

Fed Relaxes Traditional Control Rules for Private Equity and Other Minority Investments in Banks and Bank Holding Companies

September 23, 2008

On September 22, the Board of Governors of the Federal Reserve System (the “**Federal Reserve**”) issued a policy statement (the “**Equity Policy Statement**”) that relaxed and clarified its long-standing control rules relating to minority investments in banks and bank holding companies (“**Banking Organizations**”). These changes and clarifications relate to four principal areas:

- » expanded director rights;
- » increased voting and total equity ceilings;
- » permissible business relationships; and
- » veto rights.

The Federal Reserve also stated that it would use the liberalized rules to analyze noncontrolling investments by U.S. and non-U.S. bank holding companies in nonbanking firms.

Expanded Director Rights and Increased Equity Ceilings

Old Rule

Historically, the Federal Reserve has **not** allowed a minority investor that acquired 10% or more of a Banking Organization’s voting shares to have a director on the Banking Organization’s board without being deemed to have a controlling influence over the Banking Organization. In contrast, it has generally allowed a minority investor to acquire up to 9.9% of a Banking Organization’s voting shares, 14.9% of its total equity (including such voting shares) and to appoint one director.

New Rule

The Equity Policy Statement reiterates that a “control” determination still depends on all the facts and circumstances.

While the Equity Policy Statement is unclear and contradictory in certain respects, we believe that it provides that a minority investor may now generally acquire up to 15% of the voting shares of a Banking Organization, one-third (33%) of its total equity and appoint one director to the Banking Organization’s board without raising a “control” issue. In addition, such an investor may generally have two board seats as long as (i) its board representation is proportionate to its total equity interest and does not exceed 25% of the voting members of the board and (ii) another, larger shareholder is a bank holding company that controls the Banking Organization.

Board Committees

The Federal Reserve also clarified the extent to which the board representatives of a minority investor may serve on board committees. No minority investor’s board representative should be the chairman of the board or of a board committee. However, its representatives may serve on any board committees as long as they do not constitute more than 25% of such committees and do not have the authority or practical ability to make or block policymaking decisions.

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Convertible Securities

The Equity Policy Statement reaffirms the traditional rule that nonvoting shares convertible into voting shares at the holder's option or mandatorily convertible after a passage of time should be considered voting shares at all times. However, it also provides that nonvoting shares may become voting in a transfer in a widespread public offering, in a transfer in which no transferee would receive 2% of more of any class of voting shares, or in a transfer to a transferee that will control more than 50% of the voting securities of the Banking Organization without counting the transferred shares. This mechanic has traditionally aided minority investors in making larger dollar investments via nonvoting shares while still maintaining exit and liquidity rights.

Limited Business Relationships

The Federal Reserve has previously allowed minority investors to have “quantitatively limited and qualitatively nonmaterial” business relationships with the Banking Organization in which they have invested. The Equity Policy Statement reiterates that business relationships should remain limited and will continue to be reviewed on a case-by-case basis, taking into particular account the following factors: (i) the size of the proposed business relationships and (ii) whether they would be on market terms, non-exclusive and terminable without penalty by the Banking Organization.

No Meaningful Veto Rights

The Federal Reserve reiterated that minority investors will not be permitted to have any meaningful veto rights to protect the value of their investments, without being deemed to control the Banking Organization. It merely reaffirmed that minority investors may have veto rights, subject to safety and soundness concerns, over very limited matters such as issuing senior securities or borrowing on a senior basis, modifying the terms of the minority investor's security, or liquidating the Banking Organization. They may also have limited financial information rights and limited consultation rights.

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