly if the bank does not exercise prudence in dealing with all parties to the transaction by disclosing all relevant facts. Failure to disclose all material facts in connection with the purchase or sale of any security, including securities sold in private placements, may subject the bank to lawsuits by investors and other liabilities for violation of antifraud provisions of the securities laws.

The SEC's Regulation D (specifically Rules 501-503 and Rule 506 under the Act) provides guidance for issuers seeking to rely on the private placement exemption. SEC Regulation D is a "safe harbor rule" which provides a non-exclusive means of satisfying the requirements for the private placement exemption under the Act. Generally, if all applicable conditions of SEC Regulation D are met, the offering is deemed exempt from SEC registration. Even if the issuer does not satisfy all SEC Regulation D requirements, it may still be able to claim the private placement exemption directly under the Act or be able to claim another of the statutory exemptions. However, compliance with SEC Regulation D is the only way to ensure the availability of the private placement exemption. Failure to establish a registration exemption generally subjects the selling bank to absolute liability to refund the purchase price to every investor who bought the unregistered securities from the bank.

Summary of Applicable Provisions of SEC's Regulation D

Set forth below is a summary of the major provisions of SEC Regulation D that are applicable to the private placement exemption.

- The securities may be sold only to "accredited investors" (see below) or to those purchasers or purchaser representatives whom the issuer reasonably believes have knowledge and experience in financial and business matters so as to be capable of evaluating the merits and risks of the investment.

- An "accredited investor" is any investor who falls within, or whom the issuer reasonably believes falls within, one of eight defined categories of investors. The following is a partial listing of the more important categories of “accredited investors”:

- Certain institutional investors, including banks (acting in a fiduciary or individual capacity[1]), insurance companies, investment companies, small business investment companies, and certain employee benefit plans, savings, and loan associations and credit unions (acting in a fiduciary or individual capacity), and registered broker-dealers purchasing for their own accounts.
- Directors, executive officers, or general partners of the issuer.
- Persons with individual or joint net worth in excess of $1,000,000 at the time of purchase.
- Persons with individual income in excess of $200,000 for the past two years, who reasonably expect income in excess of $200,000 in the current year; as of April 11, 1988, this category is expanded to include persons with joint income of $300,000 for the past two years, who reasonably expect the same income level in the current year.
- Any corporation, partnership, or business trust not formed specifically to acquire the securities offered, with total assets in excess of $5 million.
- Any trust not formed specifically to acquire the securities offered, with assets in excess $5 million, if the trust is directed by a sophisticated person.

• No general advertising, general solicitation, or public communication about the securities offering is permitted. The SEC generally requires the issuer or its agent to have a substantive, pre-existing relationship with each offeree in order to avoid a “general solicitation.” Private placement agents should, therefore, not “cold call” new customers, even if they are sophisticated or accredited investors.

• Securities may be sold to no more than 35 purchasers, excluding accredited investors, in any one offering. The rule does not limit the number of accredited investors in a single offering. However, a general solicitation directed only to accredited investors would not meet the requirement that the securities be sold without general solicitation (see above).

[1] In spite of the SEC’s regulation D determination that banks are “accredited investors,” private placements are not eligible for investment by national banks. Private placements, by their structure, are not marketable securities and, therefore, do not meet the definition of investment security for 12 CFR 1.

- All sales of securities that are part of the same offering must be integrated (i.e., treated as part of the same offering) for purposes of determining compliance with Regulation D. Sales taking place six months before the start or six months after the completion of a Regulation D offering will not be integrated so long as no other offers or sales of the same securities are made by or for the issuer during the above six month periods. If sales occur during the above six month periods, the determination of whether they should be considered part of the same offering depends on the particular facts and circumstances.

- Adequate disclosure must be provided concerning the issuer, its business, and the securities offered:

  – If sales are made only to accredited investors, no specific disclosure is mandated.
  – If purchasers include non-accredited investors, the type of information required depends upon the size of the offering and whether the issuer is subject to the reporting requirements of the Securities Exchange Act of 1934. The required information must be provided to both accredited and non-accredited investors.
  – All purchasers in any offering have the right to ask questions and receive answers concerning the offering and to obtain information to verify the accuracy of the information disclosed.
  – All information must be provided prior to sale. A short form disclosure statement may be provided in advance of an expanded document so long as the short form does not obscure material information.
  – In addition to the required information, all material information must be disclosed that is necessary to ensure that the statements made are not misleading in light of the circumstances.

- The issuer must exercise reasonable care to assure that the purchasers of the securities are not acquiring the security for redistribution. Reasonable care must include, but is not limited to:

  – Reasonable inquiry to determine whether each purchaser is acquiring the security for his own purposes or for other investors.
  – Written disclosure to each purchaser prior to sale that the securities have not been registered and, therefore, cannot be resold unless they are

registered or unless an exemption from registration is available.
  - Placement of a legend on the securities document or certificate stating that the securities have not been registered and setting forth the restrictions on the transferability and sale of the securities (see below).

- The issuer must file a notice of sale on Form D with the SEC within 15 days after the first sale of securities. Subsequent notices are required every six months after the first sale and 30 days after the last sale.

Even though all the requirements of SEC Regulation D are met, a securities offering may still be subject to registration if it is part of a plan or scheme to evade the registration provisions. In addition, compliance with Regulation D does not relieve the issuer or the bank from applicable state law requirements relating to the offer and sale of securities.

Securities acquired in a private placement are "restricted securities," which may be resold only through use of a registration statement or pursuant to an appropriate exemption from registration under the Act. In addition to other exemptions that may be available, the SEC's Rule 144 permits the resale without registration of restricted securities, provided that all conditions of the rule are met. Generally, the rule requires a two-year holding period after which the securities may be resold, subject to restrictions on the manner of offering, the amount of securities sold, and the availability of current public information about the issuer of the securities. Non-affiliates of the issuer are free to resell securities acquired in a private placement with no restrictions after a three-year holding period.

Investors seeking to resell securities acquired in private placements without complying with Rule 144 are strongly advised to consult legal counsel. Although the SEC generally has not objected to "private resales," in which restricted securities are resold subject to the same restrictions that are applicable to the initial private placement by the issuer, the exemption for such transactions is not clearly established.

Privately placed securities have certain advantages and disadvantages for both investors and issuers. By using privately placed securities, the informed investor and issuer can tailor the securities offering, through negotiation, to meet the needs of both parties. The issuer also saves the costs incurred for securities registration and obtains access to alternative financing. Both the issuer and the investor complete the transaction without being subject to regulatory oversight or public scrutiny.

Unlike registered securities, however, the offering materials for privately placed securities are not reviewed by the SEC and, therefore, do not receive the disclosure benefits of SEC staff review. Additionally, private placement advisory fees may be high relative to the size of the issue. Another disadvantage of privately placed securities includes the lack of a secondary market. Thus, the investor often is unable to liquidate a privately placed security. Because of the lack of a secondary market and the restrictions on the manner of the offering, the issuer is limited in the amount of funds that may be raised since the number of potential investors is small compared to the number of potential investors for publicly available investments. Investors may also demand a higher yield in consideration for the relative lack of liquidity. It is the absence of a public market for privately placed securities which makes them ineligible as investments for national bank securities portfolios.

Bank Ownership of Privately Placed Securities

The legal impediments to public marketing of privately placed securities makes them ineligible as investments for national banks. However, some national banks have purchased privately placed securities and have recorded and reported these products as loans.

Lending statutes will apply when a national bank chooses to acquire a privately placed security and record and report this acquisition as a loan portfolio item. The OCC expects that prudent lending standards will prevail. The standards of BC 181 dated August 2, 1984 will apply, and privately placed loan acquisitions will be considered when calculating the adequacy of loan loss reserves.

When encountering a bank that has acquired a privately placed security as a loan, the validity of this assertion should be tested by the examiner who must make the following judgments:

- Is the management of the purchasing bank capable of doing the required credit analysis?

- Are they in fact doing the analysis, initially, and on an ongoing basis?

- Do they base their purchase decision on this analysis?

- Are the purchased assets consistent with the bank's credit policies in terms of quality, type, diversification, and borrower location?

If the answer to any of the above is no, then regard the privately placed security to be an ineligible investment.

Industrial Development Bonds

National banks sometimes distribute Industrial Development Bonds (IDBs) to investors by using a distribution process called a "private placement." This is an attempt by the national bank to apply the SEC's securities registration exemption Regulation D to items (IDBs) which are already exempt from the SEC's registration requirements because they are municipal securities. Since IDBs are exempt from SEC registration, these types of IDB transactions by banks are more appropriately characterized as "placement agent" transactions. If the national bank or separately identifiable department (SID) or division of the bank is registered with the SEC as a municipal securities dealer, then these types of IDB placement agent activities must be conducted in the registered SID and persons performing the placement agent activities for IDBs must be qualified municipal securities principals or municipal securities representatives.

National banks who act as placement agents for IDB distribution, and at the same time lend to the IDB obligor, provide letter of credit support, or act as trustee are placed in a conflict situation similar to the private placements conflicts of interest previously discussed. Accordingly, national banks functioning as placement agents should disclose all relevant facts, including possible conflicts of interest and whether the IDB obligor is borrowing from the bank or is experiencing financial difficulty.

Conclusion

A commercial bank's private placement activities will cause its board of directors to assume additional responsibilities. Accordingly, private placement activity, like any other banking activity, should be subject to adequate internal safeguards and policy considerations. Procedures should be developed to monitor private placement activity whenever such services are provided by the bank or bank subsidiary. When drafting a private placement policy, the board of directors should ensure that self-dealing practices and conflicts of interests cannot develop. Moreover, procedures should be in effect to detect any transactions that could have an adverse effect on the bank's other functions, such as lending or trust department activities.

Private Placements (Section 411)

Examination Procedures

1. Complete or update the Private Placements section of the Internal Controls Questionnaire.

2. Based upon the evaluation of internal controls and the work performed by internal/external auditors (see separate program), determine the scope of the examination.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/ external auditors from the examiner assigned "Internal and External Audits," and determine if corrections have been accomplished.

4. Perform appropriate verification procedures.

5. Request the following information from appropriate personnel:

   a. A list of all private placements advised by the bank since the last examination to include:

      - Name of issuer.
      - Name of investor(s), including banks.
      - Fee and how it was determined.
      - Amount, rate, maturity of issue.

   b. A list of any funds managed by the bank or its trust department, subsidiaries, or affiliates that have been used to purchase private placements advised by the bank or an affiliate.

   c. A letter from bank counsel regarding legality of the bank's involvement in private placement activities.

   d. A list of the person(s) performing private placement advisory services and their previous experience.

e. A list of investors that the bank normally deals with in placing private offerings and their stated investment requirements.

f. A copy of any of the bank's standard form agreements used in private placement transactions.

g. A list of any borrowers whose loans were partially or fully repaid from the sale of private placements advised by the bank since the last examination.

h. A list of participations purchased or sold in loans used to fund private placements advised by the bank.

6. Review pertinent information received in performing step 5, and compare it to the list of criticized assets from the previous examination.

7. Forward list of placements to the examiner assigned "Loan Portfolio Management" and request that he or she determine if any loans were made to fund the investment in the private placement.

8. Review opinions of legal counsel regarding private placements, and determine if there are any material deficiencies.

9. Determine if former banking relationships exist for both issuer and investor, and determine if fees charged for loans or paid on deposits are within normal bank policy.

10. Review files related to a representative sample of all placement transactions, and determine if the bank evaluates both the issuer and investor in a private placement transaction, including the suitability of the investment to the stated investment requirements of the investor.

11. Confer with examiner assigned "Duties and Responsibilities of Directors," and determine if potential conflicts of interest exist between bank-advised placements and interests of directors and principal officers.

12. Discuss with appropriate officer(s), and prepare summaries in appropriate report form of:

a. Deficiencies in policies, practices, and internal controls.

b. Any hazardous or potentially hazardous placement activities.

c. Recommended corrective action.

13. Prepare a memorandum, and update the work program with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for private placement activities. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Does the bank, bank subsidiary(s) or affiliate(s) provide private placement advisory services?

Private Placement Policies

2. Has the board of directors adopted written policies for private placement activities that:

   a. Define objectives?

   b. Provide guidelines for fee determinations based on:

      - Size of transaction?
      - Anticipated degree of difficulty or time involved?
      - Payment of negotiated fees at various stages of the transaction?

      and not solely on:

      - Successful completion of the transaction?
      - Deposit balances or the profitability of the client's other banking relationships?

   c. Require that bank officers act in an advisory rather than agent capacity in all negotiations?
      (An advisor will advise and assist a client; an agent has the authority to commit a client.)

   d. Recognize possible conflicts of interest, and establish appropriate procedures regarding:

- The purchase of bank-advised private placements with funds managed by the bank or an advisory affiliate?
- Loans to investors to purchase private placements?
- Use of proceeds of an advised placement to repay the issuer's debts to the bank?
- Dealings with unsophisticated or non-institutional investors who have other business relationships with the bank?

e. Require legal review of each placement prior to completion?

f. Direct officers to obtain certified financial statements from the seller?

g. Require distribution of certified financial statements to interested investors.

h. Require officers to request a written statement of investment objectives or requirements from interested investors?

i. Provide for a supervisory management review to determine if a placement is suitable for the investor?

Conclusion

3. Is the foregoing information considered adequate as the basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above. (Explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures.)

4. Based on a composite evaluation (as evidenced by answers to the foregoing questions), the degree of control by main office management is considered ___________ (good, medium, or bad).

Private Placements (Section 411) — Verification Procedures

1. Review advisory fees associated with private placements and trace selected fees to appropriate income accounts.

2. Trace all participations purchased or sold in any loans that were used to fund private placements advised by the bank.

3. Review advised private placements since the previous examination. Scan appropriate investment or dealer accounts to determine if any bank funds were directly involved in purchasing securities that were subsequently placed with private investors.

4. Using an appropriate sampling technique, select funds managed by the bank, its trust department, subsidiary(s) or affiliate(s), and determine if those funds have purchased private placements advised by the bank since the last examination.