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New Money: Regulators Compile Rules for Private Equity Investments in Banks

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From the peak of the last boom to the depths of the current recession, Federal regulators have discussed permitting private equity investments in banks. The extreme challenges in the banking industry have prompted consideration of loosening regulations that previously restricted outside funding of banks. The recent rules compile prior standards applied to investors in banks, and add commentary providing at least a theoretical basis for easier access to banks of capital from non-financial institution investors.

Traditional Restrictions in Bank Investments

Without changes from the Federal Reserve, Federal regulations have severely limited investment in banks by industry outsiders. Even with the new rulings, non-bank investors must comply with the following basic limits in banks and bank holding companies:

- Only investments of less than five percent could be made in the institution, without significant restrictions.
- Investments of ten percent or more of the voting equity of an institution require notice.
- To avoid classification as a bank holding company, the investor must not (i) directly or indirectly or acting through one or more other persons own, control, or have power to vote 25 percent or more of any class of voting securities of the institution; (ii) control in any manner the election of a majority of the directors of the institution; or (iii) directly or indirectly exercise a controlling influence over the management or policies of the institution.
- Adhere to the following Federal interpretations regarding restrictions on ownership:
 - Investors holding between 10 and 15 percent of any class of voting securities trigger examination by the Federal Reserve of the relationship among the investors. The Federal Reserve will also require investors to forego board representation, waive contractual restrictions on the banks, and limit additional purchase of non-voting equity.
 - Previously, regulators did not permit investors of between 10 and 24.9 percent of the voting stock of a bank to hold a seat on the board of directors.
 - Additional board representatives are permitted if they are investors owning less than 15 percent of the voting stock, so long as another stockholder owns a larger block of voting stock.

The Green Light to Invest in Banks

At the peak of the last economic financial cycle, equity funds pounded on the doors of the Federal Reserve and FDIC pleading for permission to invest in banks. The automatic classification of otherwise passive investors as bank holding companies prevented these funds from purchasing stock. With the onset of the financial crisis in 2008, however, the Federal Reserve announced new policies to assist non-bank equity funds making investments in financial institutions. With the recent frantic activity of investors looking for community bank bargains, and



community banks looking for capital, the industry has again examined these rules and the opportunities for new sources of bank capital.

The Newly Compiled Rules

The new Federal Reserve policy statement outlines somewhat more liberal ownership restrictions for equity funds:

- The investor may have a non-voting representative at bank board meetings.
- The investor may have two members of the board representing the equity fund if:
 - the aggregate director representation is proportional to the total interest in the institution,
 - the board seats are less than 25 percent of the voting members of the board, and
 - another shareholder is a bank holding company that controls the institution.
- The investor's representative does not serve as chairman of the board or any committee of the board.
- The investor's representatives on the board are less than 25 percent of the members of a board committee.

The policy statement notes elements that shield a fund from becoming a bank holding company:

- Another controlling shareholder has been approved by the Federal Reserve, is regulated by the Federal Reserve, and is obligated to serve as a source of strength for the bank.
- An investor may hold 33 percent of the total equity of a institution, not simply 25 percent of the voting equity of an institution. However, in such a case, the voting interest may not exceed 15 percent.
- Shares of non-voting equity that may convert into shares of voting equity will, in most cases, be considered by the Federal Reserve as shares of voting equity. However, the policy statement noted prior rulings where convertible shares were not considered voting where the shares were transferred:
 - to affiliates of the investor or the institution,
 - in a public offering,
 - to recipients receiving less than two percent of any class of voting securities, or
 - to recipients that would control more than 50 percent of the voting securities of the institution before the transfer.
- Investors may discuss significant matters of financial and managerial policy with the institution's management. However, financial decisions should remain with the board, or the shareholders voting as a group.
- Discussions with the institution's management should not be accompanied by threats to sell shares or launch a proxy fight.
- Investors should avoid influencing the following institution matters:
 - hiring, firing, compensating suppliers,
 - starting new businesses, or substantially changing bank operations,
 - raising additional debt or equity, or
 - merging, selling major assets or acquiring other firms.
- However, investors may impose the following restrictions on the institutions in which they invest:



- issuance of senior securities,
- senior borrowing,
- changes to the terms of the investor's security,
- liquidation, or
- receipt of financial information and "limited" consultation rights.

Passivity Commitments

In addition to investor compliance with the Federal Reserve's general policy statement, regulators will also require individual commitments to remain a passive investor. These private "passivity commitments" include restrictions on the following activities and matters:

- percentage of additional voting equity and total equity acquired,
- investor rights to restrict the target institution management determining major policies,
- investor influence over the institution's significant policy-making and operational processes,
- director and officer interlocks with the institution, and
- business relationships between the investor and the institution.

Acting in Concert

Along with entering into passivity commitments, groups of investors must avoid being aggregated by regulators as a single investor for purposes of bank holding company requirements. Investor groups may be deemed "acting in concert" triggering rules that render the group a bank holding company, where otherwise each investor would have individually avoided the classification as a bank holding company. Since private equity deals often entail coordinating multiple sophisticated investors, these guidelines have interfered with several proposed equity investments.

"Acting in concert" includes the following elements:

- Cross ownership.
- Simultaneous investments by immediate family members.
- Common control of investors.
- Oral or written agreements or understandings regarding the acquisition, voting, or transfer of control of voting securities of a institution, other than through certain revocable proxies.

Go/No Go

While the compiled rules demonstrate a new flexibility of the Federal Reserve to non-bank investors, hurdles remain. Satisfying these policy thresholds is the first step; however, until the regulators finally approve the deal investors must appreciate the nuances of bank investment restrictions.