BYBEL RUTLEDGE LLP

LEGAL ALERT

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Is the Non-Profit Board on Which You Serve Unknowingly Offering Securities?

Many officers and directors of our clients are active in the non-profit sector and may serve on boards of non-profit organizations. Larger non-profit organizations, particularly those with a religious affiliation or a distinct social mission (eg affordable housing), may have formed investment or loan funds as a means to raise money to fulfill their stated goals.

How Non-Profit Loan Funds Work

Generally, these funds solicit parishioners or socially like-minded folk to loan money to the fund for a stated period of time. Afterward, the loan might be payable on demand or rolled over to another stated term. These loans go by many names such as "deposits," "certificates" or "notes" but they all generally represent an "evidence of indebtedness" issued by the fund for which the fund is legally obligated to return the "loaned" amounts.

The fund uses the proceeds from the sale of these evidences of indebtedness to make loans to entities affiliated with the religious denomination or entities that will further a particular social goal at an interest rate that often is lower than what can be obtained from a commercial financial institution, if such loan can be obtained at all. The spread between what the fund pays to the purchasers of the evidences of indebtedness and what the recipients of the loan from the fund pay to the fund is used to defray administrative expenses, including legal and accounting expenses.

Why These Funds are Offering Securities

Both the federal Securities Act of 1933, as amended ("1933 Act"), and the Pennsylvania Securities Act of 1972, as amended ("1972 Act") define a security to include an "evidence of indebtedness." The Pennsylvania Department of Banking and Securities (the "Department") and its predecessor, the Pennsylvania Securities Commission, have long viewed that loans which individuals make to these funds constitute "securities."

Requirements under Federal and State Securities Laws

The offer and sale of these evidences of indebtedness are subject to the registration and anti-fraud provisions of federal and state securities laws. Neither the 1933 Act nor the 1972 Act exempt funds from the anti-fraud provisions of those statutes.

The 1933 Act exempts securities issued by a non-profit organization from its registration provisions, provided that the fund, at a minimum, has received a ruling from the Internal Revenue Service that it qualifies as a tax-exempt organization. The Philanthropy Protection Act of 1996 (the "PPA") extended the federal registration exemption to securities of charitable income funds relying on an exclusion from the definition of an investment company under Section 3(c)(10)(B) of the Investment Company Act of 1940, as amended.

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In contrast, the 1972 Act provides a registration exemption only for equity securities issued by non-profits and explicitly excludes "evidences of indebtedness" from such exemption. Securities issued by a charitable income fund that are exempt from registration under the 1933 Act are not exempt under the 1972 Act as the PPA permitted states to nullify the preemption provisions in the PPA by enacting a "clawback" provision in their state securities statutes which Pennsylvania did in Section 611 of the 1972 Act.

Other registration exemptions afforded by the 1972 Act may not be available to a fund because, even though funds affiliated with a religious organization generally make these securities available only to persons associated with a particular religious denomination, the potential purchasers often are too numerous to meet the numerical limitations imposed by these exemptions.

What Funds Need to Do

Therefore, such funds generally would need to register their evidences of indebtedness with the Department under Section 206 of the 1972 Act. This requires preparation of a registration statement to be filed with the Department that includes an offering prospectus and audited financial statements. No offers of securities may be made by the fund until the Department reviews the registration statement and declares it effective. The registration is effective for one year and must be renewed annually if the fund wishes to continue to offer and sell its securities. If a fund has been engaged in selling securities without benefit of registration and then files for registration, the Department may require the fund to make a rescission offer to current purchasers prior to declaring the registration statement effective.

Civil Liability for the Sale of Unregistered Securities under the 1972 Act

The 1972 Act imposes strict liability on persons selling unregistered securities to return, on demand made within two years of the sale, the purchase price of the security plus 6% interest from the date of purchase minus income received. While it is unlikely that purchasers of unregistered securities from a fund would demand their money back, this contingent liability might need to be taken into account in the fund's financial statements which could affect the fund balance. Also, making a rescission offer in accordance with Section 504 of the 1972 Act provides immunity to the fund from any future civil suit for violations of the 1972 Act from those who decline or do not respond to the rescission offer within the stated time period.

Administrative Liability

In the Department's discretion, it could initiate an administrative proceeding against a fund for alleged violations of the 1972 Act for the offer and sale of unregistered securities which could result in imposition of certain sanctions. If such a proceeding is initiated, it usually is concluded with the entry of a consent order between the fund and the Department in which the fund, without admitting or denying the allegations, consents to entry of the order which generally provides for payment of certain costs, effecting a rescission offer and disclosure of the consent order in future fund prospectuses.

Need More Information?

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