Federal Banking Agencies Recognize the Rise of Index Funds and Passive Investing

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Two recent actions by the Federal Reserve, OCC and FDIC (the **Banking Agencies**) recognize the increasing role of fund complexes and passive investing. The Banking Agencies have released a statement under the Federal Reserve's Regulation O which acknowledges the reality that equity mutual funds may sometimes go over 10% of the shares of a banking organization without triggering limitations on loans to insiders. In addition, the Federal Reserve has recently made public a general counsel's letter that provides conditions for when a fund complex may go over 10% equity ownership in a banking organization without triggering the Change in Bank Control Act (**CIBC Act**).

The Regulation O Statement

In a welcome move that appears to reveal a more nuanced acknowledgment of the reality of modern financial markets, on December 27, 2019, the Banking Agencies issued a **statement** announcing they would not take action related to extensions of credit by banks, thrifts and other depository institutions (**Banks**) to companies that may be a "related interest" of certain asset managers and their institutional accounts or investment funds they sponsor, manage or advise, including mutual funds and ETFs (collectively, **Fund Complexes**) for purposes of the Federal Reserve's Regulation O (the **Reg O Statement**).[1] The Banking Agencies explained in the Reg O Statement that due to the wide variety of companies in which Fund Complexes invest, which includes both banking and nonbanking entities, "banks have indicated that the treatment of [companies in which a Fund Complex invests] as 'related interests' under Regulation O could require the sudden and disruptive unwinding of substantial pre-existing lending relationships and reduce credit availability to a wide swath of financial and non-financial companies."

Regulation O is designed to prevent "insiders" of a Bank from improperly using the Bank to their advantage such as by obtaining a loan with preferential pricing or other non-market terms.[2] Regulation O achieves this goal by placing quantitative and qualitative limits, as well as certain reporting requirements, on extensions of credit by a Bank to any "insider" of the Bank or its affiliates, meaning any executive officer, director, principal shareholder, and related interest of such a person. The term "related interest" is defined to include a company controlled by a person, but Regulation O also includes a presumption that any company in which a principal shareholder directly or indirectly own more than 10 percent of any class of voting shares is a related interest of that person.

As a result, under Regulation O a Fund Complex that holds more than 10 percent of a class of voting securities of a Bank would be a "principal shareholder" of the Bank, and a Fund Complex Portfolio Company would be a "related interest" of the Fund Complex. ***This means that both the Fund Complex and the Fund Complex Portfolio Company would be an "insider" of the Bank and without the Reg***

[1] *See*, *e.g.*, Federal Reserve SR 19-16, *Statement Regarding Status of Certain Investment Funds and Their Portfolio Investments for Purposes of Regulation O and Reporting Requirements under Part 363 of FDIC Regulations*, available at **https://www.federalreserve.gov/supervisionreg/srletters/sr1916.htm** (Dec. 27, 2019).

[2] *See* 12 C.F.R. § 215.4.

O Statement the Bank would be unable to make a loan or extend credit to these entities without meeting the strict lending limits and other considerations and standards of Regulation O.

The Reg O Statement applies only until January 1, 2021, although the Federal Reserve stated it is "actively considering whether to amend Regulation O" to address the issue. Two requirements must be met to be eligible for the relief under the Reg O Statement, one applicable to the Fund Complex and one applicable to the Bank. These requirements are sensible and should not be overly difficult to satisfy.

- **No Control/Below 15%.** The Fund Complex may not directly or indirectly control 15 percent or more of any class of voting securities of the Bank, may not have or seek to establish any officer or employee interlock with the Bank, and may not exercise or attempt to exercise a controlling influence over the Bank. The Banking Agencies will presume a Fund Complex meets the first requirement so long as the Fund Complex has provided passivity commitments to the Federal Reserve or FDIC, or rebutted a presumption of control to the OCC, in connection with seeking the relevant agencies' non-objection to the Fund's acquiring up to 15 percent of the shares of a BHC, bank, savings association or SLHC (**banking organization**) without being required to make a filing under the CIBC Act, Bank Holding Company Act of 1956 (**BHC Act**), or Home Owner's Loan Act (**HOLA**). Many Fund Complexes have previously provided these types of commitments.[3]
- **Credit on Market Terms.** The Bank must not knowingly make an extension of credit to a company in which the Fund Complex may hold more than 10% of a class of voting shares (a **Fund Complex Portfolio Company**) *unless* the terms of the extension of credit are on "market terms" and the extension of credit does not involve more than the normal risk of repayment or present other unfavorable features. Because of underwriting standards and risk management systems, Banks typically make loans consistent with this requirement.

The Reg O Statement reflects the Banking Agencies' acknowledgment that certain restrictions and requirements that may have once been prudent regulatory tools no longer accomplish the original intent behind their implementation. For example, the presumption of control at a 10% ownership interest historically was applied to prevent a director of a community bank who also owns a 10% or greater interest in the local car dealership, for example, from causing the bank to make a "sweetheart" loan to his or her dealership. This presumption may have made sense in this historical context, but it poses unique and unduly burdensome challenges when applied to today's Fund Complexes, especially mutual funds that are required or otherwise need to hold a certain level of shares in a large number of companies, as well as to the Banks that lend to these entities.

General Counsel's Letter

The Reg O Statement is not the only instance of Fund Complexes being the focus of recent attention by the Banking Agencies. In a separate but related action, the Federal Reserve recently made public a **general counsel's letter** providing a Fund Complex additional flexibility in its ability to acquire securities of a banking organization without either having control of that organization for purposes of the BHC Act or HOLA or the need to file a notice under the CIBC Act. Specifically, a Fund Complex may now acquire up to 25 percent of any class of voting securities of a banking organization without being deemed to have acquired control of the banking organization under the BHCA or HOLA, whereas previously the Fund Complex only had clearance to acquire up to 15 percent. The Fund Complex also would no longer need

[3] *See*, *e.g.*, **Letter to Donald S. Waack** (Apr. 5, 2018); **Letter to Satish M. Kini** (June 15, 2017); **Letter to Jeffrey Hare** (Apr. 27, 2016); **Letter to Satish M. Kini** (Apr. 11, 2013); **Letter to Rebecca H. Laird** (Dec. 20, 2007); **Letter to Thomas M. Mistele** (Dec. 19, 2007).

to engage in “mirror voting” of any shares it holds in excess of 10 percent of the banking organization, and it may also seek to place one director on the board of any banking organization in which it invests.

The Federal Reserve noted in the general counsel’s letter that the Fund Complex made a number of commitments that “closely align . . . with traditional passivity commitments” regarding control under the BHC Act which influenced its decision provide the additional flexibility. This statement is not only consistent with the Federal Reserve’s recent proposal to modify the concept of controlling influence under the BHC Act, but also suggests that reports of the death of passivity commitments may have been greatly exaggerated.

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