

Client Alert

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BAKER & MCKENZIE

New Federal Reserve Policy Expands Opportunities for Minority Investments in U.S. Banks

Earlier this week, the Board of Governors of the Federal Reserve System issued *A Policy Statement on Equity Investments in Banks and Bank Holding Companies* (the “Policy Statement”)¹ which expands the levels of investment which minority investors can make in banks and bank holding companies (“banking organizations”) in the United States, and permits such minority investors to play a more active role in influencing the policies and management of such institutions, without subjecting such investors to the strictures imposed by the Bank Holding Company Act (“BHCA”). While the Policy Statement applies generally to all potential investors in U.S. banking organizations, it is of particular relevance to private equity funds, sovereign wealth funds, hedge funds and other institutional investors with diversified portfolios of commercial and banking investments. Though it comes in the midst of the current financial crisis in the United States, the Policy Statement is the culmination of a dialogue by the Fed over an extended period, principally with private equity funds. The Policy Statement should facilitate the recapitalization of banking organizations affected by the current crisis.

The BHCA restrictions applicable to shareholders of banking organizations in the United States are based on two premises. The first is that a controlling shareholder must be a source of financial and managerial resources to the banking organization which it controls. In contrast, minority investors seeking to limit their potential exposure in the event of a failure of the banking organization are expected to limit their influence over the management and policies of the institution. The second premise is that a strict segregation of banking and commerce should be maintained, and that controlling shareholders of banking organizations in the United States should not be engaged in non-banking commercial activities, such as manufacturing, retailing or real estate investment. A shareholder which controls a banking organization in the United States is broadly prohibited by the BHCA from material investments in such commercial activities, and this has restrained the ability and willingness of private equity funds and other institutional investors to invest in such banking organizations. Significant minority investments have also

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¹ <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf>

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been unattractive, given restrictions on the influence which such investors are permitted to have on the banking organization's policies and management. It is a signature characteristic of private equity firms that, even as minority investors in their portfolio companies, they contribute to those companies and enhance their investments by seeking actively to influence and improve the policies and management of such companies. Private equity investors are by nature activist investors.

Generally, the BHCA defines control as (i) ownership of 25% or more of any class of voting stock of a banking organization, (ii) the ability to elect a majority of the board or other governing body of the banking organization, or (iii) the exercise of a controlling influence over the management or policies of the banking organization, as determined by the Fed after notice and the opportunity for a hearing. Under a 1982 Policy Statement, the Fed severely restricted the role of large minority shareholders in terms of their board representation, business relationships with the banking organization, and contacts with management.

Last week's Policy Statement sets new standards which will be applied by the Fed in determining whether minority shareholders exercise a controlling influence. In particular, under the new Policy Statement the Fed has taken the view that, subject to the distinctive facts and circumstances of each case:

- A minority investor generally should be able to have a single representative on the board of directors of a U.S. banking organization. Such an investor could have up to two representatives on the board (but not more than one-quarter of the board), where such representation is proportionate to the investor's total shareholding interest in the banking organization and there are no other indicia of control by such investor. Representatives of such minority investors on the board should not serve as chairman of the board or chairman of a board committee.
- A minority investor generally will not have a controlling influence if it owns a combination of voting and non-voting shares in a U.S. banking organization which in the aggregate do not exceed one-third of the total equity and do not allow the investor to own, hold or vote fifteen percent or more of any class of voting securities. To the extent that convertible shares are involved among such non-voting shares, such shares (assuming conversion) may not result in the investor having the right to own more than one-third of any class of voting shares and such convertible shares must meet certain restrictive standards previously established by the Fed.
- A minority investor may communicate with management about, and advocate changes in, any of the banking organization's policies and operations. Examples provided by the Policy Statement include advocating changes in dividend policy, discussing strategies for raising additional debt or equity financing, arguing that the banking organization should enter into or avoid a new business line or divest a material subsidiary, or advocating a merger with another banking organization or a sale of the banking organization to a potential acquirer. Such advocacy may extend to advocating changes in management. The Policy Statement cautions, however, that advocacy should not be accompanied by explicit or implicit threats to dispose of shares in the banking organization or to sponsor a proxy solicitation.

The Policy Statement also contemplates potential business relationships between the banking organization, the minority investor and its affiliates which are quantitatively and qualitatively limited. It also contemplates that the contractual relationship between the minority investor and the banking organization will not contain restrictions which substantially limit the discretion of management over major policies and decisions. Covenants restricting the hiring or firing of senior management or their compensation, engaging in new business lines or making substantial changes in operations, raising debt or equity, merging or consolidating, and the acquisition or disposal of material subsidiaries or assets are all viewed as suspect indicia of control.

Properly structured, private equity, sovereign wealth fund and other institutional investors -- through a combination of voting and non-voting shares, board representation and dialogue with management -- will now have the opportunity to make economically significant minority investments in banking organizations in the United States and exert a material voice in the restructuring of those organizations. This opens a new chapter of bank investment opportunities for such investors and an important source of additional capital for American financial institutions.

This information is intended to provide our readers with information on recent legal developments and issues of significant interest. It should not be regarded as legal advice or opinion.