Banking Law

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# Does Dodd-Frank Contain a Virus for Private Equity Investments in Banks?

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**A little-noticed provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") has the potential of curtailing significant investments by private equity firms in banks. Section 616(d) of Dodd-Frank adds a new Section 38A[1] to the Federal Deposit Insurance Act ("FDIA"), which provides at subparagraph (b):**

If an insured depository institution is not the subsidiary of a bank holding company or savings and loan holding company, the appropriate federal banking agency for the insured depository institution shall require any company[2] that directly or indirectly controls the insured depository institution to serve as a source of financial strength for such institution.

Depending on how this provision is implemented through regulations to be developed within the next nine months, this provision has the potential of curtailing a substantial number of future investments in banks by private equity funds. Since this provision has no grandfather exception, it could also present those private equity funds that have already invested in banks at a level that is deemed to constitute "control" with an unanticipated obligation to serve as a source of financial strength in the banks or holding companies in which they invested. At a minimum it will change the filing practice currently utilized for obtaining noncontrol determinations from relevant regulators.

**Who Was Intended to Be Covered by Section 38A(b)?**

There are a large number of FDIC-insured industrial banks, credit card banks and trust companies that are exempt from the definition of "bank" for purposes of the Bank Holding Company Act ("BHCA"), either because they are categorically exempted[3] or they do not accept demand deposits or make commercial loans. As a consequence, the companies that control these exempt insured depositories are not bank holding companies or savings and loan holding companies, and therefore are not subject to the provisions of the new Section 38A(a) of the FDIA to serve as a source of financial strength for their bank subsidiaries.

In order to fill this coverage gap and to establish "source of strength" parity among all companies that control FDIC-insured depository institutions, whether or not they are exempt from the definition of a "bank" under the BHCA, Congress enacted Section 38A(b) to impose a "source of financial strength" obligation on those companies that are neither bank nor savings and loan holding companies, but control FDIC-insured depository institutions.

Read literally, however, Section 38A(b) could be interpreted and implemented to capture not only owners of BHCA-exempt insured depository institutions that were the ostensible target of this provision, but also certain owners of banks and savings and loans that are not bank or savings and loan holding companies.  The group most obviously at risk is companies that own between 9.9% up to 24.9% of the voting securities of a banking organization without a holding company structure—the range that is presumed to create control for purposes of the Change in Bank Control Act ("CBCA"), but not control for purposes of the BHCA.  The "at risk" group, however, could also include investors in holding companies depending on how the regulators interpret the term "insured depository institution" for purposes of Section 38A(b).  The FDIC has an incentive to interpret this new provision broadly to capture this group of owners and impose the source of strength obligation on them.  Hopefully, the federal regulators will resist this incentive and reconcile their definitions and interpretations of "control" and "insured depository institution" under the FDIA, CBCA, the BHCA, and new Section 38A(b), and develop a comprehensive procedure that facilitates significant investments in the banking system.

**Notices Under the Change in Bank Control Act**[4]
Under the CBCA no person, acting directly or indirectly or through or in concert with one or more other persons, shall acquire control of any insured depository institution unless the appropriate federal banking agency[5] has been given 60 days' prior written notice of such proposed acquisition and within that time period the agency has not issued a notice disapproving the proposed acquisition or, in the discretion of the agency, extending for an additional 30 days the period during which such a disapproval may issue.  The terms "control" and "insured depository institution" are defined and applied very broadly.

"Control" generally means the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25% or more of any class of voting securities of an insured bank.

Under their regulations[6] the banking agencies presume that an acquisition of voting shares of an insured depository institution constitutes the acquisition of the power to direct the management or policies of an insured bank or a parent company requiring prior notice to the appropriate federal agency, if, immediately after the transaction, the acquiring person (or persons acting in concert) will own, control, or hold with power to vote 10% or more of any class of voting shares of the institution, and if:

(i) The institution has registered shares under section 12 of the

Securities Exchange Act of 1934 (15 U.S.C. § 78l); or

(ii) No other person will own, control or hold the power to vote a greater percentage of that class of voting shares immediately after the transaction. If two or more persons, not acting in concert, propose to acquire simultaneously equal percentages of 10% or more of a class of voting shares of an insured state nonmember bank or a parent company, such persons shall file prior notice with the relevant federal agency.

The regulations of each agency under the CBCA provide for a procedure to rebut this presumption of control.[7] Prior notice to the agency is not required for any acquisition of voting shares under the presumption of control, if the agency finds that the acquisition will not result in control. The regulations further provide that the agency will afford any person seeking to rebut a presumption of control an opportunity to present views in writing or, if appropriate, orally before its designated representatives at an informal meeting.

Even if the terms of an acquisition support a noncontrol determination, the customary practice is to prepare and file a notice under the CBCA instead of attempt to rebut the presumption of control, because it is just as or more time-consuming and costly to rebut the presumption than it is to file a notice. Since the CBCA does not provide for a source of strength obligation, there was no downside to filing the required notice if the 10% presumption threshold was met. This conclusion is now complicated by Section 38A(b).

Under the FDIA[8] the term "insured depository institution" means any bank or savings association the deposits of which are insured by the FDIC. But for purposes of the CBCA the term "insured depository institution" includes more than the FDIC-insured bank or savings and loan. It also includes any company, whether or not a depository institution holding company, that controls a depository institution.[9] For CBCA purposes the statutory obligations do not stop at the immediate holding company level, but are carried up the chain of ownership within the regulatory framework developed around the concept of "control." Thus, if a bank is owned by a holding company that in turn has a 24.9% company owner, for purposes of the CBCA, each of the bank, its holding company, and the 24.9% company owner is an "insured depository institution." Otherwise, for purposes of the FDIC, only the subsidiary bank or savings and loan, not any holding company, is considered to be the "insured depository institution."

**Recent Filing Practice for Private Equity Investment in Banks**

Over the last several months an investment structure and filing practice that appears to have become generally accepted by regulators has developed for significant investments in banks and their holding companies by private equity funds and similar investors. One or more lead investors agree to purchase up to 24.9% of the proforma voting equity of the depository institution or company with other investors purchasing lesser amounts, often capped at 9.9%.

The related filing practice for this investment structure is for each lead investor to (a) seek a noncontrol determination from the appropriate Federal Reserve Bank, whether the investment is in the depository institution directly or the holding company, which implicates involvement by the staff of the Federal Reserve Board (collectively, the "FRB") under the BHCA to avoid bank holding company characterization and the resulting supervision and regulation of the investor by the FRB; (b) in connection with such noncontrol determinations, provide passivity commitments[10] that are intended to rebut the factors indicating control or a controlling influence; (c) file a notice and related financial and biographical information under the CBCA; and (d) if appropriate, file notices with state regulators equivalent to those required under CBCA.

Consistent with the expansive definitions of "insured depository institution" and "control" under the CBCA, the parties that file notices under the CBCA in connection with lead investors include not only the immediate investing entity itself, but also the parties that are deemed to control such investing entity, such as general partners of general or limited partnerships, under-certain-circumstances limited partners, controlling investors in such general and limited partners, and individuals who constitute the executive management of the general partner or investing entity.

While each of the regulatory filing requirements under the BHCA and CBCA is triggered with reference to the concept of "control," with many shared elements, such as the 10% ownership threshold, the current regulatory view is that "control" for CBCA purposes is different than for BHCA purposes.  The regulators have tended to be fairly rigid in requiring CBCA notices once the 10% presumptive ownership threshold is reached while allowing greater ownership and involvement in banks prior to subjecting investors to the BHCA supervision and regulation scheme.  This distinction is appropriate since the CBCA and the BHCA address different aspects of bank ownership.

The BHCA is intended primarily to preserve competition in the banking industry by requiring prior regulatory approval of holding company acquisitions of banks and to separate banking and commerce by restricting the nonbanking activities of bank holding companies.[11]  The CBCA is intended primarily to protect the banking system from unscrupulous or incompetent individuals acquiring control of banks. Since the statutory purposes of each statute differ, the interpretation of fundamental concepts, such as "control," and the application of regulatory supervision, differ as well.  Since the CBCA is focused on the acquisition of controlling interests in banks rather than ongoing supervision of the acquiring person after the acquisition, a more rigid interpretation of "control" triggering a filing requirement with detailed biographical and financial information demonstrating the investor's character and qualifications to control a bank is appropriate.  The BHCA is applicable only to companies (actual or constructive) and triggers ongoing supervision and regulation and after-Dodd-Frank responsibility to serve as a source of financial strength to their portfolio banks.  Since the consequences of being a bank holding company are more severe, it is appropriate that the interpretation of “control” that triggers this extensive regulatory mechanism be applied in a more nuanced fashion than under the CBCA.

**Dilemmas Presented by Dodd-Frank**

Two issues are presented by Section 38A(b).  One is which of the two interpretative models used to determine “control” will be used by the regulators for Section 38A(b) purposes, or should a new hybrid approach be developed that is appropriate for the statutory purposes of this new provision.  The second is how the phrase “insured depository institution” will be defined for purposes of Section 38A(b).

*Control*

Until the regulators clarify how “control” will be applied for purposes of Section 38A(b), the current practice of filing a CBCA notice and an FRB noncontrol determination request with passivity commitments exposes the investor and certain of its affiliates to the risk that Section 38A(b) can be used in the future by regulators to impose a source of strength obligation on an investor that is a company, such as a private equity fund, in the 10%-24.9% range.  The reason for this is that filing a notice under the CBCA presumes that the investor is acquiring control if the investment exceeds the ownership thresholds.  If the investor has already conceded control for CBCA purposes, it might be difficult to argue that it has not acquired control under Section 38A(b) and its source of strength purpose.[12]  In the current uncertain situation, the only way to eliminate this risk is to request a noncontrol determination from the appropriate federal regulators under both the BHCA and the CBCA while providing voluntarily the detailed biographical and financial information with a specific disclaimer of control.[13]  We have recently made such a request in connection with a proposed investment in a bank in California and are awaiting a response from the FDIC.  Unless the FDIC and the FRB provide clear noncontrol determinations, our client will not make the proposed investment.

*Insured Depository Institution*

A similar issue is presented by the uncertainty of whether a controlling investment is being made in an “insured depository institution.” The FDIA definition would limit the scope of the term only to the bank or savings and loan that accepted deposits.  A plain reading of Section 38A(b), and one that is supported by its legislative history, also supports this view.  Under this definition neither a holding company nor an investor in such holding company would be subject to a source of strength claim even if the regulators adopt the expansive CBCA model of control for purposes of Section 38A(b).  If this interpretation is adopted, as a practical matter future investments in banks and savings and loans without holding companies in the 10%-24.9% range would be conditioned on the creation of a holding company to establish the negative predicate provided in the first phrase of Section 38A(b).

The CBCA definition of an "insured depository institution," however, leads to a different conclusion. The CBCA definition of "insured depository institution" includes depository institution holding companies and other companies that are not depository institution holding companies but that "control" an insured depository institution. If this interpretation is adopted for purposes of Section 38A(b), then the source of strength obligation could not be avoided by simply forming or investing in a bank or savings and loan holding company. The analysis would flow as follows: If a bank holding company is itself an "insured depository institution," but is not a subsidiary of another bank holding company or savings and loan holding company, then the FRB, the appropriate federal banking agency for the bank holding company/insured depository institution, has a duty to require any company that directly or indirectly controls the bank holding company/insured depository institution, like potentially a 10%-24.9% company investor, as well as the holding company itself, to serve as a source of strength to the insured depository institutions down the chain of ownership.

If an expansive definition of "control" is combined with an expansive definition of "insured depository institution" for purposes of Section 38A(b), then the current investment structure involving lead investors at the 10%-24.9% level investing in banks or their holding companies would cease immediately because lead investors would be subject to the source of strength obligation.

Based upon our understanding of the specific and limited purpose of Section 38A(b) in creating parity among traditional bank and savings and loan holding companies with companies that control FDIC-insured depositories that are not technically banks for BHCA purposes, we believe the expansive definition of an "insured depository institution" used for purposes of the CBCA would be inappropriate and unsupportable, both from the perspective of legislative history as well as statutory interpretation, for purposes of Section 38A(b).

**A Comprehensive Approach to Control Determinations Should Be Adopted as soon as Possible.**

Adoption of interpretive rules and procedures for purposes of Section 38A(b) that are consistent with its regulatory purpose and the existing CBCA and BHCA control structure should be adopted as soon as possible to avoid the current uncertainty facing investors.

Since Section 38A(b) was intended to establish "source of strength" parity among companies that own insured depository institutions, whether or not they are technically banks, the most logical reference to use for determining control for the source of strength obligation is the BHCA model utilized by the FRB. All companies that own insured depository institutions, whether or not they are banks for purposes of the BHCA, should have the same source of strength obligation. On the other hand, owners of exempt banks should not be subject to a greater obligation to serve as a source of strength than owners of banks, which would result if the more rigid CBCA model for "control" is utilized at the 10% ownership level.

The source of strength obligations contained in Section 38A(a) (for bank and savings and loan holding companies) and (b) (for companies that are not bank or savings and loan holding companies) should be triggered by the same standards and procedures. If an investor is not deemed to be in control of a bank for purposes of the BHCA (and its source of strength obligation) then that investor should not be deemed to be in control for purposes of Section 38A(b). Consistent with the principle of regulatory parity, the passivity commitments that are currently used by the FRB in connection with noncontrol determinations under the BHCA could be used by the agencies for purposes of noncontrol determination under Section 38A(b).

The most logical approach would reconcile the three different statutory requirements that are triggered by control determinations involving insured depository institutions. The existing interpretative models and procedures for filing information under the CBCA and BHCA should continue. However, the CBCA procedures should adopt an additional feature that addresses Section 38A(b) to allow an investor in a banking organization, whether a bank or holding company, to seek a noncontrol determination for purposes of Section 38A(b) while still providing regulators with the information required to enforce the CBCA.

If the FDIA definition and common understanding of "insured depository institution" and the BHCA definition and interpretation of "control" are utilized for purposes of Section 38A(b), the new provision can be incorporated into the existing regulatory structure without causing unintended consequences, such as stopping private equity investment in the banking industry. Lead investors can still be required to file all the information required by the CBCA and allow the regulators the ability to supervise investments in banks and their holding companies without causing all filing parties to be subject to a Section 38A(b) "source of strength" obligation. But if an investor does not become a bank holding company by virtue of its investment in a bank or its holding company or does not own 25% or more of a BHCA-exempt insured depository institution, and thereby avoids the source of strength obligation under Section 38A(a), the investor should not be subject to a source of strength obligation under Section 38A(b).

This approach is consistent with the legislative purpose of Section 38A and reconciles Dodd-Frank with the existing regulatory structure. All companies that control insured depository institutions, whether or not they are technically banks, as determined by the same standards, will have an equivalent statutory duty to serve as a source of financial strength. All investors in insured depository institutions or their holding companies at the 10%-24.9% level will be required to provide the detailed biographical and financial information currently required by the CBCA without fear that they will be subject to an additional source of strength burden that has not and should not be imposed on them. This approach should allow the continued investment of private capital into the banking system.

We are hopeful that the regulators adopt this or a similar approach as soon as possible to avoid needless delays in desired investments in the banking industry.

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[1] More significantly this provision also eliminates any doubt that bank holding companies and savings and loan holding companies are to serve as sources of financial strength to their subsidiary insured depository institutions.

[2] Individuals are not subject to this provision or any other statutory obligation to serve as a source of strength to insured depository institutions they control.

[3] The exempt institutions include foreign banking institutions, savings associations, certain trust companies, credit unions, limited purpose credit card banks, and certain industrial loan companies. *See* 12 U.S.C. §1841(c)(2). Prior to the adoption of Dodd-Frank, savings and loan holding companies were not subject to any statutory requirement under the Home Owners Loan Act to serve as a source of financial strength. Just as is the case for bank holding companies, as a result of Section 616(d), savings and loan holding companies will have such an obligation.

[4] 12 U.S.C. § 1817(j).

[5] The FRB for state member banks and bank holding companies, the OCC for national banks and federal savings and loans and the FDIC for state nonmember banks. If a transaction triggers a requirement under either Section 3 of the BHCA or Section 10 of the Home Owners Loan Act to register as a holding company, the transaction is exempt from the requirements of the CBCA.

[6] *See, e.g.*, 12 C.F.R. § 303.82(b)(2) and 12 C.F.R. §225.41(b).

[7] *See, e.g.*, 12 C.F.R. § 303.82(e).

[8] 12 U.S.C. § 1813(c).

[9] 12 U.S.C. § 1817(j)18(A) and (B).

[10] The principles underlying these passivity comments were provided by the FRB in a Policy Statement regarding Nonvoting Equity Investments (12 C.F.R. § 225.143 (1982), and then adapted to significant investments in voting securities in subsequent FRB letters and approvals of such investments.

[11] *See Federal Bank Holding Company Law,* Heller and Fein, Revised Edition (2010) at 1-21. Some might observe that the concentration of banking assets in a handful of banks with the resultant "too big to fail" issues calls into question the effectiveness of the realization of this purpose since adoption of the BHCA.

[12] Regulators also will have to determine whether or not Section 38A(b) was intended by Congress to be applied retroactively to companies that have already invested in banks and savings and loans or their holding companies. There is no stated grandfather relief in Section 38A(b).

[13] The regulators may seek to continue their practice of providing a nonobjection letter to an investment under the CBCA and noncontrol determination process and refuse to provide a noncontrol determination finding, leaving open the possibility of a future Section 38A(b) claim. However, investors may be unwilling to expose themselves to the risk of being subjected to a "source of strength" claim in the future.

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