

October 1, 2008

Federal Reserve Makes it Easier to Invest in Banks and Bank Holding Companies

On September 22, 2008, the Board of Governors of the Federal Reserve System (the “FRB”) released a policy statement on equity investments in banks and bank holding companies (the “Policy Statement”) that addresses when such investments may amount to a “controlling influence” over a bank or bank holding company (“BHC”). The Policy Statement expands the indicia of control an investing company may have without being considered to have a controlling influence and therefore subjecting itself to treatment as a BHC. Traditionally, companies have sought to avoid bank holding company status and the attendant regulation, examination and capital requirements imposed by the FRB under the Bank Holding Company Act of 1956, as amended (the “BHCA”). In summary, the Policy Statement makes it easier for companies to invest in banking organizations without being considered a BHC.

Background

The BHCA sets forth the tests by which control determinations are made with respect to banks and bank holding companies (“banking organizations”). Specifically, the BHCA provides that a company¹ has control over a banking organization if (i) the company directly or indirectly or acting through one or more other persons owns, controls or has power to vote 25% or more of any class of voting securities of the banking organization;² (ii) the company controls in any manner the election of a majority of the directors or trustees of the banking organization; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization.

The Board had not previously provided significant guidance with respect to the third prong of the control test: namely, the facts and circumstances that amount to a determination that an investor has a “controlling influence” over a banking organization. In 1982, the Board issued a Policy Statement on Nonvoting Equity Investments by Bank Holding Companies (the “1982 Statement”) that sought to set forth certain restrictive covenants that the Board would consider to be limitations on the exercise of a controlling influence. During the intervening years between the 1982 Statement and the Policy Statement, a somewhat standard set of “passivity commitments” had evolved. These commitments contained certain covenants made by investors to the FRB to assure that their minority equity investments would not constitute a controlling influence over the target banking organization. Examples of such passivity commitments include:

- a commitment to not, directly or indirectly without FRB approval, exercise or attempt to exercise a controlling influence over the management or policies of the acquired bank or bank holding company (as the case may be) or any of its subsidiaries.
- a commitment to not, directly or indirectly without FRB approval, seek or accept representation on the board of directors of the acquired bank holding company or any of its subsidiaries.
- a commitment to not, directly or indirectly without FRB approval, have or seek to have any employee or representative serve as an officer, agent or employee of the acquired bank or any of its subsidiaries.

¹ Note that the BHCA only applies to “companies” that make investments in banking organizations, not to individuals doing so in their individual capacities. Investments by individuals are covered by the FRB’s Regulation Y.

² In certain instances, a regulatory “presumption of control” arises with respect to acquisitions between 10% and less than 25% of a banking organization’s voting securities.

The Policy Statement

The FRB's intention with respect to the Policy Statement was to provide guidance with respect to the meaning of the term "controlling influence." In so doing, the Board considered the following indicia of control:

Director representation. Generally, the Board has not permitted an investor holding between 10% and less than 25% of a banking organization's voting stock to have representation on the board of directors. As set forth in the Policy Statement, this position has been revised so that a single representative on the board of directors of the banking organization will not be deemed to be a controlling influence over such organization. According to the Policy Statement, however, a director appointed by a minority investor should not serve as the chairman of the board of the banking organization nor should he or she serve as the chairman of a committee of the board.

The Board further stated that, in certain circumstances, a minority investor could place "up to two representatives" on the board of directors when the potential investor's "aggregate director representation is proportionate to its total interest in the banking organization but does not exceed 25% of the voting members of the board *and* another shareholder of the banking organization is a bank holding company that controls the banking organization" pursuant to the BHCA. By way of example, the Board notes that proportionate director representation would result where an investor that owned 15% of the voting stock of a banking organization had two representatives on a board of directors with 10 or more members, but such proportional representation would not be achieved if the banking organization's board was composed of nine or fewer members.

Total equity. In the 1982 Statement, the Board stated as a general guideline that nonvoting equity investments that exceed 25% of the total equity of a banking organization generally raise control concerns. Pursuant to the Policy Statement, however, an investor would not be deemed to have a controlling influence if such investor owned a combination of voting and nonvoting shares of the banking organization that, upon aggregation, represented "less than one-third of the total equity of the banking organization (and less than one-third of any class of voting securities, assuming conversion of all convertible nonvoting shares held by the investor) and did not allow such investor to own, hold or vote 15 percent or more of any class of voting securities of the organization."

Consultations with management. Pursuant to the passivity commitments previously required by the FRB from potential investors, investors were often required to agree not to attempt to influence the management or operations of the banking organization in which they intended to invest or not to threaten to sell their shares in protest over a proposed management position or directive. The Policy Statement, however, sets forth direct guidance with respect to communications with the banking organization's management by minority investors. Specifically, the FRB stated that a minority investor may communicate with management and may "advocate with banking organization management for changes in any of the banking organization's policies and operations." The Policy Statement affirms, however, that (i) the ultimate decision as to whether a particular position is adopted or action taken is dependent upon the decision of the banking organization's shareholders as a group, its board of directors, or its management, as appropriate; and (ii) communications by investors should not be accompanied by threats to sell the banking organization's shares or sponsor a proxy solicitation.

Business relationships. The Policy Statement affirms that investments by a banking organization's major supplier, customer or lender will continue to be reviewed by the FRB on a case-by-case basis within the context of the proposed investment structure. Importantly, the FRB noted in the Policy Statement that some type of investments evaluated in this context have been permitted when the investor's voting securities percentage in the banking organization was "closer to 10 percent than 25 percent."

Covenants. Although the Board will continue to view covenants that "substantially limit the discretion of a banking organization's management over major policies and decisions" as the potential exercise of a controlling influence by a minority investor, certain covenants, such as those that prohibit the banking organization from taking enumerated actions including:

- Prohibiting the banking organization from issuing senior securities or borrowing on a senior basis;
- Modifying the terms of the investor's security; or
- Liquidating the banking organization.

Conclusion

As was the case with its release of the 1982 Statement, when the Federal Reserve stated that the complexity of legitimate relationships precluded the establishment of rigid rules with respect to control determinations, the FRB again stated that whether a minority investor has acquired or proposes to acquire a controlling influence over a banking organization “depends on all the facts and circumstances surrounding the investor’s investment in, and relationship with, the banking organization.” As such, future control applications to the Federal Reserve must be structured to comport with this “all the facts and circumstances” framework. Nonetheless, the Policy Statement relaxes the prior interpretation of control and will make it easier for companies to accumulate larger positions in banking organizations without being deemed to be a BHC.

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