Schulte Roth&Zabel LLP

Alert

Federal Reserve Provides Greater Flexibility for Non-Controlling Investments in Banks and Bank Holding Companies

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The Federal Reserve Board ("Board") on Monday announced the approval of a Policy Statement on equity investments in banks and bank holding companies (to be published at 12 C.F.R. § 225.144). The policy statement provides additional guidance on the Board's position on non-controlling equity investments in banks and bank holding companies (each a "Banking Organization"). In general, the Board's new policy allows an investor to maintain a greater interest and/or involvement in a Banking Organization, without the investor, itself, becoming subject to the Bank Holding Company Act ("BHCA"). [1]

We expect that these changes will make investments in Banking Organizations more attractive to investors, including private equity funds and hedge funds.

Why is being deemed non-controlling important?

Under U.S. banking law, an entity that is deemed to control a Banking Organization must register as a holding company with the Board. Becoming a holding company subjects the entity to regulatory supervision, capital requirements, "source of strength" obligations, and potentially significant activity and investment restrictions.

How does the Board's new Policy Statement change the level of investment and/or involvement permissible for a non-controlling investor?

Under the BHCA, any entity that, directly or indirectly, acquires 25% or more of any class of a Banking Organization's voting stock (or instruments convertible into such voting stock) will be deemed to control the Banking Organization. However, under the Board's regulations, an entity possessing as little as 10% of any class of a Banking Organization's voting stock or 25% of its total equity (even if it does not hold any voting rights) may also be deemed a controlling shareholder, depending on its overall relationship with the Banking Organization. The new Policy Statement indicates increased flexibility in several areas that will allow non-controlling investors to maintain increased total equity stakes and greater relationships without being deemed to be in control of a Banking Organization. The chart below provides a brief summary of the changes. It is important to note, however, that the new Policy Statement does not change the effect of the BHCA on entities that acquire 25% or more of any class of a Banking Organization's voting stock or are otherwise deemed to control the Banking Organization.

[1] The Policy Statement indicates that the same principles will also be used to analyze investments by bank holding companies in non-banking entities.

Feature of the Minority Investment	Previous Policy	New Policy
Total Equity	Nonvoting equity investments equal to 25% or more of the total equity of a Banking Organization were almost always viewed as controlling.	Investments up to 33% of total equity generally will be viewed as non-controlling, so long as the investor does not hold 15% or more of any class of voting stock of the Banking Organization (or instruments convertible into such voting stock).
Director Representation	Non-controlling investors that acquired 10% or more of the voting stock of a Banking Organization were usually not permitted to have any board representation, unless they owned less than 15% of the voting stock and were not the largest holder of voting stock.	Investors with less than 25% of voting stock will be permitted to have one board representative (and one observer) and still be viewed as non-controlling. Additionally, an investor may have two board seats without being deemed in control, so long as: (a) there is at least one other shareholder with a greater interest and that larger shareholder is a registered holding company; (b) the two seats would not constitute more than 25% of the board's voting members; and (c) the two seats would be proportionate to the investors total interest in the Banking Organization.
Consultations with Management	All non-controlling investors were required to commit not to attempt to influence the operations, management, or strategies of the Banking Organization, which precluded any discussions with management advocating for changes.	Non-controlling investors may communicate with management and advocate for changes, so long as there is no explicit or implicit threat to sell shares (or solicit proxies) to influence management's decisions.
Business Relationships	Non-controlling investors were generally prohibited from having any material business transactions or relationships with the Banking Organization.	The Board continues to believe that business relationships should remain limited and will continue to review such relationships on a case by case basis. Factors of such review include whether the relationship will be on market terms, non-exclusive and terminable without penalty by the Banking Organization.
Covenants	Covenants that substantially limit the discretion of the Banking Organization management over policies (e.g., regarding hiring, firing, executive compensation, operations, raising debt and equity, merging, consolidating, acquiring assets and companies, etc.) were viewed as suggesting control. In contrast, covenants that were limited to matters that would affect the rights or preference of an investor's interest (e.g., regarding issuing senior securities, borrowing on a senior basis, modifying the terms a security, or liquidating the Banking Organization) were not viewed as indicia of control.	No change.

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