Law360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What Fund Investors Should Know About Bank Control Rules

Law360, New York (July 7, 2016, 4:17 PM ET) --

Thomas P. Vartanian

David L. Ansell

Many private equity, hedge and mutual funds constantly have to confront the complex control rules that may impact even the smallest of investments in banks or bank holding companies (BHCs). The issue may be as simple as avoiding acquiring more than 10 percent of a BHC through the aggregation of all investments in that BHC by a number of commonly advised funds.

While passive and active investors are generally aware of the extensive federal and state restrictions on the acquisition of control of a BHC, less obvious is the fact that federal change-in-control rules also apply to the acquisition of securities in commercial and retail companies that directly or indirectly "control" a trust bank, credit card bank or industrial loan company.

Concept of Control

The magic concept of "control" for federal bank regulatory purposes generally arises when a company: owns 25 percent or more of any class of voting securities; controls the election of a majority of directors; or has the power to exercise a controlling influence over management or company policies. But federal banking agencies also use other factors to determine control, the most common of which is holding 10 percent or more of any class of a company's voting securities. At that point, a presumption of control arises, which must be rebutted. Since most bank investors cannot operate as BHCs, they must structure their investment to avoid control of a bank or its parent.

Over the past 15 years, novel investment structures have been approved — in part to accommodate private equity and hedge fund investments in financial institutions, and in part to moderate the adverse effects of the financial crisis when the recapitalization of failing and failed institutions was so important. Such structuring has included: (1) passive investments up to 33.3 percent of the total equity of a company; (2) "club" investments by an unaffiliated group of passive investors; and (3) "silo" structures created by asset management principals. Some of these continue to be viable structural options, but some have fallen out of favor and are no longer viewed as approvable outside an emergency situation.

Factors That Impact Control

To determine the amount of voting stock that an investor controls, federal rules apply certain principles that impact the ownership and control of company securities, including the following:

1. Voting securities underlying a convertible nonvoting security or option may be attributed to holders as voting securities, even if the investor doesn't vote them.
2. When persons and companies are associated with each other (e.g., through contract, employment, financial arrangements or a family relationship), the shares owned by them may be attributed to all of them.
3. The securities of shareholders who act in concert, form a group, or otherwise engage in parallel shareholder behavior may be aggregated and attributed to each of them, so that if the group controls more than 25 percent of a class of voting stock, it may qualify as a BHC.
4. Aggregation of various parties' stock ownership occurs for control purposes when persons, funds and companies that are related, affiliated, under common control, or acting in concert, own or control securities in the same bank, BHC or nonbank. This is often an issue with investment managers who operate a complex of different funds that invest independently in banking companies. Investment managers must ensure that their advised funds do not acquire, in the aggregate, in excess of 10 percent of the voting stock of a banking company, without prior bank regulatory approval.

The "Controlling Influence" Test

Perhaps the most challenging and mysterious questions for shareholders and their legal advisers is whether a combination of stock ownership, board seats, business relationships and other affiliations equate to a "controlling influence" that may trigger a control determination and the need for prior regulatory approval. While a controlling influence determination under the law technically requires a hearing, such hearings rarely, if ever, occur. Yet, the threat of a finding of controlling influence continues to be a significant governor of shareholder actions, causing most shareholders to be cautious about exercising what might otherwise be considered to be customary shareholder rights.

The Federal Reserve Board attempted to clarify these issues in a 2008 policy statement, which also serves as a general guide for other bank regulators with respect to control issues under their respective jurisdictions. The 2008 policy statement recognizes that there are no rigid rules in this area, and that decisions regarding the presence or absence of control must take into account the specific facts and circumstances of each case. It also recognizes that the exercise of a modicum of shareholder rights and influence does not necessarily amount to a controlling influence. A minority investor, like any other shareholder, may communicate with management of a banking organization and advocate for changes in the organization's management or policies (including advocating for a merger or sale of the company to a potential acquirer) without being deemed to control the institution. Although these types of discussions represent attempts by an investor to influence the management or policies of the organization, discussions alone are not the type of controlling influence targeted by the FRB. However, a minority investor must stop short of threatening to dispose of its shares or threatening a proxy contest if management fails to accede to its wishes.

As a matter of practice, the FRB often requires minority investors to provide "passivity commitments" to evidence their intent not to exercise a controlling influence over an organization, as well as the passive nature of their investment. Private equity and hedge fund investors are often surprised by the FRB's very broad interpretation of the entities within their organizations that must provide such passivity commitments, and by the broad and often undefined affiliated-party certifications that may be required.

The Rebuttal of Control

An investor that owns 10 percent or more, but less than 25 percent, of any class of voting stock, and who does not have more than one board seat and maintains only limited financial connections to the company, may rebut control of the company by, among other things, providing the FRB with written passivity commitments. This is a path that most investors take, since they cannot accommodate the operational limitations and financial commitments that BHC status would involve. The FRB's passivity commitments are now a relatively standard set of provisions, although they are tailored to the particular situation.

But passivity commitments typically handcuff shareholders, restricting them from, among other things: (1) exerting or attempting to exert a controlling influence over the institution; (2) engaging in any intercompany transactions with the institution (although current or contemplated future arrangements may be negotiated with the FRB); (3) soliciting proxies in opposition to management; (4) disposing or threatening to dispose of an equity interest in the institution as a condition of, or inducement for, specific action or inaction by the institution; and (5) having more than one representative on the board.

Proxy Contests

A shareholder's ability to either solicit or participate in a proxy contest usually raises complex control issues. On its face, a proxy solicitation would appear to be a direct attempt to influence management or the policies of a company. But the banking agencies have attempted over time to rationalize the control rules with the legitimate exercise of shareholder rights.

Shareholders that own less than 10 percent of a company's voting securities may be in the best position to conduct a proxy contest, since they will not necessarily have committed to passivity to rebut control. They can take advantage of the one-time proxy solicitation exemption under federal banking rules, as long as the proxy is revocable. Further, questions as to whether a group acting in concert has come into existence (thus causing the aggregation of the group's shares) usually arises in proxy contests, if for no other reason than companies will often oppose the solicitation by raising objections with regulators based on alleged violations of control rules.

Board Representation

The easiest way for a shareholder to have an influence on a regulated company is to have a representative on the board of directors. After all, a director's obligation is to oversee the way the company operates, consistent with the shareholder's fiduciary duties under state law. Shareholders who do not have a representative on the board of directors may express themselves to management, but they will not have the same leeway and margin for error, from a control perspective, as a director will have. Since 2008, the FRB has permitted a minority investor to have one, and in certain limited cases, two representatives on the board of directors. In that regard, an important factor in determining the number of director representatives a shareholder may have may be the existence of other large shareholders.

Structures That Limit Control

As noted above, there have been instances where a group of unrelated investors was able to acquire an aggregate interest that would constitute conclusive control if it were held by a single person, through

the use of a consortium (or “club”) structure. In essence, in a club structure, ownership is sufficiently dispersed among unaffiliated parties so that no individual investor is considered to be in a position to control the company by virtue of its equity interest or its relationship to the other investors; the same analysis applies to the investors collectively.

One of the first and most notable structures of this nature was permitted when the FRB general counsel indicated, in a July 18, 2007, letter, that a group of private equity firms and hedge funds that sought to acquire indirectly the voting stock of Doral Financial Corp. would not be deemed, individually or collectively, to control the company. For such structures to work, however, it is imperative that, among other things, there be a strong, independent management team that has credibility with the regulators. Further, the entity serving as a managing member or general partner that controls the day-to-day operations of the acquired financial institution must register as a BHC and accept the resulting restrictions.

A nonvoting equity or debt security may also be used to avoid control and BHC status. However, merely labeling a security as “nonvoting” does not end the analysis of whether it is truly nonvoting or noncontrolling. When a nonvoting security is found to have the indicia of a voting security, it will be treated as such for regulatory control purposes.

Various hybrid instruments that have characteristics of both debt and equity have been used to make noncontrolling investments. These instruments will be evaluated by regulators from a number of perspectives, including: (1) the obligation of the issuer to pay interest or dividends; (2) whether the return on the investment is fixed or based on the success of the issuer; (3) the voting rights of the holder; (4) the economic rights of holders in the event of the failure of the issuer; (5) whether the security has a limited life; and (6) whether the security is rated.

Investors may also be able to use a combination of voting and “restricted” convertible nonvoting securities to avoid control. For example, “conversion blockers” may be used to prevent the conversion of nonvoting securities if the conversion would cause an investor to own in the aggregate more than 9.9 percent, or more than 24.9 percent of any class, of voting securities. Transferability restrictions that, for example, prevent an investor from rapidly selling large amounts of voting securities and converting its nonvoting securities, or from selling nonvoting securities to other investors not subject to the conversion blocker, may also be useful in negating presumptions of regulatory control.

The circumstances under which an investor might be able to “reload” and convert an amount of its blocked securities to bring its voting security holdings back up to the blocker threshold will be an issue that needs to be discussed with regulators. Pro rata or voting sterilization provisions may also be used in some cases to limit the indicia of control.

Finally, voting trusts have been used in transitional situations where either a control determination or the time required to obtain approval for the transfer of a subsidiary financial institution would derail an otherwise permissible transaction.

Special Considerations for Registered Investment Companies

Registered investment companies, which are subject to strict regulation and oversight by the U.S. Securities and Exchange Commission under the Investment Company Act of 1940, are generally subject to the same control and acting in concert rules as other investors, despite their unique structure and passive investment mandate. While there is a “fiduciary exception” built into the control rules, that

exception has not been uniformly construed or applied. Shares of BHCs owned by commonly advised funds generally must be aggregated across the entire fund family for purposes of complying with the bank control rules.

However, the FRB has issued no-action letters to several fund families allowing them to acquire up to 15 percent of the voting stock of a BHC (rather than 10 percent) without the need for prior regulatory approval. Fund families that take advantage of this additional investment flexibility must enter into specialized passivity commitments with the FRB that, among other things, require the adviser to vote any shares held in excess of 10 percent on a “mirror” basis with other shareholders or, if mirror voting cannot be implemented, not to vote the excess shares at all.

Conclusion

The complexities of bank control are the product of some 40 years of contrasting and sometimes inconsistent transactions. Many of the rules, norms and conventional wisdom have not been written down by the regulators. Further information regarding this area of the law is contained in "The Bank Investor’s Survival Guide," which reflects our analysis of the many tools that have been used to structure transactions in ways that will not raise bank control issues.

—By Thomas P. Vartanian and David L. Ansell, Dechert LLP

Thomas Vartanian is a partner in Dechert's Washington, D.C., office. Vartanian served in the Reagan administration as the general counsel of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corp.

David Ansell is a partner in the firm's Washington office.

This article is based on "The Bank Investor’s Survival Guide: A Guide for Private Equity, Hedge Fund, Mutual Fund & Activist Investors to Navigate U.S. Federal Bank Investment Rules," a new book by Thomas P. Vartanian, David L. Ansell and Robert H. Ledig.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2016, Portfolio Media, Inc.