

## Capital-Raising Strategies for Community Banks

By Nicholas Bybel, Jr.  
G. Philip Rutledge  
Mark Worley

### Executive Summary:

Today, many banks and their holding companies are in a position where they need to raise capital to comply with federal regulatory capital requirements, enhance reserves for their securities and loan portfolios, refinance existing high-cost debt, improve liquidity, pursue an acquisition, or fund general corporate purposes. This article is intended to provide the management and boards of directors of bank holding companies for community banks with insight into the capital-raising process so they may develop a comprehensive capital plan for their company.

Part I of this article summarizes the different methods a bank holding company may employ to raise capital or improve its federal regulatory capital ratios, such as:

1. Increase Retained Earnings;
2. Restructure Securities Portfolio and Loan Portfolio;
3. Adjust Dividends and Dividend Payouts;
4. Create or Amend Dividend Reinvestment and Stock Purchase Plans;
5. Issue Debt Securities;
6. Issue Securities in a Non-Public Offering; and
7. Issue Securities in a Public Offering.

Part II describes types of equity securities which a financial institution may sell in public and non-public securities offerings to raise Tier I capital for federal regulatory purposes, and Part III summarizes federal and state securities law requirements associated with debt and equity securities offerings. Together, this article provides management and boards of directors with a broad understanding of the issues they will encounter when developing a capital plan for their company.

However, before developing a company's capital-raising strategy, its management must determine the amount of capital the company requires and the timeframe in which it must be raised. There are a wide range of matters that may call upon the capital reserves of a company. Among them are the potential increase of regulatory capital requirements, the current state of the company's securities and loan portfolios, and the company's strategic plans. First, management should take into account that federal regulatory capital ratios for well-capitalized financial institutions likely will increase in the near future. Based upon the individual minimum capital ratio requirements that the Office of the Comptroller of the Currency recently has issued to particular institutions, the ratios for Tier I (leverage) capital, Tier I risk-based capital, and Total risk-based capital may increase to 8%, 9%, and 12%, respectively, from 5%, 6%, and 10%. Although new capital regulatory requirements have not yet been released and institutions likely will be given a transition period of one or two years to meet any new requirements, a bank's regulator may require it to meet heightened requirements sooner based upon its specific risk profile.

Also, a capital review should include assessing a company's securities and loan portfolios to determine whether the company likely will need a capital buffer to absorb future losses not yet reflected in the other-than-temporary impairment of investment securities or its allowance for loan losses. Furthermore, management should assess the company's strategic plans in the context of concomitant capital requirements. For example, banks will need capital to support acquisitions, new business activities, or significant additions or renovations to current facilities. A full discussion of the unique capital needs of each company is prerequisite to developing a comprehensive and effective strategy for raising the needed capital.

**This article is intended for general information purposes only and should not be construed as legal advice or legal opinions on any specific facts or circumstances. Please contact Bybel Rutledge LLP concerning any specific situation.**

## **Part I:** **Capital-Raising Methods**

Below is a step-by-step approach which a financial institution should consider when developing its capital-raising strategies with particular emphasis on improving regulatory capital ratios:

1. Increase Retained Earnings;
2. Restructure Securities Portfolio and Loan Portfolio;
3. Adjust Dividends and Dividend Payouts;
4. Create or Amend Dividend Reinvestment and Stock Purchase Plans;
5. Issue Debt Securities;
6. Issue Securities in a Non-Public Offering; and
7. Issue Securities in a Public Offering.

### **Increase Retained Earnings**

Increasing retained earnings is the most basic approach to raising capital. Under the regulations promulgated by the Board of Governors of the Federal Reserve System (the “Federal Reserve”), retained earnings are included in the definition of qualifying common stockholders’ equity and qualify for Tier I treatment. Increasing retained earnings also may involve cutting costs (e.g., shrinking the operational and marketing budgets, limiting employee benefits or reducing payroll, and refraining from growing the company through acquisitions of other banks or branches). For some conservative community banks, retained earnings has been their exclusive capital-raising strategy. However, many are finding that this strategy may no longer be sufficient on its own and have begun to expand their capital-raising strategies. A strategy of increasing retained earnings also may be used in coordination with a company’s dividend payout strategy and dividend reinvestment plan discussed below.

### **Restructure the Securities Portfolio and Loan Portfolio**

Instead of raising capital, a company may reduce the need for capital if its subsidiary bank sells or redistributes its asset holdings to those requiring less capital support (e.g., reducing loans in favor of U.S. government securities which require less capital). This strategy may have undesirable consequences and should be carefully considered before being implemented. For example, selling assets may result in the loss of good customers whose loans are sold and may leave the bank with its less marketable assets which are its poorer quality and less liquid loans. The portfolio shift also may lower the bank’s earnings if it redistributes its assets from higher risk, higher yielding assets to lower risk, lower yielding assets.

A bank would recognize additional benefits if it were able to sell some of its troubled assets. For example, a bank could sell securities that it felt were at high risk for recognition of other-than-temporary impairment (“OTTI”) or for further OTTI markdown. Although this would not increase the amount of a company’s capital, it is a defensive measure that would protect a

company's retained earnings from being adversely impacted by recognition of future OTTI of these securities.

Also, selling troubled loans could result in a company no longer needing to maintain a loan loss allowance for such loans. The company could then allocate the loan loss allowance on the loans it sold to retained earnings which would constitute Tier I capital. If the company were forced to sell a loan at a loss, the company still might recognize an increase in capital to the extent the loan loss allowance allocated for the loan was greater than the loss recognized upon the sale.

### **Adjust Dividends and Dividend Payouts; Create or Amend Dividend Reinvestment and Stock Purchase Plans**

Also, a company can increase its capital through its dividend policy by (1) decreasing dividend payments to its common stock shareholders and/or (2) allowing its shareholders to reinvest their dividends (as well as additional payments) in common stock of the company through a dividend reinvestment and stock purchase plan (a "DRIP").

First, a company can reduce its dividends and allocate those funds to its retained earnings which would qualify as Tier I capital. Second, since a decision to decrease dividends likely would be controversial among shareholders, a company may consider creating or amending its DRIP instead of, or in addition to, decreasing dividends.

A DRIP may offer benefits to both shareholders and companies. First, a DRIP can provide shareholders who choose to participate with a simple and convenient way to buy additional shares of a company's common stock by enabling participants to elect to reinvest their cash dividends automatically in shares of a company's common stock. Some DRIPs also contain a stock purchase plan feature which affords shareholders the option of making voluntary optional cash purchases of the company's common stock on a monthly or quarterly basis. If a company does not have a history of declaring dividends or has dramatically decreased or suspended its dividends, it may still create a Direct Stock Purchase Plan separate from a DRIP wherein participants could make periodic investments in the company.

A company also may offer a discount (e.g., 5-10%) to the market price for shares purchased in the DRIP as a means of encouraging participation in the DRIP. However, a participant will recognize dividend income for federal income tax purposes to the extent of the discount. By purchasing stock directly from the company through a DRIP, shareholders can avoid imposition of service charges or brokerage commissions usually associated with the purchase of stock.

Companies benefit from being able to raise capital efficiently through the direct sale of shares to the DRIP for the benefit of shareholders participating in the DRIP. This creates a source of relatively inexpensive equity capital and avoids the time and expense typically associated with loans, debt offerings, public stock offerings, private placements, and other capital-raising alternatives.

To avoid registration under the Securities Act of 1933, as amended (the “Securities Act”), a company could limit the offering solely to existing Pennsylvania shareholders, thereby qualifying for an exemption from securities registration under Section 3(a)(11) of the Securities Act and SEC Rule 147, the requirements of which are described in part three of this article.

For companies that have instituted a DRIP, they may amend the DRIP to encourage greater participation by its shareholders by (1) offering a discount on the purchase price of shares under the DRIP, e.g, 5 to 10 percent of the fair market value of the common stock (2) increasing the minimum and maximum amounts for voluntary cash payments, and (3) increasing the frequency in which additional voluntary cash payments are invested. Although these amendments are intended to encourage greater participation in the DRIP, the amount of capital generated by these changes is uncertain and would depend upon a company’s shareholders’ interest in investing in the company at any particular time.

### **Issue Debt Securities**

While the proceeds generated from a debt offering would not constitute Tier I capital for federal regulatory purposes for a bank holding company other than qualifying trust preferred securities generally up to 25% of a company’s total core capital elements, these proceeds could be downstreamed to a company’s subsidiary bank and allocated to the bank’s surplus which would constitute Tier I capital for the bank. The treatment of proceeds from a securities offering may not be of concern to small bank holding companies (generally bank holding companies with fewer than \$500 million of consolidated assets and an immaterial amount of debt or equity securities registered with the Securities and Exchange Commission) since they are not held to the same regulatory capital requirements as larger bank holding companies. Instead, the treatment of the proceeds at the bank level is of primary concern.

In a debt offering, a company may issue secured or unsecured debt and senior or subordinated debt which could be accomplished through a public or non-public offering discussed in part three of this article.

When issuing debt of a bank holding company, it should be remembered that the holding company’s equity in its subsidiary bank is subordinate to the creditors of the bank. Consequently, if the bank were to liquidate, the bank’s creditors would be paid before creditors of the holding company (including debt holders) because the holding company stands as a common shareholder of the bank.

### **Issue Securities in a Non-Public Offering**

A non-public offering of securities also is known as a private offering or private placement. Unlike public offerings of securities, federal and state securities regulators will not require issuers to file registration statements for private placements. However, a company would deliver a private placement memorandum to prospective investors in connection with a private offering containing disclosures covering all material information necessary for an investor to make an informed investment decision as to the purchase of the securities.

Reliance on an exemption from federal registration requirements makes the capital-raising process much less expensive than in a public offering but requires issuers to be exceedingly careful in crafting the offering to meet the conditions which federal and state securities regulators have imposed under various registration exemptions. Some conditions may include:

1. Prohibition on the use of general advertising and general solicitation;
2. Prohibition on the payment of sales commissions to anyone who is not registered as a broker-dealer or agent of a broker-dealer;
3. Minimum investor annual income or net worth requirements;
4. Maximum number of offerees and purchasers;
5. Restrictions on the resale of the securities purchased based on a minimum holding period or state of residence of the purchaser, or both;
6. Maximum dollar amount of the offering; or
7. Requiring the offering be limited to residents of Pennsylvania or to existing equity shareholders on a pro rata basis.

Although it is not a condition imposed by applicable government regulations, issuers in private placements generally will require a significant minimum investment per investor, particularly if the issuer is relying on an exemption which limits the total number of offerees and purchasers.

Pricing also becomes more of an issue in a private placement, even where the security offered may be listed on a national securities exchange or quoted on the Over-the-Counter Bulletin Board. The size of the investment and the illiquidity of the investment also tend to affect pricing. First, prospective investors usually expect a “bulk” discount from the market price of the securities being offered if they are required to make a substantial minimum investment. Second, prospective investors usually expect a discount from the market price of the securities being offered because the securities purchased are illiquid either due to little, if any, trading market for the securities or regulatory restrictions imposed on transfers. For securities issued in a private offering, the general holding period prior to resale is six months for SEC reporting companies and one year for non-reporting companies.

Underwriter involvement in the private placement arena is severely limited. Any investment banking firm which would undertake a private placement as “placement agent” would do so probably only on a “best efforts” basis and will command significantly more compensation than in a public offering. Securities offered in most private placements are sold by the officers and directors of the issuer without compensation except that reimbursement of reasonable business-related out-of-pocket expenses is permissible. The company could engage, even on an *ad hoc* basis, a registered broker-dealer to engage in the offer and sale of the securities and pay such broker-dealer a sales commission. However, most brokerage firms have internal rules and approval processes which their registered representatives must follow, and these firms generally are not disposed to incurring potential liability as to a private placement where most of the sales compensation goes to the registered representative.

A securities offering also may result in an increase in the number of shareholders. Companies not currently subject to the reporting obligations under the Securities Exchange Act of 1934, as amended (the “Exchange Act”) should take steps to ensure that the number of its registered shareholders at any fiscal year-end is not greater than 499 as a result of a non-public offering because this will trigger reporting obligations under Exchange Act.

### **Issue Securities in a Public Offering**

A public offering is one in which any person may purchase the securities offered without regard to one’s status as an existing shareholder, level of financial sophistication or net worth, or state of residence. Furthermore, securities offered and sold in a public offering would be freely transferable, except as SEC Rule 144 may apply to the company’s affiliates.

Public offerings, however, are subject to the highest degree of regulation under federal and state securities laws and necessitate the filing of a registration statement with the SEC, the Pennsylvania Securities Commission (the “PSC”), and the securities regulator of any other state in which an offeree resides. Hence, public offerings are the most expensive in terms of cost of capital.

A public offering may or may not include an investment banking firm as an underwriter of the offering. If an underwriter is involved, the issuer enters into a formal underwriting agreement in which it generally agrees to pay the underwriter a commission of 7-9% of the gross proceeds of the offering to place the securities. Due to attendant liability and economies of scale, an underwriter generally will not engage in underwriting an offering of less than \$10-15 million.

The underwriter may undertake distribution of the securities on a “firm commitment” or “best efforts” basis. In a firm underwriting, the underwriter agrees to purchase the securities from the company at an agreed upon price. The company obtains the proceeds from the sale of the securities from the underwriter and the underwriter assumes the risk of distributing the securities to the public. In a “best efforts” underwriting, the underwriter only agrees to use its best efforts to place the securities and the risk of not being able to sell all of the securities remains with the company.

Before undertaking a public offering, a company should consider the current market in general for bank stocks, the timeframe in which the company would like to raise the needed capital, the cost of engaging an underwriter, and the expense associated with filing a registration statement with the SEC. Furthermore, conducting a public offering likely would not be practical for a non-public company due to the expense of preparing a registration statement and the future costs of complying with the reporting requirements under the Exchange Act which would be triggered upon the effectiveness of a registration statement with the SEC.

**Part Two:**  
**Securities That May Be Involved in**  
**Public and Non-Public Offerings**

**Common Stock**

Common stock represents the most basic equity ownership in a corporation and is the most preferred type of Tier I capital for federal regulatory purposes. The regulations promulgated by the Federal Reserve state that it is desirable, from a supervisory standpoint, that voting common stock remain the dominant form of Tier 1 capital. Common stock evidences an equity ownership in a company and imposes no financial obligation on the company except as may be provided by Pennsylvania corporate law and federal law applicable to registered bank holding companies which generally relate to liquidation, dissolution and winding up.

If a company issues common stock within the limits authorized by its articles of incorporation, no prior shareholder approval is required. However, prior to issuing common stock, you should consider whether the company's shareholders have preemptive rights which require a company to offer existing shareholders the opportunity to maintain their current percentage share ownership with respect to any future offerings of common stock.

The factors most affecting a potential offering of a company's common stock are (1) market prices and investor appetite for bank stocks generally and the company in particular and (2) dilution to existing shareholders who may have paid substantially more for their shares than the price per share which a company will have to price an imminent offering of common stock.

**Common Stock Purchase Warrants.** This instrument grants the holder the right to purchase directly from a company a share of common stock at a set price for a specific length of time. A company, however, may vary the purchase price for the common stock during the period of time that the warrant is exercisable. Until exercised, the warrant holder is not entitled to any dividends on a company's common stock or to any other rights or privileges enjoyed by the common stockholders. Furthermore, the decision to exercise a common stock warrant is totally within the discretion of the holder (i.e., it may never be exercised and the company would not receive any proceeds from the sale of common stock thereby).

The warrants may be transferrable or non-transferrable at the option of the company. Deciding the issue of transferability often is determined by the securities registration exemption under federal and state securities laws which the company may seek to rely upon for the offering. Establishment of the exercise price and the length of the warrant is at the discretion of the company. However, the longer the warrant is exercisable, the more concern an outside investor might have about the effect that the "overhang" of the warrants might have on future dilution of his purchase price.

Since warrants to purchase common stock in smaller bank holding companies generally have little intrinsic value in and of themselves, in these cases, common stock warrants often are issued as an "inducement" or "sweetener" to purchase common stock in a larger common stock offering. These are known as "unit" offerings and are discussed later in this article.

## Preferred Stock

Preferred Stock is a more specialized class of security that has characteristics of debt and equity. Preferred stock acts like debt because there usually is attached to it a specified annual dividend payment expressed as a percentage of the principal amount of the security (usually sold in \$1,000 principal amounts). Preferred stock acts like equity because, upon liquidation, repayment generally remains junior to outstanding debt of the company. However, as the name implies, preferred shareholders will receive assets of the company upon liquidation prior to any distribution of assets to the common stockholders. As discussed below, preferred stock must be structured in a specific manner if it is to qualify as Tier I capital under federal regulatory capital requirements.

A company only may issue preferred stock to the extent its articles of incorporation authorize such issuance. If a company's articles of incorporation do not authorize a company's board of directors to issue preferred stock, the company's shareholders would have to approve an amendment to the articles of incorporation before the company could issue preferred stock. Any amendment should authorize the board of directors to divide the preferred stock into series, determine the designations and number of shares of any such series, and determine the voting rights, preferences, limitations, and special rights of the shares of any such series without further shareholder approval.

There are a number of federal banking regulations which apply to the issuance of preferred stock. If the preferred shareholders are given any voting power with respect to the election of directors, such as in the event of four consecutive quarters of non-payment of dividends, the Federal Reserve may view the preferred stock as a separate class of voting equity security. In such case, a person which is a non-bank holding company that holds 33.4% or more of the preferred stock may be required to register as a bank holding company, and a person who owns 10% or more of the preferred stock may need to file a notice with, and seek the approval of, the Federal Reserve under the Change in Bank Control Act. Voting rights are not required for preferred stock to be given Tier I treatment though prospective investors may attempt to negotiate voting rights.

Preferred stock ranks junior to all of a company's outstanding liabilities, including notes, subordinated debt, and trust preferred securities. Dividends on the preferred stock also would be subordinate to interest payments on trust preferred securities or subordinated debt, if any.

**Non-Cumulative Perpetual Preferred Stock.** This type of preferred stock qualifies as Tier 1 capital for federal regulatory purposes. Non-cumulative perpetual preferred stock has the following characteristics: (1) it does not have a maturity date, (2) it cannot be redeemed at the option of the holder, (3) it cannot be redeemed at the option of the company without approval from the Federal Reserve, (4) it may not contain any other provision that would require future redemption of the shares, and (5) its dividends may not be cumulative (i.e., if a dividend is not declared for a quarter, it does not accumulate and never has to be paid).

**Convertible Non-Cumulative Perpetual Preferred Stock.** Non-cumulative perpetual preferred stock may be convertible into shares of common stock and still qualify as Tier I capital so long as the holder can convert the preferred shares into a fixed number of common shares at a preset price established at the time of issuance of the preferred stock.

The Federal Reserve has shown a willingness to allow the conversion price to increase over time based on conversion prices determined at the time of the issuance of the preferred stock. For example, the conversion price in year one could be \$10.00, the conversion price in year two could be \$11.00, the conversion price in year three could be \$12.00, etc. This willingness, however, may change as the Federal Reserve reassesses its regulatory capital requirements. Preferred stock that converts into common stock at the prevailing market price at the time of conversion likely would not qualify as Tier I capital.

If a company is considering a convertibility feature, it may establish (1) an initial period of time when no conversion is permitted, (2) conversion at the option of the preferred shareholder for a certain period of time, or (3) mandatory conversion as of a certain date.

## **Units**

A company may offer more than one type of security at the same time either in separate but simultaneous offerings or as a single offering consisting of units comprised of different types of securities. An example of a unit would be:

- One share of common stock and one common stock purchase warrant;
- One share of common stock and one share of preferred stock; or
- One share of common stock, one share of preferred stock, and a common stock purchase warrant.

At the option of the company, the units may be detachable or non-detachable. Detachable means that the common stock and warrant can be separated after purchase or after a specified time after purchase and resold separately. Non-detachable usually means that, until the warrant is exercised, the shares and the warrants purchased as a unit must be resold as a unit. Warrants may be designated as transferable or non-transferable. Non-transferability often is imposed to prevent a separate market from developing in warrants which may act to undermine the common stock share price.

**Part Three:**  
**Federal and State Regulatory Requirements of**  
**Public and Non-Public Offerings**

**Public Offerings Requiring Registration with the SEC**

If a company were to engage in a public offering of securities, it would have to file a registration statement with the SEC and with the securities regulator of each state in which it wanted to offer the securities being registered. SEC staff may elect to review and comment on the registration statement, and no securities could be offered or sold until the SEC declared the registration statement effective. Any type of security described in this memorandum or combination thereof could be the subject of a public offering.

If a company does not have shares listed on a national securities exchange, it would have to file a copy of the SEC registration statement in each state in which it wanted to offer the securities. States may elect to review and comment on the registration statement. This review is in addition to, and independent of, SEC review. Even if the SEC grants a “no review” status to a company’s registration statement, it cannot sell securities in Pennsylvania or any other state until the registration statement is declared effective by the PSC and the securities regulator of any other state in which an offeree resides.

Conducting a public offering likely would not be practical for a non-public company due to the expense of preparing a registration statement and the future costs of complying with the reporting requirements under the Exchange Act which would be triggered upon the effectiveness of a registration statement with the SEC.

**Offerings Exempt From Registration with the SEC**

A company must comply with both federal and state laws when issuing securities. Although both the SEC and PSC have established exemptions from registration for certain offerings, the exemptions have been adopted under different laws and, in some instances, are not totally compatible. Some exemptions require the filing of a notice and a copy of the offering documents. Offerings exempt from federal and state registration requirements include an offering in reliance on Section 4(2) of the Securities Act; offerings in reliance on Rule 506, 505, and Rule 504 of SEC Regulation D; offerings in reliance on SEC Regulation A; and an intrastate offering in reliance on Section 3(a)(11) of the Securities Act and SEC Rule 147. Like in public offerings, any type of security described in this memorandum or combination thereof could be the subject of an exempt offering. The terms and conditions of these offerings are also summarized in the chart that follows this article.

*Section 4(2) Offering.* A company could offer and sell securities under Section 4(2) of the Securities Act as a transaction by an issuer not involving any public offering. The Securities Act and the regulations promulgated thereunder do not define “public offering”. Therefore, to maintain the non-public nature of the offering, an offering exclusively relying on Section 4(2) may wish to restrict the offering to directors, officers, and shareholders who own at least 10% of

a company's voting common stock. In such an offering, a company would not have to submit any filing with the SEC or the PSC, though other states might have filing requirements.

*Rule 506 Offering.* Rule 506 of SEC Regulation D operates as a safe harbor for companies that wish to offer securities in a non-public offering in reliance upon Section 4(2). An offering conducted in compliance with Rule 506 is deemed to be a transaction not involving a public offering with the meaning of Section 4(2). A company could sell to an unlimited number of Accredited Investors and no more than 35 persons who have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment. The definition of an Accredited Investor includes:

1. A bank or savings and loan association whether acting in its individual or fiduciary capacity;
2. A broker or dealer registered under Section 15 of the 1934 Act;
3. An insurance company;
4. An investment company registered under the Investment Company Act of 1940;
5. A Small Business Investment Company licensed by the U.S. Small Business Administration;
6. An employee benefit plan within the meaning of the Employment Retirement Income Security Act if the investment decision is made by a plan fiduciary which is either a bank, savings and loan association, insurance company or registered investment adviser or if the benefit plan has total assets in excess of \$5 million or, if a self-directed plan, with decisions made solely by persons who are Accredited Investors;
7. Any private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940;
8. Any Internal Revenue Code Section 501(c)(3) organization, corporation, Massachusetts, or similar business trust or partnership not formed for the specific purposes of acquiring the securities offered with total assets in excess of \$5 million;
9. Any director or executive officer of the Company;
10. Any natural person whose individual net worth, or joint net worth with that person's spouse, is \$1 million or more at the time of purchase;
11. Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
12. Any trust with total assets in excess of \$5 million not formed for the specific purpose of acquiring the securities offered whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii); and
13. Any entity in which all of the equity owners are Accredited Investors.

In a Rule 506 offering, a company could:

- Offer securities to persons inside and outside of Pennsylvania and need only file SEC Form D with the SEC within 15 days of the first sale and Form D with state securities regulators within 15 days after the first sale in each state; and
- Offer any dollar amount of securities.

Regulatory restrictions on a Rule 506 offering include:

- Offers and sales may be made to an unlimited number of Accredited Investors and to no more than 35 persons who do not meet the Accredited Investor standard but who the company has documented have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment;
- Prohibition on the use of general advertising and general solicitation;
- Prohibition on the payment of sales commissions to persons who are not registered as broker-dealers or registered agents of the broker-dealer; and
- Restrictions on resale of the securities under SEC Rule 144 for affiliates and non-affiliates.

*Rule 505 Offering.* Under Section 3(b) of the Securities Act, the SEC may promulgate rules exempting certain securities from registration. The SEC has exercised its authority under Section 3(b) through Rule 504 and Rule 505. Everything applicable to a Rule 506 offering described above applies to a Rule 505 offering except:

- The maximum offering amount is \$5 million;
- The issuer and affiliates of the issuer cannot be subject to certain disqualifications;
- There is no “knowledge and experience” test for the 35 non-accredited investors; and
- Filings will need to be made at the state level in accordance with applicable state law.

*Rule 504 Offering.* An offering under Rule 504 has the same requirements as a Rule 505 offering except:

- The maximum offering amount is \$1 million;
- No disqualification provisions apply;
- Sales may be made to an unlimited number of purchasers; and
- General advertising and general solicitation may be permitted and the holding period requirements of Rule 144 may not apply to the securities if the securities are sold in accordance with state Accredited Investor exemptions.

*Integration.* If contemplating the use of multiple offerings, a company must address the concept of integration. Succinctly, an issuer cannot divide what otherwise would be a single offering into several different pieces, each piece which alone meets the exemption requirements, for the sole purpose of avoiding filing a registration statement with the SEC. In considering whether to apply the integration concept to any particular offering, the SEC looks at the following factors:

- Whether the sales are part of a single plan of financing;
- Whether the sales involve the issuance of the same class of securities;
- Whether the sales have been made at or about the same time;
- Whether the same type of consideration is being received; and
- Whether the sales are made for the same general purpose.

This concept becomes important if, for instance, the company would undertake a Rule 506 offering followed by a Rule 505 offering. The following is an example of how integration might work.

If a company engaged in a Rule 506 common stock offering in November 2009 and raised \$3 million and then opted to engage in another common stock offering under SEC Rule 505 in January 2010, the Company would be limited to raising only \$2 million in the January 2010 offering because the prior sales under Rule 506 would be “integrated” with the January 2010 offering since it occurred within six months of the Rule 505 offering and the maximum dollar amount in a Rule 505 offering is \$5 million. Integration would apply because the transaction meets all of the factors enumerated by the SEC.

However, if the company engaged in a Rule 506 offering of non-cumulative perpetual preferred stock in November 2009 and raised \$3 million and then opted to engage in a Rule 505 common stock offering in January 2010, there would be no integration because the second offering involved a different class of security than the first offering and the company could raise up to \$5 million in the common stock offering.

*Regulation A.* Another alternative is a Regulation A offering under the Securities Act. The SEC still must “qualify” the offering but the requirements are not as stringent as filing a registration statement. Pennsylvania affords a coordinating provision under the Pennsylvania Securities Act of 1972, as amended (the “Pennsylvania Securities Act”) for Regulation A offerings. The maximum amount of securities which may be sold pursuant to Regulation A is \$5 million but the securities may be sold to any investor and are freely transferable.

Although a Regulation A offering may be appealing due to Pennsylvania’s coordinating provision in the Pennsylvania Securities Act, most states do not afford the coordination with Regulation A offerings available under the Pennsylvania Securities Act. A company might be limited to making sales in other states to any available isolated transactional exemption. In order to lower the costs of the offering, a company might limit itself to only offering and selling the securities in Pennsylvania. If that were the case, a company would be better served relying on the intrastate offering exemption under Section 3(a)(11) of the Securities Act and SEC Rule 147 because there is no maximum offering amount.

*Intrastate Offering.* A company could conduct a public offering only to Pennsylvania residents under an exemption from registration with the SEC pursuant to Section 3(a)(11) of the Securities Act and SEC Rule 147, but a registration statement would need to be filed with, and declared effective by, the PSC unless the offering was made in compliance with an exemption from registration under the Pennsylvania Securities Act. In order to rely on an exemption under SEC Rule 147:

1. All offerees and purchasers must be residents of Pennsylvania;
2. The principal place of business of the company must be in Pennsylvania;
3. At the time of the offer and sale, the company must derive at least 80% of its gross revenues through the conduct of business in Pennsylvania, 80% of its assets in Pennsylvania, and 80% of the net proceeds of the offering will be employed in Pennsylvania; and
4. During the period in which the securities are offered and sold by the company and for a period of nine (9) months from the date of the last sale by the company of such securities, all resales of any part of the issue by any person shall be made only to residents of Pennsylvania which is in lieu of the holding period set forth in SEC Rule 144.

An intrastate offering could take the following two forms:

Pro Rata Public Offering to Existing Pennsylvania Shareholders. The offer and sale of securities to existing shareholders is exempt from registration under Section 203(n) of the Pennsylvania Securities Act. In this type of offering, only existing shareholders of a company who are residents of Pennsylvania would be able to participate in the offering. However, the offering initially must be made on a pro rata basis. For example, a company could offer the opportunity to purchase one share of common stock for each share held as of a certain record date. If, after an initial pro rata phase, there remained additional shares available for purchase, the company could permit existing shareholders to purchase additional shares without regard to the pro rata requirement.

Although there are no filing requirements with the SEC or PSC for this type of offering, the purchasers would be subject to the federal rule prohibiting the transfer of securities to non-Pennsylvania residents for nine months from the date of the last sale of securities in the offering.

*DRIP.* A company could offer securities under a DRIP or a Stock Purchase Plan under Section 3(a)(11) of the Securities Act and Section 203(n) of the Pennsylvania Securities Act. While it is clear on the face of the exemption that a DRIP under Section 3(a)(11) may be made to registered holders of the company's shares, it would be advantageous if a company also could extend the DRIP to beneficial owners of its shares (i.e., those shareholders who hold the company's shares in "street name" in a custodial account at a brokerage firm). A concern to this approach is how SEC staff might view the holding of shares on behalf of a Pennsylvania resident in a brokerage account held by a broker-dealer that was not domiciled in Pennsylvania to which the DRIP applies.

A review of SEC staff no action letters and informal conversations with SEC staff appear to indicate that the exemption in Section 3(a)(11) of the Securities Act and Rule 147 would be available where (1) the offering materials were sent only to Pennsylvania residents, (2) Pennsylvania residents would be making the investment decision, (3) the proceeds from the sale of the shares would be used in Pennsylvania, and (4) shares of the company were held in brokerage accounts wherein the broker acted solely in a custodial capacity.

Due to the restriction on resale imposed by SEC Rule 147, resales of shares issued under a DRIP, for all practical purposes, would be restricted indefinitely since the DRIP would be expected to be ongoing for years. Therefore, those shares should be treated as restricted shares with stop transfer orders placed against them or separate certificates should be issued with the required resale legend inscribed thereon. Section 203(n) of the Pennsylvania Securities Act exempts transactions made pursuant to an offer of securities to existing equity security holders of a company. This exemption also is self-executing. PSC Regulation 203.141(a)(2), however, limits the availability of this statutory exemption to offerings which are made on a pro rata basis. Therefore, to be eligible to use the Section 203(n) exemption and satisfy the regulatory pro rata requirement, the DRIP could only permit reinvestment of dividends and only allow optional cash purchases on a pro rata basis. For example, participants could invest optional cash purchases up to designated multiple (i.e. ten times) of their dividend. Companies that choose to offer a DRIP under this exemption usually forego allowing optional cash purchases since it may be confusing to shareholders and difficult for issuers to track.

*Broker-Dealer and Agent Registration.* The availability of the foregoing exemption may be nullified and broker-dealer or issuer agent registration under the Pennsylvania Securities Act may be invoked if any person receives compensation for the sale of any securities in such offerings. This would include any discretionary compensation to a company's employees which may be based upon the amount or percentage of shares sold.

Public Offering Only to Residents of Pennsylvania. In this type of offering, the company could avoid a filing with the SEC but would have to file a registration statement with the PSC. Once the offering was approved by the PSC, a company could offer and sell securities to any person who was a resident of Pennsylvania. However, Pennsylvania purchasers would have a two business day right of rescission.

Alternatively, a company could structure the offering so that it was exempt from registration under Pennsylvania securities law in reliance on Section 203(d) and (e) of the Pennsylvania Securities Act and PSC Regulation 204.010. Under this exemption, a company could offer securities to no more than 90 persons in Pennsylvania and make sales to no more than 35 persons in Pennsylvania in any consecutive twelve-month period. There is no maximum offering amount under this exemption, but purchasers would have to agree not to sell the securities purchased for 12 months from the date of purchase and must be given a notice that they can rescind their investment within two business days of purchase without any liability.

Deciding how to structure an offering and the type of security to offer thereby requires an analysis that is unique to each company depending on, among other things, the size of the company, the financial condition of the company, the condition of the economy generally, and the state of the capital markets for community banks. With our experience in community banking and the capital markets, we are in a position to counsel you in this decision-making process. Please do not hesitate to contact us with any questions.

**This article is intended for general information purposes only and should not be construed as legal advice or legal opinions on any specific facts or circumstances. Please contact Bybel Rutledge LLP concerning any specific situation.**



## Capital-Raising Alternatives Not Requiring Registration with the SEC

Federal Exemption	Max. Offering Amount	SEC Notice Filing	Federal Resale Restriction	Federal Prohibition on General Solicitation	Restriction on Number or Type of Investor	PA Exemption	Special PA Conditions or Restrictions
Section 4(2)	None	No	6 months or 1 year*	Yes	Officers, Directors, & 10% shareholders	Regulation 203.184	No notice filing; Officers, Directors & 10% shareholders
Rule 506	None	Yes	6 months or 1 year*	Yes	35 non-Accredited Investors and unlimited Accredited Investors	Section 211(b)	Notice filing within 15 days of first sale in PA
Rule 505	\$5 million	Yes	6 months or 1 year*	Yes	35 non-Accredited Investors and unlimited Accredited Investors	Section 203(s)	Pre-sale notice filing; Federal restrictions apply to entire offering; State disqualification provisions apply
Rule 504	\$1 million	Yes	None if sold to Accredited Investors	None, if sold to Accredited Investors	Only Accredited Investors if seeking ability to utilize general solicitation pursuant to state Accredited Investor exemption.	Section 203(t)	Pre-sale notice filing with PSC
Regulation A	\$5 million	Form 1-A	None	No	None	Section 205 (registration)	Filing of preliminary prospectus or offering circular
Section 3(a)(11); Rule 147; PA Residents Only	None	No	No resales to Non-PA residents for 9 mos. from last sale in the offering	No	Offers to no more than 90 persons in PA; Sales to no more than 35 persons in PA in a 12 month period; No maximum offering amount	Sections 203(d) and 203(e); Regulation 204.010	Pre-sale notice filing; prohibition on general solicitation; 2-day right of withdrawal; 12 month restriction on resale; must file report on sales
					Existing PA Shareholders No maximum offering amount	Section 203(n)	No form filing; Must initially be on a <i>pro rata</i> basis

\* Generally, the holding period for SEC reporting companies is six months and the holding period for non-reporting companies is one year.

# Levers of Capital

