

UPDATE

News of Developments in the Financial Sector and Related Areas

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Two Alternatives For Capital

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Trust preferred securities and non-cumulative perpetual preferred stock are two alternatives for financial institutions needing to raise additional capital through the private placement of these securities with local investors such as board members, existing shareholders and major customers.

Section 171(b)(5) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 allows a small bank holding company with consolidated assets under \$500 million to issue trust preferred securities. The Federal Reserve Board's ("FRB") Small Bank Holding Company Policy generally provides that a small bank holding company is only tested for capital at the subsidiary bank level. As a result, there is no capital requirement at the holding company level of a small bank holding company and the proceeds from the sale of trust preferred securities can be contributed by the holding company to its subsidiary bank as additional tier 1 capital. Approximately 80% of all institutions in the United States are less than \$500 million in asset size.

A key advantage of trust preferred securities to bank holding companies is that for tax purposes the dividends paid on trust

preferred securities, unlike those paid on directly issued preferred stock, are a tax deductible interest expense.

Trust preferred securities are typically issued as non-perpetual cumulative preferred stock by a wholly-owned trust subsidiary of a small bank holding company. The small bank holding company owns all of the common stock of the trust subsidiary. Revenue from the sale of the trust preferred securities by the trust subsidiary is exchanged for junior subordinated debentures issued by the small bank holding company. The debentures feature a coupon payment and term to maturity, which are identical to those of the trust preferred securities. Payments on the subordinated debt and the trust preferred securities are "interest only" until maturity.

In Interpretive Letter No. 908, the Office of the Comptroller of Currency ("OCC") held that trust preferred securities may be purchased and treated as loans by national banks. The OCC noted that trust preferred securities are instruments that possess characteristics particularly associated with debt securities. Before purchasing trust preferred securities as loans, the OCC noted that a national bank should conduct a complete review of relevant credit information and loan administration practices, and determine that the purchase meets the bank's own internal loan underwriting standards. The interpretive ruling by the OCC provides a vehicle for a small bank holding company to convert debt to equity while allowing a bank purchaser of the trust preferred securities to treat the purchases as loans.

Noncumulative perpetual preferred stock ("Perpetual Preferred") is an excellent alternative to all bank holding companies including small bank holding companies. Although common stock should generally be the dominate form of capital for a bank holding company, Perpetual Preferred qualifies as capital for all bank holding companies.

Perpetual Preferred may be issued at both the bank holding company level and the bank level in order to increase capital. Because Perpetual Preferred is considered a separate class of stock, Subchapter S corporations are not eligible since they can only have one class of stock.

A coupon payment on Perpetual Preferred is similar to trust preferred, and the issuer has the option to call the securities after five (5) years. Any redemption of Perpetual Preferred is subject to regulatory approval. Perpetual Preferred has no voting rights and is perpetual, meaning that it has no final maturity date. Quarterly dividends are subject to board approval and are noncumulative if not paid. Unlike dividends paid on trust preferred securities, dividends paid on Perpetual Preferred are not a tax deductible interest expense.

Allowing the company to select investors with compatible goals and interests is one of the advantages of a private placement. Another advantage is they are less expensive and time consuming since a private placement does not require the assistance of an underwriter.

Although other exemptions from the requirements to register securities may be available, Sections 3(b) and 4(2) of the Securities Act of 1933 may be utilized in making a private placement with local investors. Section 4(2) of the Securities Act of 1933 exempts from registration "transactions by an issuer not involving a

public offering." To qualify for this exemption, purchasers must:

- have enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment or be able to bear the investment's economic risk;
- have access to the type of information normally provided in a prospectus, *i.e.*, an offering memorandum; and
- agree not to resell or distribute these securities to the public.

Section 4(2), often referred to as the *private offering exemption*, is one of the most frequently relied upon exemption in making private placements under the provisions of both state and federal law.

The enactment of Regulation D by the Securities and Exchange Commission sets forth the requirements for a substantial portion of private offerings. Regulation D is designed to permit the sale of securities to sophisticated investors, which are also known as accredited investors under Regulation D. A bank holding company as issuer still may claim an exemption under Section 4(2) even though the technical provisions of Regulation D are not fully met. Although an issuer may fully comply with the requirements of federal law relating to a private placement, it must also comply with any applicable state securities law.

Both trust preferred securities and Perpetual Preferred are excellent vehicles for increasing capital, maintaining shareholder ownership, funding acquisitions, stock repurchases and providing funds for internal growth. Our firm is available to answer questions on the benefits of issuing both trust preferred and Perpetual Preferred and the placement of these securities with third parties.