The

Board Chair Forum

Opening the door to new ideas

Gerrish Smith Tuck, Consultants and Attorneys
March 2024

This month's Board Chair Forum Newsletter comes on the heels of the ICBA LIVE Annual Convention, and also comes on the heels of some feedback we received regarding last month's edition. A bank reviewing last month's newsletter sent us a comment that the organization agreed with some of the premises that we outlined, but felt we did not do enough to provide what the solutions or alternatives should be. It was a comment well-received and right on point so, you guessed it, we are addressing that issue specifically in this month's edition.

In addition, we are looking at a related issue of being public versus being private and, specifically, in the context of a new SEC rule regarding climate policies. Do you really need to be a part of that? Finally, and somewhat unfortunately, we bring to light another regulatory problem we encountered for a client. In this circumstance, it simply appeared that the regulator (hopefully unintentionally) provided the bank with incorrect information, the result of which would be to deprive the bank of its rights. Our hope and belief is that it was just an error by an uninformed examiner, but it is important for organizations to know their rights.

Don't hesitate to send us comments on our newsletters anytime. We are happy to address those where needed.

Happy Reading!

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Board Chair's Summary

- ***Is It Better to be a Public Company or a Private Company?***
- ***How to Create Shareholder Liquidity for Illiquid Shares***
- ***In Dealing with Regulators, Know Your Rights***

Is It Better to be a Public Company or a Private Company?

In past issues of *The Board Chair Forum Newsletter*, we have discussed the difficulty that some smaller banks and holding companies have when their stock is listed on a "quasi" exchange like the pink sheets or the OTCQX, but yet the organization has very little liquidity and therefore cannot control its stock price. In the wake of that, a number of organizations contacted us asking if we were suggesting that public companies should "go private" or not have their stock listed. Our response has been that, for the most part, community banks and their holding companies (no matter how large in asset size they may actually be) generally find very little benefit in being public. Now there is even another reason not to be public.

Recently, the Securities and Exchange Commission (SEC) finalized a rule regarding disclosure requirements that SEC reporting companies must follow in terms of disclosing certain climate related matters. As a result, the SEC will require various registration statements and periodic filing reports to contain detailed disclosures regarding climate related risks the organization may pose, steps that are being taken to mitigate those kinds of risks, the various steps the Board of Directors has taken to manage oversight of climate related risks, and including information regarding greenhouse gas emissions that are produced or are directly caused by the activities of the company. Now, if you are running an oil refinery business, even if you are a staunch opponent of climate-related initiatives, you can probably see how that might have some justification for the investor community to know about the company. But, what type of greenhouse gas emissions are public bank holding companies engaging in and what role has the Board taken to demonstrate they are managing greenhouse gas emissions and mitigating potential climate risks? Candidly, it is one that produces a giant eyeroll from most bankers.

So, while the final rule did provide some relief for smaller reporting companies, you can clearly envision (as has been the case in the past) where something that is a rule for one group of entities may not actually be a rule for others, but it becomes understood to be a "best practice." So, again, why be public at all if you have all of the extra reporting burden, you have new initiatives being thrown at you like climate disclosure rules, and you are getting no benefit from greater liquidity in your stock when you really have no need to access public capital markets? As Board Chair, make sure your organizational structure is appropriate for what you are really doing. For those of you who are public bank holding companies (which typically tends to be the case for those of you on the West Coast that tend to be smaller yet publicly reporting), it is time to reevaluate your structure.

How to Create Shareholder Liquidity for Illiquid Shares

In last month's edition of *The Board Chair Forum Newsletter*, under the article titled "Creating a Market for Your Stock Doesn't Always Work" we further discussed the issue of having small bank and holding company stock listed on an exchange when there is really little to no liquidity. Following that publication, we received a comment from one of the newsletter subscribers (and we love receiving comments, by the way) that while they generally agreed with the premise of the article, we had not really given any strong alternatives of how to do things and it seemed like if they simply had the Bank President matching up buyers and sellers as they have done in the past, that would create a conflict of interest. The point is well-taken! That article needs some further clarification and expansion, and we will provide some solutions below.

The bank that wrote to us indicated that while they agreed with the premise in the article about the difficulties of being on the OTCQX or the pink sheets, that we did not really address what kind of options there might be, other than going back to the old way of keeping a list of buyers and sellers and trying to match those up and facilitating their own "market" transactions. This bank mentioned that they actually preferred the old way of matching up buyers and sellers because it helps you keep control in your organization, or at least the organization has knowledge of what is happening with buying and selling of shares. The core question raised was whether the concern about a conflict of interest is really a big concern if you do decide to forego trading on the exchange. Here was our response to the client which we thought everyone might find helpful.

First, in a bit of a hyper-technical way, the problems that exist with the "old way" of having the Bank President facilitate the buying and selling of shares is not so much one of a conflict of interest, as much as it is putting a person between the buyer and seller (in most cases, the President), who is then in the untenable position of being an unlicensed broker of securities. If you are helping to facilitate the transaction, providing information about the value, information on past trades, what the outlook for the organization might be, etc., that is not a position the President should want to be in or ought to be in. You are not a licensed broker of securities. So, rather than just conflicts of interest, it is fraught with potential legal exposure.

Candidly, many smaller banks still use somewhat of that process and it can be managed appropriately. What we tell our clients is that, if the Bank President basically keeps a list of buyers in one drawer and a list of sellers in the other, and provides those lists to either side, we really do not have a problem with that, provided the President is not put in the middle of negotiating the price. If all you are doing, for example, is providing a list of known potential buyers to someone that wants to sell their stock, there generally is not a problem with that.

However, our firm's recommendation is to even avoid taking the step of matching buyers and sellers or simply providing a list to either side. Rather, we believe the holding company itself should be the "buyer of first resort" that makes a market in the shares for stockholders. The Board of Directors, by Resolution, could authorize the President to purchase shares from stockholders who approach the organization, within certain parameters (such as paying up to a certain amount, buying no more than a certain number of shares in one block, etc.). When the holding company repurchases shares, particularly where it simply uses excess capital resources or cash at the holding company to do so, the organization as a whole is materially benefitted. Key metrics like earnings per share, return on equity, and dividends per share all typically go up. In addition, all stockholders have their ownership percentages increased without spending any of their own money. So it is a great use of existing capital resources, it provides a market for stockholders willing to sell, and the selling shareholder receives the liquidity they desire on a quick basis.

Further, when the holding company repurchases shares, unless it is a very large block purchase (normally 10% or more of the organization's net worth), there is typically no regulatory approval involved, so the process can happen quickly. Even if it is more than the 10% threshold, there are still other exceptions that apply that may avoid the necessity of any regulatory approval.

In these circumstances, the holding company can set the price wherever it desires, within its fiduciary duties. In addition, the holding company has the obligation of full disclosure *and honesty in dealing with a shareholder that wants to sell, but there is no requirement to pay a particular price since it is a voluntary transaction on the part of the shareholder.*

We also think using the holding company to buy shares also prevents some other potential conflicts of interest, such as stockholders questioning how the list of potential buyers is created, the issue of why all shareholders are not given the opportunity to purchase, what happens if only board members or other insiders are on the list of potential buyers, etc. All of that is avoided by having the holding company serve as the primary purchaser.

So from the Board and Board Chair's role, utilize your holding company as much as possible, take your Bank President out of a potential conflict of interest situation, but do not fall for the notion that listing your stock on an exchange with all of the costs and complications, is the right answer.

In Dealing with Regulators, Know Your Rights

It seems like each new issue of one of our newsletters unfortunately comes back around to talking about the increase in regulatory scrutiny of financial institutions and problems we are encountering with the way in which regulators are dealing with things across the country. This is an area where the Board Chair needs to demonstrate appropriate leadership. We commented in a past edition about a bank alleged to have violated the Fair Housing Act where it simply appeared on the face that the regulators were absolutely incorrect in their analysis. As we mentioned, we appealed that and ultimately the regulatory finding was overturned and the bank was found to be justified in how it was doing things, but the Board had to be committed to pushing back.

Now, our latest iteration of comment on the regulators is to advise banks and holding companies to fully understand and know your rights when dealing with the regulators, because apparently, the regulators might be a bit less than forthcoming if you ask them (we're being kind). A recent example is a client of ours that was experiencing a few minor regulatory issues, but nothing of any real substantive concern. The regulators had cited the bank with some Matters Requiring Attention and Matters Requiring Immediate Attention where they wanted the bank to increase oversight or compliance, and as a result, the regulators were, in our opinion, going to ask the bank to sign some type of enforcement action, even if it were an informal one. One of the key pieces of evidence of our belief that a request for an enforcement action would be forthcoming was that the regulators wanted to hold an exit interview with the Board, postponed that a few times, and then sent a list of the multiple representatives from the regulatory agency that would be attending. That is normally a key "tell." As we often joke, you can tell how many members a board of directors has based on the number of regulators that are going to be attending the exit interview, because it is always one more than the number of directors.

In this particular situation, because it seemed likely to us the Board might be given some bad news, or perhaps they might be asked to sign an informal enforcement action, we suggested to the client that it would be helpful for our firm to be a passive participant in the telephone conference in order to be able to appropriately advise the Board following the meeting, and they should probably give the regulatory agency the heads-up that we would be on the call for the exit interview, because when we are, the regulators often like to bring regulatory counsel as well. So the client reached out to the regulator and suggested that we would be participating via telephone conference. The examiner responded to the bank indicating that we, as the bank's counsel, could not attend the meeting and were not allowed to participate because confidential information would be discussed. For the record, over the past 36 years our firm has been in business, we have attended hundreds of exit meetings like that. Because the bank was not facing any severe types of penalties (although they were told that a corrective program through the execution of a Board Resolution would be appropriate, as we suspected), the bank chose not to really contest that statement by the examiner.

After learning they would be asked to sign a Board Resolution, we mentioned to the client that when they received that, it would be appropriate for them to review it and decide if there were elements where compliance would be difficult and they might want to ask for a modification, even if it is just to extend timeframes a little longer, or something like that. The bank also mentioned this to the examiner, and the examiner told them that was not appropriate and that they would be expected to sign whatever was sent to them. Once again, that is never the case, and all types of proposed enforcement actions, informal or formal, are generally negotiable and should be negotiated if a bank cannot comply with a requirement.

So, we will not call out this particular examiner by name or the particular agency, but it was one of the federal regulators, not a state regulator. More importantly, they are simply wrong in this situation, and since we know this newsletter makes its way to many regulatory personnel, we hope it gets in their hands so there can be a bit of "retraining" for their staff examiners. Most of the time the regulators do not make this kind of basic mistake, but when a regulator does something in an attempt to deprive a bank of their rights, it is not only incorrect, but we view it as improper. If you are a bank mired in problems where the regulators appear to be bullying you a bit, make sure you know your rights and when you should acquiesce and when you should stand up for yourself, and get all of the assistance, and in particular, legal assistance, you are entitled to, whether the regulators like it or not.

Meeting Adjourned

We were blessed to see so many of our clients and friends at the ICBA LIVE Convention in Orlando. If you are a reader of one of our newsletters and have never attended that Convention, we strongly encourage you to do so. Our firm was fortunate enough to have multiple speaking sessions, roundtable facilitations, and the like, and the camaraderie among community bankers is unparalleled. We will be seeing many of you in the coming weeks as the spring strategic planning season starts up, and if you have not yet booked your session for the summer or fall, we encourage you to do so as soon as possible.

Until next time,

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