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## Federal Reserve Board Issues Policy Statement on Equity Investments in Banks and Bank Holding Companies

On September 22, 2008, the Federal Reserve Board (the "Board") announced the approval of a policy statement on equity investments in banks and bank holding companies. Consistent with the Board's desire to increase capital in the banking system, the policy statement allows more flexibility for private investors to invest in banks and bank holding companies and provides such banks and bank holding companies access to new sources of capital.

Private investors have traditionally avoided investments in banking institutions in order to avoid being classified as bank holding companies under the Bank Holding Company Act ("BHC Act") and being subject to accompanying regulation. The new policy statement demonstrates increased flexibility in the Board's assessment of private investments in banks and bank holding companies.

The Board clarified its position on the following issues:

### Director Representation

The Board traditionally did not permit a company that acquired between 10 and 24.9 percent of the voting stock of a banking organization (a "minority investor") to have representation on the board of directors. However, the Board has now reexamined this precedent and now believes that a minority investor should be able to have a single representative on the board of directors of a banking organization without being found to acquire a controlling influence over the management or policies of the banking organization.

Additionally, a minority investor with up to two representatives on the board of the banking organization is unlikely to be in a position to exercise a controlling influence "when the investor's aggregate director representation is proportionate to its total interest in the banking organization but does not exceed 25 percent of the voting members of the board, and another shareholder of the banking organization is a bank holding company that controls the

banking organization under the BHC Act." The Board stated that the presence of a large, regulated bank holding company shareholder will act as a countervailing force to any influence the minority investor may exert.

The Board emphasized its continued belief that a representative of a minority investor that serves on the board of directors should not serve as the chairman of the board or as the chairman of a committee of the board of the banking organization.

### Total Equity

The traditional view of the Board was that nonvoting equity investments exceeding 25 percent of the total equity of a banking organization generally raised control issues under the BHC Act. The Board now recognizes that there may be some cases where ownership by a minority investor of 25 percent or more of a banking organization's total equity may not confer a controlling influence. The Board states that the ability of an investor to exercise a controlling influence through nonvoting equity instruments depends significantly on the nature and extent of the investor's overall investment in the banking organization and on the capital structure of the banking organization.

The Board noted that it would not expect "that a minority investor would have a controlling influence over a banking organization if the investor owns a combination of voting shares and nonvoting shares that, when aggregated, represents less than one-third of the total equity of the organization (and less than one-third of any class of voting securities, assuming conversion of all convertible nonvoting shares held by the investor) and does not allow the investor to own, hold, or vote 15 percent or more of any class of voting securities of the organization." The Board believes that in these situations, the "limi-

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tation on voting rights reduces the potential that the investor may exercise influence that is controlling.”

### Consultations with Management

The Board provided additional guidance on the extent of communications between a minority investor and a banking organization’s management that would be consistent with a non-control determination. The Board believes that a non-controlling minority investor generally may communicate with banking organization management about, and advocate with banking organization management for changes in, any of the banking organization’s policies and operations.

In all cases, in order to avoid a control determination, the decision whether or not to adopt a particular position or take a particular action must remain with the organization’s shareholders, its board of directors, or its management, as appropriate. Furthermore, communications by minority investors “should not be accompanied by explicit or implicit threats to dispose of shares” or to “sponsor a proxy solicitation as a condition of action or non-action by the banking organization or its management.”

### Other Indicia of Control

#### Business Relationships

The Board traditionally prohibited a non-controlling minority investor from having any material business transactions or relationships with the banking organization. The Board now recognizes that not all business relationships provide the investor a controlling influence over the management or policies of the banking organization. The Board will review business relationships on a case-by-case basis within the context of other elements of the investment structure. The Board will pay particular attention to the size of the relationship and whether the relationship would be on market terms, non-exclusive, and terminable without penalty by the banking organization.

#### Covenants

The Board continues to take the position that covenants that substantially limit the discretion of a banking organization’s management over major policies and decisions suggest the exercise of a controlling influence. For example, a covenant that places restrictions on the banking organization’s ability to make decisions about hiring, firing, or compensating executives would be an indicator of a controlling influence.

Though the Board retains its broad discretion to find a controlling influence based on all of the facts and circumstances, this policy statement outlines the major factors that the Board will consider when making its determination.

### **ABOUT THE AUTHORS**

Douglas P. Faucette is a banking attorney in Locke Lord Bissell & Liddell’s corporate department in Washington, DC. Mr. Faucette has more than 30 years of experience representing publicly and privately held companies in a variety of corporate and securities transactions. In the past decade, he has been involved in the passage of all major financial institution legislation including FIRREA and FDICIA.

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