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Equity Financing: Using Stocks, Bonds, Mutual Funds and Other Investment Vehicles as Collateral

Navigating the Interplay of Regulations U and X, Rule 144,
and UCC Articles 8 and 9 for Lenders and Borrowers

THURSDAY, JULY 21, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Strategies and Common Pitfalls in Commercial Lending: When Using Equity Interests as Collateral

Todd Ransom and Craig Unterberg

July 21, 2016



haynesboone

Setting precedent.

Agenda

1. Common Types of Equity Interests
2. Documentation and Perfection Issues
3. Lender Remedies
4. Panel Discussion and Audience Questions

Common Types of Equity Interests

- Common Types
 - Stock of Public Companies
 - Stock of Private Companies, Partnerships and LLC Interests
 - Foreign Companies
- Importance of Up-front Due Diligence

Common Types of Equity Interest: Stock of Public Companies

- Securities Law Issues:
 - Restricted/Control Securities
 - Section 13 Filings
 - Section 16 and Group Issues
 - Material Non-public Information
 - Edgar: SEC Filings
- Contractual Issues:
 - Registration Rights
 - Shareholder Agreements

Common Types of Equity: Stock of Public Companies – Securities Law Issues

- Securities Act imposes a prohibition on sale of securities unless:
 - Effective registration statement, or
 - Exemption from Securities Act
- Ability to sell collateral will depend on nature of securities:
 - Freely saleable: can be sold freely on applicable exchange, subject to any contractual limitations
 - Restricted/Control Securities
 - Restricted Securities: unregistered securities acquired directly from the issuer
 - Control Securities: unrestricted securities held by affiliates of the issuer
 - Who is an affiliate?
 - Rule 144
 - non-exclusive safe harbor under Section 4(a)(1) of the Securities Act for selling security holders
 - satisfaction of all applicable conditions of Rule 144 in connection with the applicable sale results in the seller being deemed not to be an "underwriter" as defined in Section 2(a)(11) of the Securities Act and allows such seller to rely on the Section 4(1) exemption
 - Public resales of restricted securities and control securities outside the Rule 144 safe harbor may also be made under other available exemptions under the Securities Act

Common Types of Equity: Stock of Public Companies – Securities Law Issues cont.

- Section 13
 - Beneficial Ownership
 - Exists where a person directly or indirectly shares voting power or investment power (the power to sell the security)
 - Filing Requirements
 - Initial Filings: triggered when a person or group of persons acquires beneficial ownership of more than 5% of a voting class of a company's equity securities
 - 13(d): within 10 days
 - 13(g): within 45 days of the end of the calendar year
 - Group Issues: when have persons agreed to act as a group?
 - When does the lender acquire beneficial ownership?

Common Types of Equity: Stock of Public Companies – Securities Law Issues cont.

- Section 16
 - 16(a) – Reporting Requirement: more than 10%
 - 16(b) – Short-swing profit recapture
 - Does not apply to foreign private issuers
 - Group Issues
- Material Non-Public Information
 - Important to ensure no MNPI
 - Section 10(b) and Rule 10(b)(5) (Anti-Fraud Provisions) apply to pledge and foreclosure
- Edgar SEC Filings: good resource for due diligence

Common Types of Equity: Stock of Public Companies – Contractual Issues

- Registration Rights Agreements
 - Shelf Registration
- Shareholder Agreements
 - Contractual Lock-up Provisions

Common Types of Equity: Stock of Private Companies, Partnerships and LLC Interests

- Ownership Structure
- Certificated v. Uncertificated
- Contractual Issues
 - Restrictive provisions of organizational documents
 - Restrictions on pledges/transfers
 - Rights of first refusal
 - Shareholder Agreements

Common Types of Equity: Foreign Equity Interests

- Foreign corporate structure analysis
- Foreign perfection issues: PRIMA v. look through
- Foreign securities exchange rules where publicly listed, including applicable takeover codes
- Foreign currency exchange issues
- Foreign bankruptcy issues

Documentation and Perfection Issues

- UCC Issues
- Indirect Holding System
- Federal Reserve Board Margin Regulations
 - Regulation U
 - Regulation T
 - Regulation X
- Contractual Issues

Documentation and Perfection Issues: UCC Issues

- Article 8 Perfection
 - Control
 - Securities
 - Securities Accounts
 - Securities Entitlements
- Article 9 Perfection
 - Filing
 - General Intangibles: entities that do not qualify as securities under Article 8
- LLC's and LP's: Consent v. Securities Entitlements

Documentation and Perfection Issues: Indirect Holding System

- Securities v. Securities Entitlements
 - What is the distinction?
 - Who is the owner of record?
- DTC
 - Most publicly traded equity securities held in this form
- Transfer Agent and Removal of Restrictive Legends

Documentation and Perfection Issues: Federal Reserve Board Margin Regulations

- Regulation U: Non-Broker-Dealer lenders
- Regulation T: U.S. Broker-Dealers
- Regulation X: U.S. Borrowers and U.S. Securities

Documentation and Perfection Issues: Federal Reserve Board Margin Regulations – Reg U

- Purpose: to regulate extensions of credit by non-broker-dealer lenders that are both (i) made “for the purpose, whether immediate, incidental or ultimately, of buying or carrying margin stock” and (ii) secured directly or indirectly by margin stock.
- Margin Stock Definition
- What is purpose credit?
- When is an extension of credit directly or indirectly secured by margin stock?

Documentation and Perfection Issues: Federal Reserve Board Margin Regulations – Reg U cont.

- Compliance with Regulation U where applicable:
 - Maximum Loan Value
 - Margin Stock – 50%
 - Other – Good faith value
 - Single credit rule
 - Form FR U-1

Documentation and Perfection Issues: Federal Reserve Board Margin Regulations – Reg X

- Purpose: to subject to the Board's margin regulations, “United States persons and foreign persons controlled by or acting on behalf of or in conjunction with United States persons, who obtain credit outside the United States to purchase or carry United States securities, or within the United States to purchase or carry any securities”
- United States Persons: includes any “person which is organized or exists under the laws of any State or, in the case of a natural person, a citizen or resident of the United States; a domestic estate; or a trust in which one or more of the foregoing persons has a cumulative direct or indirect beneficial interest in excess of 50 per centum of the value of the trust”
- United States Securities: means “a security (other than an exempted security) issued by a person incorporated under the laws of any State, or whose principal place of business is within a State”

Documentation and Perfection Issues: Contractual Issues

- Issuer Consent Letters
- Covenants Restricting MNPI
- Other

Lender Remedies

- UCC Issues
- Securities Law Issues
- Contractual Issues
- Bankruptcy Issues
- Lender Liability Issues

Lender Remedies: UCC Issues

- Commercially Reasonable Standard
 - UCC 9-610(b): “Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms.”
 - UCC 9-627(a): “The fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner.”
 - UCC 9-627(b): “A disposition of collateral is made in a commercially reasonable manner if the disposition is made: (1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.”

Lender Remedies: UCC Issues cont.

- Manners of Sale
 - Private Sale (UCC 9-610)
 - Recognized market required
 - Public Sale (UCC 9-610)
 - Public has had a meaningful opportunity for competitive bidding
 - Advertising Requirement: lengthier process than private sale
- Notice Requirement and Notice Safe Harbor (UCC 9-611 and 9-612)
 - 9-611(b): reasonable authenticated notification of disposition under 9-610 required
 - 9-612(a): whether notice sent within a reasonable time is a question of fact
 - 9-612(b): notice safe harbor – after default and 10 days or more before disposition
 - 9-611(d): no notice requirement if collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market
- Strict Foreclosure (UCC 9-620)
 - Requires post-default consent of debtor (which may be assumed if no notification of objection is sent by debtor within 20 days after proposal sent by secured party)

Lender Remedies: Securities Law Issues

- Registration Requirement Generally
- Commonly Used Registration Exemptions
 - Rule 144
 - Regulation S
 - 4(1^{1/2})
- Section 16(b)

Lender Remedies: Securities Law Issues – Registration Requirements

- Section 5 of the Securities Act requires that transactions in securities be registered absent an applicable exemption.
- This requirement applies not just to sales by owners of securities, but also to lenders secured by such securities in connection with sales made by such lenders in exercising their remedies under the applicable loan documents.

Lender Remedies: Securities Law Issues – Registration Exemptions – Rule 144

- Exemption most often used for sales on public exchange
- Applies to sales of restricted or control securities (or securities which are both)
 - Affiliate v. Non-Affiliate
 - Reporting Company
 - Holding Period & Tacking
 - Recourse v. Non-Recourse
 - Current Public Information
 - Volume Limits
 - Manner of Sale
 - Form 144

Lender Remedies: Securities Law Issues – Registration Exemptions – Other Exemptions

- Regulation S: exemption for off-shore offerings
 - Limited to “offers and sales of securities outside the United States” to the extent made in good faith and not as an attempt to circumvent the registration requirements of the Securities Act
 - Requires both (1) offshore transaction and (2) no directed selling efforts (i.e., “activity undertaken for the purpose of, or that could be reasonably expected to result in, conditioning the U.S. market for the relevant securities”)
 - Additional restrictions are imposed during a distribution compliance period depending on the level of risk that securities in a particular type of transaction will be sold back into the United States
 - Distribution compliance period ranges from 40 days to 6 months for reporting issuers or one year for non-reporting issuers

Lender Remedies: Securities Law Issues – Registration Exemptions – Other Exemptions cont.

- Background
 - 4(1): exemption for any person other than an issuer, underwriter or dealer
 - Underwriter: person who acquires securities with a view to distribution or is participating in a distribution – generally means an offering other than a private offering
 - In order to rely on, need to avoid classification as an underwriter
 - 4(2): exemption for transactions by an issuer not involving any public offering
- 4(1^{1/2}): used for private resale of restricted securities
 - A holder of restricted securities who wishes to resell them privately (rather than publicly via Rule 144) must ensure it is not an underwriter in order to rely on the 4(1) exemption
 - The 4(1^{1/2}) exemption has evolved from practice (not expressly set forth in Securities Act) as a means of establishing non-underwriter status for purpose of relying on the 4(1) exemption
 - Basically attempts to mirror 4(2) type restrictions imposed on an issuer in connection with private placements by an issuer
 - Requirements:
 - Limited to less than 25 purchasers
 - No public advertisement or general solicitation
 - Seller to provide purchaser with information about issuer available to seller
 - If seller is affiliated with issuer, limited to purchasers sophisticated enough to evaluate the risks
 - Seller did not purchase with a view to resell – generally considered that a 6 month holding period will be sufficient (but no statutory holding period)
 - Purchaser represents it is acquiring for investment – not for resale

Lender Remedies: Securities Law Issues – Section 16(b)

- Section 16(b) of the Exchange Act
 - Requires insiders to pay over to the issuer any profits realized from any purchase and sale (or any sale and purchase) of issuer's securities within a six month period – must be an insider at the time of both the sale and the purchase
 - Who are insiders?
 - Directors and executive officers
 - Persons/entities who beneficially own more than 10% of a class of securities of issuer (based on beneficial ownership – not legal title)
 - An insider is considered to have a beneficial ownership interest of securities held by members of the insider's immediate family sharing the same household – immediate family household members include grandparents, grandchildren, siblings and in-laws, as well as the insider's spouse, children and parents
 - Intent to take unfair advantage of non-public information is NOT required – profit from any matchable transactions within the six month period, whether intentional or inadvertent, will be recoverable – rules also allow for a situation where there was an economic loss, but still a profit for purposes of 16(b) due to the calculations applied
 - Active plaintiff bar

Lender Remedies: Contractual Issues

- Blocker Language
- Issuer Consent
- Hedging Rights
- Power of Attorney

Lender Remedies: Bankruptcy Issues

- Automatic Stay: Bankruptcy Code Section 362 – prohibits ability to exercise remedies under loan documents
- Safe Harbor Provisions: provide relief from automatic stay in certain situations
 - Section 555: Securities Contracts
 - Section 559: Repurchase Agreements
 - Section 560: Swap Agreements
 - Financial Participant:
 - not less than \$1 billion in notional or actual principal amount outstanding on any day during the 15-month period preceding the date of the filing of the petition
 - has gross mark-to-market positions of not less than \$100,000,000 (aggregated across counterparties) in one or more such agreements or transactions during such period
 - is a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).
- Basel III

Lender Remedies: Lender Liability Issues

- Consistency in message to borrower
- Documentation
 - Reservation of Rights
 - Clear Language in Limited Waivers or Forbearance Agreements
- Scope of acts permitted under power of attorney

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