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Securities Offering Structures for Community Banks

As the Basel III capital standards begin to be phased-in, and as banks discover that the new "capital conservation buffer" requirements in the capital regulations could restrict dividend payments to shareholders, a number of banking organizations are reviewing the possibility of issuing new common stock[1]. The emphasis in Basel III on "old-fashioned" Tier 1 equity instruments such as common stock means that issuers are increasingly looking at this option to raise capital. Subchapter S financial organizations in particular may be impacted by these capital requirements, and insufficient Tier 1 capital under the new rules could impair the ability of a Subchapter S entity to pay a dividend sufficient to cover the shareholder's pass-through income tax liability.[2]

One of the initial choices privately held banks must make when considering a sale of common stock is whether to register the securities offering with federal and state authorities, or instead take advantage of one or more of several available federal and state securities offering exemptions. The "form" of the stock offering has important implications relating to where, to whom and to how many persons the Company's securities may be offered for sale.

In our experience, very few smaller banking organizations would want to undertake a public offering absent special circumstances, making the exemption route the better choice in most instances.

What follows is a brief description of the types of exempt common stock offerings that can be utilized by privately held companies in Wisconsin. We have included a chart at the end which we hope is helpful in reviewing and comparing the various types of exempt offerings.

Private Placements Under Rule 506 of Regulation D

Rule 506 of Regulation D is considered a "safe harbor" for the private offering exemption of Section 4(a)(2) of the Securities Act of 1933. Companies relying on this exemption can raise an unlimited amount of money. Because of recent changes to Rule 506, there are now actually two separate securities offering exemptions available under the Rule (one that permits a general solicitation or advertising, and one that does not).

Under Rule 506(b), a company can be assured it is within the Section 4(a)(2) exemption by satisfying the following requirements:

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- The company cannot use general solicitation or advertising to market the securities.
- The company may sell its securities to an unlimited number of "accredited investors" and up to 35 other purchasers. All non-accredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.
- Companies may decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws. But companies must give non-accredited investors disclosure documents that are generally the same as those used in registered offerings. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well.
- The company must be available to answer questions by prospective purchasers.
- In the event financial statements are required to be provided to investors (because they are not accredited), then (1) financial statements need to be certified by an independent public accountant and (2) if a company cannot obtain audited financial statements without unreasonable effort or expense, only the company's balance sheet (to be dated within 120 days of the start of the offering) must be audited.

Under Rule 506(c), a company can broadly solicit and generally advertise the offering, but still be deemed to be undertaking a private offering within Section 4(a)(2) if:

- the investors in the offering are all accredited investors; and
- the company has taken reasonable steps to verify that its investors are accredited investors, which could include reviewing documentation such as W-2s, tax returns, bank and brokerage statements, credit reports and the like.

Purchasers of securities offered pursuant to Rule 506 receive "restricted" securities, meaning that the securities cannot be sold for at least a year without registering them. Companies relying on the Rule 506 exemption do not have to register their offering of securities with the SEC, but they must electronically file a Form D with the SEC after they first sell their securities. Form D is a brief notice that includes the names and addresses of the company's promoters, executive officers and directors, and some details about the offering, but contains little other information about the company. A Rule 506 offering preempts state qualification and registration requirements.

Wisconsin Intrastate-Only Offering—Section 3(a)(11)

The Wisconsin securities laws provide for a securities offering exemption for Wisconsin issuers when making offers to not more than 100 residents of Wisconsin. The only offerors or companies that may use this exemption are issuers that:

- are business entities organized under the laws of Wisconsin;
- are authorized to do business in Wisconsin; and
- have a majority of their full-time employees in Wisconsin.

Sales of securities made under this exemption must be made in compliance with the "intrastate offering" exemption under section 3(a)(11) of the Securities Act of 1933 and Rule 147 adopted thereunder, and may result only from the 100 or fewer offers. Certain institutional, accredited, and certified investors need not be counted for purposes of the 100-offeree limit. No commission or other remuneration may be given for soliciting investors, except to Wisconsin-registered brokers-dealers or agents. No advertising may be made unless permitted by the administrator of the Wisconsin Division of Securities.

There is a limit on the number of people the offeror can talk to because the issuer may offer securities and distribute solicitation materials to only 100 or fewer persons in Wisconsin. Because the offering must comply with the requirements of the "intrastate offering" exemption, there is a limit on the type of people the offeror can talk to. This exemption precludes a general advertising or solicitation because the broadcast or publication would invariably result in distribution to more than 100 persons, thus making the issuer ineligible for this exemption. There is no limit on the amount of money that may be raised under this exemption.

Regulation A+ Offerings

The recent amendments adopted by the SEC to Regulation A creates two separate tiers or offering exemptions.

- Tier 1 permits securities offerings of up to $20 million in a 12-month period.
- Tier 2 permits securities offerings of up to $50 million in a 12-month period.

Regardless of whether the issuer relies on Tier 1 or Tier 2, the issuer must file an

offering statement or disclosure document with the SEC, which must go through the SEC qualification process. The offering document is relatively similar to a prospectus for an IPO registration, with some scaled-back disclosures (which would include executive compensation disclosures and a management discussion and analysis of financial condition and results of operation-type discussion). Tier 1 offerings are not preempted by state qualification requirements and, therefore, must be exempt or qualified in each applicable state. Tier 2 offerings, however, preempt applicable state securities laws qualification requirements.

For both Tier 1 and Tier 2 offerings, the issuer must provide financial statements prepared in accordance with GAAP for the preceding two fiscal years; however, for Tier 2 offerings, the financial statements must be audited. Moreover, under Tier 2 offerings, issuers must file ongoing periodic reports with the SEC, which are scaled-back versions of annual, quarterly and current reports that public companies must file. For Tier 1 offerings, the issuer must file a post-offering report containing information on sales of the securities within 30 days after the earlier of completion or termination of the offering.

Crowdfunding Offerings (Wisconsin)

Effective June 1, 2014, Wisconsin adopted a change in its securities laws that permits Wisconsin businesses to raise money through Internet crowdfunding sites. This new law allows a Wisconsin business to raise up to $1 million from state investors through crowdfunding portals. The amount that can be raised increases to $2 million if the issuer has had an audit in its most recent fiscal year, and has provided the audit to prospective investors and the Wisconsin Department of Financial Institutions (DFI). Any single purchaser may invest a maximum of $10,000 in a crowdfunding offering, unless the purchaser is an accredited investor or a certified investor. Certified investor is defined as someone who has an individual net worth (or joint net worth with the individual's spouse) of at least $750,000, or had an individual income in excess of $100,000 in each of the two most recent years (joint income with spouse in excess of $150,000).

To qualify for this exemption under Wisconsin law, issuers must:

- file a notice with the Wisconsin Division of Securities at least ten days before commencing an offering—the notice must include a disclosure document, an escrow agreement with a Wisconsin-chartered financial institution, a financial audit and a $50 filing fee;

- comply with the "intrastate" exemption under federal law, meaning that all offers and sales must be to Wisconsin investors;
- make the offer available through one or more Internet sites or portals that are registered with the DFI;
- provide a copy of the disclosure document to each prospective investor, and hold all payments in escrow and not access them until the target offering amount has been raised; and
- provide quarterly reports to investors.

Conclusion

Although time will tell if certain of the more recent changes to the available securities offering exemptions (like Regulation A or crowdfunding) will see more use by issuers seeking to raise capital, we do believe the attention of regulators on promoting capital raising, along with the heightened requirements in the Basel III capital standards, will result in more community banks exploring potential offering alternatives to improve their capital structure. Each community bank is unique in its capital structure, geographic focus and shareholder base, and we do not believe a "one-size fits all" approach to raising capital in this economic and regulatory climate works, especially given the various costs and benefits with varying capital raising options.

We have included a chart comparing some key considerations when evaluating different capital raising structures. If you have questions on the topics discussed in this e-alert, please contact James A. Sheriff, John T. Reichert, Eric P. Hagemeier, Robert F. Henkle, Jr. or your Reinhart attorney.

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[1] A brief review of the impact of the new Basel III capital rules on community banks is essential to understand why many banks are considering raising more capital. Parts of Basel III became effective on January 1, 2015, and other parts, such as the "capital conservation buffer," will be phased-in over three years, beginning January 1, 2016. Bank holding companies with less than $1 billion in assets, who are covered by the FRB's Small Bank Holding Company Policy Statement, are not subject to Basel III, but their bank subsidiaries are. Basel III applies to national banks, state member and nonmember banks, and savings associations, regardless of asset size.

[2] In addition to meeting Basel III's tougher new minimum capital ratios which focus on Tier 1 common equity rather than other capital instruments, community

banks also must maintain a common equity capital conservation buffer of greater than 2.5% of its minimum risk-based capital requirements to avoid restrictions on dividends, redemptions or executive bonus payments. Basel III requires community banks to deduct more mortgage servicing assets and deferred tax assets from their common equity capital than under existing capital rules, which also shrinks the bank's capital base. The capital conservation buffer may only be satisfied with Tier 1 common equity or common stock.

Comparison of Securities offering Structures

Compliance Requirement	Rule 506 of Regulation D	Wisconsin (Intrastate) / Section 3(a)(11)	Regulation A+	Crowdfunding (Wisconsin)
Dollar / Offering Limit	None	None	Tier 1: $20 million per 12-month period (up to $6 million for selling shareholders) Tier 2: $50 million per 12-month period (up to $15 million for selling shareholders)	$1 million; up to $2 million if have audited financials
Number of Investors	No limit on accredited investors; maximum of 35 nonaccredited investors	No more than 100 offerees (certain accredited and institutional investors are not counted)	No limit	No limit, but subject to investment dollar thresholds
Investor / Purchaser Limitations	None	None, but all offerees must be residents of Wisconsin	Tier 1: None Tier 2: None if accredited; otherwise restricted by income/ net worth/revenue/net assets	Maximum investment of $10,000 unless the investor is accredited or a certified investor

Disclosure Requirements	Not required if all accredited investors; Form D filing with SEC required within 15 days of first sale	Generally, no filing required with Wisconsin	Must file any test-the-waters documents, Form 1-A, sales material and a report of sales and use of proceeds report with SEC	At least ten days prior to the offering, must file a notice and disclosure documents with Wisconsin
Manner of Sale Limitations	No general solicitation or advertising unless take reasonable steps to verify accredited investors only	None other than to maintain intrastate character of offering	Testing the waters permitted; general solicitation permitted after qualification	Offering must be through a qualified portal and can include only Wisconsin residents
Ongoing Disclosure / Filing Requirements	None	None	Tier 1: None—other than exit report filing within 30 days of completion or termination Tier 2: Yes; audited financials required to be filed annually; required to file annual, semiannual and current reports	Must provide quarterly reports to investors while securities remain outstanding
State Filing Obligations	Usually exempt from state registration and qualification requirements	Self-executing exemption available	Tier 1: Not exempt from state registration and qualification requirements Tier 2: Exempt from state registration and qualification requirements	Subject to Wisconsin notice filing and disclosure of offering documents

Resale Restrictions	Restricted securities	The offering must rest within Wisconsin and the securities can only be transferred to Wisconsin residents for a period of time after the offering	Not restricted securities	The offering must rest within Wisconsin and the securities can be transferred only to Wisconsin residents for a period of time after the offering