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Increased Foreign Investments in U.S. Banks

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Will CFIUS reviews and potential investigations become another regulatory step in bank acquisitions?

One by-product of the international credit and liquidity crisis, which emanated from U.S. lending and funding practices, is increased political attention to foreign investments in U.S. banks. Foreign interest in U.S. bank investments from certain countries flush with liquidity and concentrated wealth can be expected to increase as U.S. banks seek to replenish capital and the dollar remains weak. This week the Senate Banking Committee held hearings on the influence "Sovereign Wealth Funds" may have through their investments in U.S. financial institutions even though these investments may be accepted as "non-controlling" by the Federal Reserve.

The Treasury Department has released proposed regulations for comment to implement provisions of the Foreign Investment and National Security Act of 2007. FINSA amended the Defense Production Act of 1950, which empowers the President to suspend or prohibit certain foreign acquisitions of U.S. entities that are determined to threaten national security. FINSA is administered by the Committee on Foreign Investments in the United States (CFIUS), a multi-agency committee chaired by the Secretary of the Treasury.

Bankers will recall the high profile coverage of the aborted acquisition of Unocal Corp by a Chinese government-controlled oil company and the Congressional threats of legislation that caused Dubai Ports World to divest its indirect ownership of U.S. port operations. Most recently, the Sovereign Wealth Fund investments by the Abu Dhabi Investment Authority in Citicorp and by China Investment Corporation in Morgan Stanley in the early wake of the current

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credit and liquidity crisis have raised new questions if foreign investors generally, and foreign government-controlled investment entities in particular, should have large strategic equity stakes and potential influence in the U.S. banking industry. Imagine the headlines if Countrywide had to look to a Qatar bank instead of Bank of America or if only a Hong Kong investment banking firm would agree to take over Bear Stearns?

So far, the U.S. bank regulatory constraints on acquiring control of U.S. banks and the self-interest of sovereign wealth funds--and other foreign investors, such as Citicorp shareholder Saudi Prince al Waleed and foreign companies and private equity funds--have been compatible. Banking regulators generally will not oppose foreign investors so long as the investments do not exceed regulatory "control" thresholds (10% generally, but under 5% in some situations and up to 15% or more in others) and are supported by "passivity commitments" not to dominate boards of directors or seek to influence policies or management. Sovereign Wealth Funds and other foreign investors, similar to private equity funds, have so far been very willing to limit their investments to below the percentage thresholds and to provide non-control commitments to avoid disclosure of financial information and restrictions or prohibitions on other investments that would be required in order to receive approval to control U.S. banks. Future U.S. investment opportunities may cause some foreign investors to consider larger investments and seek policy and management control of U.S. banks notwithstanding that this would also require Federal Reserve approval. In that case, the applicability of FINSA and CFIUS to such transactions may become a key issue.

Amendments to FINSA in 1988 established a process for pre-acquisition voluntary "notice" filings by foreign investors seeking written confirmation from the Department of the Treasury that the U.S. government would not later block or unwind a proposed transaction on national security grounds. This so-called "Exon-Florio" review process requires the submission of information (which is accorded confidential treatment) and ends with a CFIUS determination as to whether the proposed transaction requires a formal investigation or the negotiation of mitigation agreements, and whether CFIUS will make a recommendation and/or refer the transaction to the President for a decision and action. This powerful authority has been rarely invoked by the President

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and U.S. policy has generally been very open to foreign investments. This is particularly true with respect to foreign banking organizations--whether or not government owned--which are generally allowed to compete and expand in the U.S. on a level playing field with domestic banks under the principle of national treatment adopted by the International Banking Act of 1978.

A CFIUS review of the proposed foreign control of a U.S. bank would have to determine first if the bank falls within the broad FINSA definition of assets "so vital to the United States" that the incapacity or destruction of the assets "would have a debilitating impact on national security." National security is only defined by examples (such as ports, defense systems and nuclear plants), but it now seems assumed in Congress that foreign government control of major U.S. financial institutions could raise a national security concern. Therefore, a CFIUS review and investigation of a foreign acquisition of Citicorp or Morgan Stanley would be expected; however, a proposal by a China bank to acquire control of one of the large U.S. regional banks primarily serving the U.S. Chinese market would also be subject to FINSA and a CFIUS review.

When foreign governments are involved in the transaction, CFIUS must consider the relationship between the foreign country involved and the U.S., and specifically its record of cooperating with the U.S. in counter terrorism. This requirement is where a foreign government which owns or controls a foreign bank could face scrutiny under FINSA that it would not under a bank holding company application by the government-controlled foreign bank. This contrasts with the anti-money laundering programs of a foreign government which are subject to review in connection a foreign bank's application under the Bank Holding Company Act. Sovereign wealth funds are treated as state-owned enterprises and are to be reviewed with more scrutiny by CFIUS under FINSA as foreign government-controlled entities.

The safe harbor test under the Treasury's proposed regulations from a determination of control by CFIUS is similar to the control thresholds and indices of control under the Bank Holding Company Act--the equity investment must be no more than 10 percent and there must be no other evidence of intention to influence management or policies. Formal passivity commitments and other mitigating actions can be negotiated in conjunction with "pre-filing" meetings and consultations to ensure that notices will be filed that can receive a favorable CFIUS review. This is also very similar to

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the process generally encouraged by the Federal Reserve for resolving anticipated issues before applications are filed formally and publicly. However, the remarks of Senators at this week's hearing included the suspicion that foreign investment transactions may be structured to avoid Federal Reserve scrutiny and hide a true intent to exercise influence and control for political reasons. Also noted were possible policy concerns over the potential effect and indirect influence arising from the sheer size of shareholdings of U.S. financial institutions by foreign investors notwithstanding the longtime U.S. policy of encouraging foreign investments.

Banks should also consider the possible M&A use of a CFIUS challenge. CFIUS challenges may be added to the list of strategic defenses often used by target banks or competing bidders to fend off or stall a foreign bidder, in the same way that anticompetitive charges and CRA non-compliance are often used as defensive or negotiating tactics. Because a CFIUS review may also be initiated by CFUIS itself if not voluntarily filed, CFIUS could be advised of a potential acquisition by a target institution or a competitive bidder asserting a CFIUS review and investigation is warranted. Therefore, even potential foreign investors from countries not normally considered to pose a risk to U.S. national security or to be subject to government control or influence (such as Korea and India) may have to consider FINSA and the CFIUS notice process as they plan investments and acquisitions in the U.S.

Click **here** for the proposed Treasury regulations.

A Manatt White Paper entitled, "**Key Banking Laws and Regulatory Issues to be Considered by Foreign Investors in U.S. Banks**," is available in the "Resource Center" at **www.manatt.com**.

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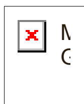

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