

Federal Reserve Policy Statement on Equity Investments in Banks and Bank Holding Companies

September 23, 2008

On September 22, 2008, the Federal Reserve Board issued a long-awaited policy statement that addresses equity investments in banks and bank holding companies.¹ The policy statement makes three significant changes to the terms on which investors can make investments in bank holding companies without being deemed to have acquired “control” (and thereby becoming bank holding companies themselves):

- An investor can own up to 24.9% of the outstanding voting shares of a bank holding company and obtain a seat on its board of directors. Previously, an investor generally could not obtain a board seat if it held 10% or more of the outstanding voting shares.
- An investor can own up to 33% of the total equity of a bank holding company (as opposed to the current limit of 24.9%), provided that the investment does not include ownership of 15% or more of any class of voting securities of the target; and
- An investor will be permitted to actively attempt to influence certain governance matters of the bank holding company.

The policy statement does not change any other restrictions that the Federal Reserve Board has traditionally placed on minority equity investments in bank holding companies and so in our view will not fundamentally alter the landscape for private equity investments in bank holding companies.

The policy statement also makes it clear that the Federal Reserve Board continues to believe in the “source of strength” doctrine: any company that acquires control of a bank holding company needs to be prepared to use its resources to financially support the bank holding company should the need arise. This doctrine will present an insurmountable obstacle for the acquisition of control of a banking organization by most private equity funds if it is interpreted to require such a fund to make an open-ended commitment to make additional investments in banks that are held by a portfolio company.

The policy statement does not address many of the technical issues that have come up in recent noncontrolling investments by private equity firms in bank holding companies. In particular, the

¹ For ease of discussion this memorandum will refer only to bank holding companies because the policy statement applies in the same way to investments in banks and bank holding companies.

policy statement expressly states that it does not address the circumstances in which multiple investors in a bank holding company or different fund vehicles managed by the same private equity firm will be viewed as “acting in concert” or as constituting a *de facto* company for purposes of the Bank Holding Company Act of 1956, as amended (the “BHC Act”).

CONSEQUENCES OF ACQUIRING CONTROL OF A BANK HOLDING COMPANY

An investor other than an individual that acquires “control” of a bank holding company will itself become a bank holding company. Although bank holding companies that qualify as “financial holding companies” (because their bank and thrift subsidiaries are “well capitalized” and “well managed”) are permitted to engage in a broad range of financial activities, including insurance, securities and private equity investments, nevertheless there remain some significant restrictions on financial activities, particularly in the area of real estate investments, and, more importantly, bank holding companies are subject to consolidated capital regulations, extensive reporting requirements, and examination and supervision by the Federal Reserve Board.

Also, even a bank holding company that is already subject to the BHC Act may not want to acquire control of another bank holding company because in that case, if a bank or thrift subsidiary of the target bank holding company required assistance from the FDIC, the FDIC could assess the cost of such assistance against any of the bank or thrift subsidiaries of the investing bank holding company. Also, if a bank or thrift subsidiary of the target bank holding company fails to meet the “well capitalized” or “well managed” criteria, the financial holding company status of the investing bank holding company will be placed in jeopardy.

THE DEFINITION OF CONTROL

If an investor acquires 25% or more of any class of voting securities issued by a bank holding company, then it “controls” the bank holding company for purposes of the BHC Act, even if another shareholder holds the remaining 75%. Securities that are immediately convertible into voting securities in the hands of the investor are treated as voting securities.² An investor controls a bank holding company if it controls in any other manner the election of a majority of its board of directors. Finally, a company controls a bank holding company if the Federal Reserve Board determines, after a hearing, that the company exercises a “controlling influence” over the bank holding company.

A “controlling influence” determination is made by the Federal Reserve based on all the circumstances of the transaction, including: voting securities held; total equity investment; board representation; officer and employee interlocks; agreements that restrict the manner in which the

² In calculating an investor’s voting percentage it is assumed that the investor exercises any immediately exercisable rights to acquire voting securities pursuant to warrants, options and convertible securities it holds and that other investors who hold warrants, options and convertible securities do not exercise such rights.

bank holding company conducts its business or restrict the ability of third parties to acquire the bank holding company; agreements between the investor and the bank holding company regarding future business relationships; and whether the investor has the unrestricted right to sell its shares as a block to a third party. The policy statement addresses certain of these features.

BOARD REPRESENTATION

The Federal Reserve Board's longstanding position had been that if an investor acquired 10% or more of a class of voting securities of a bank holding company, and either the bank holding company was a public company or the investor would be the largest investor, then representation of the investor on the target's board of directors would enable the investor to have a controlling influence over the target. If the investor would not be the largest investor and the target was not a public company,³ then an investor that acquired less than 15% of a class of voting shares would be permitted to have a single director. The practical effect of this position is that most noncontrol investments have been kept below 10% of the voting shares so that the investor could obtain a board seat without itself becoming a bank holding company.⁴

The policy statement permits all investors to have at least one director on the target's board of directors. This change will enable private equity investors to take up to 24.9% (instead of 9.9%) of their investment in the form of voting securities while obtaining a board seat, which means they will have greater influence over the company. A director that represents a noncontrolling investor may not serve as chairman of the board of directors or of a committee of the board.

The policy statement permits an investor to have two directors without being deemed to control the target provided that (i) another company controls (and is therefore a bank holding company with respect to) the target and (ii) the noncontrolling investor's representation is not disproportionately larger than its equity investment (and, in any event, does not exceed 25% of the board).⁵ Because it is highly unusual for a public bank holding company to have another bank holding company as a controlling shareholder, this provision is likely to be applicable only for investments in a bank or thrift subsidiary of a bank holding company or to private, closely held bank holding companies with multiple large investors.

³ The policy statement only refers to there being a larger shareholder, but the Federal Reserve Board has not permitted a director for investments greater than 9.9% if a control presumption is triggered, which would be the case if the investor is the largest shareholder or the target is a public company.

⁴ Investments in less than 10% of any class of voting shares also make it unnecessary to obtain approval under the Change in Bank Control Act.

⁵ Note that this provision would not allow an investor to have two board seats if the controlling shareholder was an individual or a family.

TOTAL EQUITY INVESTMENT

Another longstanding position of the Federal Reserve Board was that an investor that acquired 25% or more of the equity of a bank holding company was deemed to control the bank holding company even if the equity was held in the form of nonvoting shares. Moreover, for purposes of this analysis, nonvoting equity, convertible debt and subordinated debt (if the investor acquires a significant amount of subordinated debt) are treated as “equity”. The calculation is made by dividing the cost of the investment by the sum of GAAP shareholders’ equity and the cost of the investment.

Unlike the limits on voting shares, the limit on equity investment is not derived directly from the BHC Act, which, in defining control, refers only to voting shares. The Federal Reserve Board adopted this position at a time when stake-out investments by bank holding companies in other bank holding companies often took the form of nonvoting equity investments that were convertible to voting securities in the hands of a transferee. An earlier Federal Reserve Board policy statement provided that, to avoid control, such nonvoting equity investments should not involve the right to 25% or more of the voting shares of the target. Over time, this position evolved so that, to avoid control, an investor could not acquire 25% or more of the equity of a bank holding company, without regard to whether the equity carried with it the ability to transfer voting rights. The odd result was that voting and nonvoting equity were treated as carrying the same degree of influence.

The new policy statement provides that an investor generally will not be viewed as having a controlling influence over a bank holding company where the investor holds up to 33% of the equity of the bank holding company, provided that the investment (i) does not include ownership of 15% or more of any class of voting securities of the target, and (ii) does not represent more than 33% of a class of voting securities of the target, including for the purpose of this second calculation nonvoting equity that is convertible into equity in the hands of a transferee (as converted).⁶

PASSIVITY COMMITMENTS

When an investor acquires 10% or more but less than 25% of any class of voting securities of a bank holding company, it is presumed to have a “controlling influence” over the bank holding company if the latter is a public company or the investor will be the largest holder of that class of voting securities. This presumption can be rebutted by entering into “passivity commitments” with the Federal Reserve Board. The passivity commitments are also required by the Federal Reserve Board if an investor that holds less than 10% of a class of voting shares of a bank holding company wants a

⁶ When an investor holds nonvoting equity securities that are convertible into voting securities, the Federal Reserve Board does not treat the investor as owning the underlying voting securities, provided that the nonvoting equity securities can be transferred only in a widespread public distribution, in a private distribution in which no transferee receives more than 2% of the voting shares of the target, or to a transferee that, not counting such shares, controls a majority of the voting securities of the target.

written noncontrol determination from the Federal Reserve Board. The standard passivity commitments include commitments not to:

- attempt to exercise a controlling influence over management; or
- attempt to influence: the dividend policies or practices; the investment loan, or credit decisions or policies; the pricing of services; personnel decisions; operations activities (including the location of any offices or branches or their hours of operations, etc.); or any similar activities or decision of the bank holding company or any of its subsidiaries.

These commitments severely limit the extent to which an investor may even attempt to influence the bank holding company. The policy statement provides what it refers to as “additional guidance on the extent of communications” between an investor and the management of a bank holding company in which it has made an investment. The policy statement provides:

The Board believes that a noncontrolling minority investor, like any other shareholder, generally may communicate with banking organization management about, and advocate with banking organization management for changes in, any of the banking organization’s policies and operations. For example, an investor may, directly or through a representative on a banking organization’s board of directors, advocate for changes in the banking organization’s dividend policy; discuss strategies for raising additional debt or equity financing; argue that the banking organization should enter into or avoid a new business line or divest a material subsidiary; or attempt to convince banking organization management to merge the banking organization with another firm or sell the banking organization to a potential acquirer. These communications also generally may include advocacy by minority investors for changes in the banking organization’s management and recommendations for new or alternative management . . . communications by minority investors should not be accompanied by explicit or implicit threats to dispose of shares in the banking organization or to sponsor a proxy solicitation as a condition of action or non-action by the banking organization or its management.

This “guidance” allows investors to be more active, both publicly and privately, than had previously been the case, and may thus affect the type of investors that take significant stakes in bank holding companies.

COVENANTS

The policy statement includes statements in which the Federal Reserve Board reaffirms without change various aspects of its controlling influence analysis. One of those areas is the Federal Reserve Board's position that investors may not use investment covenants to obtain rights that normally are obtained through the ownership of voting securities. For example, to avoid control, an investor may not include covenants that restrict the ability of the bank holding company to, without the investor's consent, enter new lines of business, make acquisitions or divestitures, or hire, fire and compensate executive officers. At the same time, the policy statement reaffirms the permissibility of covenants that provide to preferred shareholders the protections that they generally receive under state law, such as protections against the issuance of additional amounts or classes of senior securities.

CONCLUSION

Although the policy statement may be disappointing to investors that were expecting more broad-ranging changes to the Federal Reserve Board's policy on noncontrolling investments, in our view, within the narrow range of issues that the policy statement addresses, it does represent meaningful change over the Federal Reserve Board's prior positions. Moreover, by showing a willingness to change positions that have been unchanged for over twenty-five years, the policy statement may open the way to further incremental changes as time goes by.

However, the policy statement is silent on relationships among investors. The difficult and pressing questions as to when investors will be viewed as "acting in concert" and, even more importantly, when their relationships will be viewed as causing them to be a "company", the aggregate shares of which would be attributed to each investor, remain unanswered.

For more information, please contact Lee Meyerson (212-455-3675; lmeyerson@stblaw.com), Gary Rice (212-455-7345; grice@stblaw.com), John L. Walker (212-455-7365; jwalker@stblaw.com) or another member of the Firm's Financial Institutions Group.