



Federal Reserve Loosens Limitations on Private Equity Investments in Banking Organizations

On Monday, September 22, 2008, the Federal Reserve Board issued a policy statement easing the limitations on private equity investments in banks and bank holding companies. The policy statement addresses when such an investment creates a presumption of “control” which would require registration as a bank holding company.

In issuing this policy statement, the Federal Reserve has provided all banking organizations with access to additional sources of capital that may not have been previously available.

The Bank Holding Company Act was intended to ensure that investors that acquire control of banking organizations have the financial and managerial strength, integrity, and competence to exercise that control in a safe and sound manner, premised on the belief that an investor that is positioned to benefit from successful management of the banking organization should also be prepared to provide additional resources to support the banking organization in times of need. Registration as a bank holding company submits investors to additional supervision and regulation, including capital requirements and limitations on debt. As a result of this regulation, many private equity investors desire to avoid registration as a bank holding company.

The Bank Holding Company Act sets forth a three-pronged test for determining whether a company has control over a banking organization and, as a result, is subject to federal regulation: “if (i) the company directly or indirectly or acting through one or more other persons owns, controls or has power to vote 25 percent or more of any class of voting securities of the banking organization; (ii) the company controls in any manner the election of a majority of the directors or trustees of the banking organization; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization.” In interpreting the Bank Holding Company Act, the Federal Reserve has historically placed significant limitations on any investments of 10% or more of the voting securities of a banking organization to ensure that such investment does not provide a controlling influence on management.

This client alert describes the new standards that the Federal Reserve has given in defining what constitutes exercising a controlling interest and analyzes how the policy statement may impact the ability of financial institutions to receive additional capital from private equity sources.

1. Board Representation

The Federal Reserve’s previous position on board representation for non-controlling investors was that investors that acquire between 10 and 24.9 percent of the voting stock of a banking organization were not permitted to have any representation on the board of directors, subject to limited exceptions. In the new policy statement, the Federal

Reserve has loosened this restriction, and now provides that a non-controlling investor, generally speaking, should be permitted to designate one member of the board of directors without being considered to have a controlling influence. The Federal Reserve notes that “in the absence of other indicia of control, it would be difficult for a minority investor with a single board seat to have a controlling influence over the management or policies of the banking organization.” The new policy statement further provides that a non-controlling investor may be able to designate a second board member so long as (i) the board of directors has at least nine members, (ii) such level of representation is proportionate to its total investment, and (iii) the non-controlling investor is not the largest shareholder. The Federal Reserve notes that the non-controlling investor’s board representative should not serve as the chairman of the board or any committee of the board, but may serve as a committee member. The Federal Reserve’s loosening of its board representation stance may be attractive to private equity firms, as these types of investors frequently desire to appoint members to the boards of directors of their portfolio companies.

2. Voting Securities

The Federal Reserve’s previous position on ownership of voting securities limited non-controlling investors to holding 9.9 percent of the total outstanding voting shares of the banking organization. The new policy statement raises this threshold to 14.9 percent of the total outstanding voting shares of the banking organization. Nonvoting shares that are convertible into voting shares are generally considered voting shares by the Federal Reserve, unless such convertibility is restricted. The Federal Reserve’s raising of the voting securities threshold may be attractive to private equity investors, as many private equity firms have a minimum dollar amount that they are willing to invest.

3. Total Equity Investment

The Federal Reserve’s previous position on the total equity investment required that non-controlling investors limit their investment to 24.9 percent of the total equity of the banking organization, to avoid constituting a controlling influence. In the new policy statement, the Federal Reserve has increased the equity ownership threshold, allowing a non-controlling investor to own up to one-third of the total equity of the banking organization (so long as voting control is limited to 14.9 percent). The Federal Reserve’s expansion of the total equity threshold may permit private equity investors to make larger total investments without needing to register as a bank holding company.

4. Communications with the Board of Directors and Management

The Federal Reserve requires non-controlling investors to commit to the Federal Reserve that they will not attempt to change the operations, management or strategies of a banking organization, will not threaten to sell their shares as a method of influencing decisions of management, and will not solicit proxies from other shareholders. The Federal Reserve felt these commitments were necessary to prevent the investor from having a controlling influence over the banking organization. The Federal Reserve’s new policy statement does not remove these commitments but confirms that, similar to other investors, non-controlling investors are permitted to communicate generally with the banking organization’s board and management about, and advocate changes in, any of the banking organization’s policies and operations. Specifically, the policy statement notes that a non-controlling investor may

advocate for changes in the banking organization's dividend policy, discuss strategies for raising additional debt or equity financing, or influence decisions to merge or sell the banking organization. The role of the non-controlling investor in making final decisions must be limited to voting its shares and exercising any voting privileges as a board member. While still limiting, the Federal Reserve's clarification should be attractive to private equity investors, as they may now raise issues or new management ideas with the board of directors and management without being concerned they will be considered a controlling investor.

5. Additional Considerations

The Federal Reserve's new policy statement deals exclusively with the Federal Reserve's determination of whether an investor has a controlling influence over the banking organization under the Bank Holding Company Act. The Federal Reserve has emphasized that the ultimate determination of whether a particular investment constitutes a controlling influence will be made on a case-by-case basis by the Federal Reserve, based on direct conversations between the investor and Federal Reserve staff. The Federal Reserve has also noted that its controlling influence determination will not be based solely on the contractual rights and obligations of the investor and the banking organization, but rather will depend on the amount of influence the investor ultimately exercises over the banking organization. As a result, the Federal Reserve will continue to monitor non-controlling investors to ensure that such investors do not, in fact, exercise a controlling influence.

The new policy statement does not alter the statutory limit under the Bank Holding Company Act that requires that any investor of more than 24.9 percent of the outstanding voting securities of a banking organization register as a bank holding company. Any change to this 24.9 percent threshold would have to be adopted by Congress.

Additionally, the new policy statement does *not* apply to control determinations under the Change in Bank Control Act. Therefore, an investor acquiring more than 9.9 percent of the voting securities of a banking organization may be required to make a Change in Bank Control filing even if the Federal Reserve determines that the investor is not a controlling investor under the Bank Holding Company Act. Such a filing may require the private equity investor to submit biographical and financial information, and subjects the investment to the approval of (or "non-objection" by) the Federal Reserve.

6. Conclusion

The Federal Reserve's new policy statement demonstrates that the Federal Reserve is willing to provide additional flexibility to encourage private equity investments in banking organizations. Powell Goldstein's Private Equity and Financial Institution groups have extensive experience in advising private equity firms and banking organizations in addressing the Federal Reserve's limitations, and can help guide either private equity firms or banking organizations through the regulatory landscape in forming an investment instrument that satisfies the business interests of the parties without triggering a determination by the Federal Reserve that such investment constitutes a controlling influence.

If you would like to discuss the Federal Reserve's new policy statement or this client alert, please contact your regular Powell Goldstein team member, or any of the attorneys listed below.

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