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Federal Reserve Board Liberalizes Rules for Investments in Banks

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The Federal Reserve Board (the “Board”) yesterday issued eagerly anticipated guidelines for non-controlling, minority investments in banks and bank holding companies. The guidelines clarify and liberalize the conditions under which an investor can make a minority investment in a banking organization without being regulated as a bank holding company under the Bank Holding Company Act (“BHCA”). The guidelines should facilitate private equity fund investment in the financial services sector.

BHCA Framework

Under the BHCA, an investor is deemed to control a banking organization if it (i) directly or indirectly owns 25% or more of any class of voting securities of the banking organization; (ii) controls the election of a majority of the board of directors of the banking organization; or (iii) otherwise exercises a controlling influence over the management or policies of the banking organization. The guidelines deal with the third prong of the test—by addressing in general terms what investments do not constitute the exercise of a controlling influence. Ultimately, a determination whether a particular minority investment involves the exercise of “controlling influence” by the investor depends on all the facts and circumstances of each individual investment, but the guidelines are helpful in providing a degree of predictability that should encourage minority investment.

Existing Policy Statement

The Board’s last policy statement in this area was issued in 1982, in the context of stakeholder investments by out-of-state banks seeking to prepare for the advent of interstate banking operations. The 1982 policy statement has served as a compass for controlling influence determinations by the Board’s legal staff involving a broad range of proposed investments. In addition, over time, the Board staff has grappled with many “controlling influence” issues not contemplated by the 1982 policy statement, which has resulted in staff-developed policy in the area. Yesterday’s policy statement incorporates existing staff policy judgments in a number of areas and, in addition, provides additional flexibility that the staff appears to have been unwilling to provide in the absence of Board guidance. We summarize below the general guidance provided by the policy statement with regard to arrangements that have been particularly sensitive in controlling influence determinations.

What degree of director representation may an investor have on a banking organization board without being deemed to exercise controlling influence?

The Federal Reserve staff generally has regarded board participation by an investor with between 10% and 24.9% of the voting shares of a banking organization as indicative of control. Under the new policy, a minority investor will generally be permitted to have a single representative on an organization’s board of directors without being deemed to exercise controlling influence over that organization. The policy statement also permits a minority investor in an organization to elect two directors of that organization’s board, subject to the following conditions: (i) board representation must be proportionate to the minority investment; (ii) no more than 25% of the board seats can be controlled by the minority investor; and (iii) another shareholder, approved by the Board, must

control the banking organization. Without regard to the number of board seats held, no minority investor's board representative can serve as Chairman of the Board or chairman of any committee of the Board without raising control concerns.

What amount of total equity can a minority investor own in a banking organization without exercising controlling influence?

As explained above, as a statutory matter, an investor is deemed to exercise control over a banking organization if it controls 25% or more of any class of *voting* securities of that banking organization. The BHCA, however, does not explicitly address the holding of non-voting equity (or a combination of voting and non-voting equity). In the 1982 policy statement, the Board suggested that holding 25% or more of the total equity of a banking organization would be indicative of control. In yesterday's policy statement, the Board liberalized the standards for holding non-voting equity, while continuing to express a belief that a large equity investment (regardless of voting power) can provide an investor with controlling influence over the organization. Under the new policy statement, the Board takes the view that a minority investor will not be seen to exercise controlling influence if its investment meets the two following criteria:

- Its total equity investment does not exceed one-third of the total equity of the organization, and
- It does not own 15% or more of any class of voting securities of the organization.

In the context of investment in non-voting shares, the Board also discusses situations under which rights to convert non-voting shares into voting shares will be deemed to trigger control issues.

To what degree can a minority investor consult with management without being deemed to exercise controlling influence?

Minority investors often seek to protect their investments by communicating to management and/or to the board their views about how best to enhance the value of the organization. Thus, a minority investor's board representative might seek to advocate changes in management; new strategies for the organization; capital or liquidity policies; mergers or acquisitions or other major corporate policies or decisions. Under the policy statement, advocacy in and of itself will not be equated with controlling influence as long as decision-making is left to an organization's board, shareholders or management, as the case may be. Nonetheless, control could be implicated if advocacy were linked to explicit or implicit threats to disinvest, sponsor proxy solicitations or take other actions that might coerce a banking organization or its management to take a particular course of action.

What other circumstances might demonstrate that a minority investor in fact exercises a controlling influence?

In the past, the Board has generally prohibited a non-controlling minority investor from conducting any material business transactions or having material business relationships with the banking organization in which it has invested. However, the Board in the past has allowed business relationships limited quantitatively and qualitatively, particularly if the minority investment were closer to 10% than to 25%. The Board will continue to review such relationships on a case-by-case basis to determine whether they might involve a controlling influence.

Past Board precedent and the 1982 policy statement also recognize that controlling influence might be exercised through the imposition by the investor of particular covenants accompanying the investment. In this regard, the Board has expressed particular concern about such covenants that might affect hiring, firing, executive compensation, engaging in new business lines, making substantial changes in operations, raising additional capital or otherwise retaining, disposing of or acquiring material corporate assets. On the other hand, covenants that are protective of the essential characteristics of the security held by the minority investor generally have been viewed as permissible. As the policy statement makes clear, these would include, for example, covenants that might prohibit the issuance of senior securities or the incurrence of senior borrowings that might adversely affect the existing rights or preferences of the security in which the minority investor has invested. Covenants that provide information rights to an investor also do not necessarily trigger control considerations.

Conclusion

The Board staff has moved cautiously in the control area in recent months in anticipation of the issuance of these guidelines. The guidelines should ease the path for Board staff action on pending applications that involve controlling influence determinations and encourage minority investment in banking organizations at a time when capital in the industry is sorely needed. In particular, the guidelines provide a constructive framework for private equity funds to invest in the financial services sector.