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EQUITY INVESTMENTS IN BANKS AND NONBANKS

Remarks of

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I. Introduction

My topic today is recent changes in the Federal Reserve's policies with respect to equity investments in banks and bank holding companies. These changes also liberalize the Fed's rules concerning equity investments in nonbanks by bank holding companies and foreign banks.

First, I will discuss the background to these changes, then the changes themselves and close out with some general observations about the prospects for bank holding companies and foreign banks subject to the Bank Holding Company Act to engage in expanded nonbanking activities in the United States in the wake of current market crises.

It is important to note at the outset that absent changes in the statute there are limitations on the ability of the Fed to make major changes to the control test. As a result, the changes in the policy statement are more in the nature of incremental changes.

II. Background

As we all know, the acquisition of "control" of a U.S. bank or bank holding company subjects the acquiring company to the requirements of the U.S. Bank Holding Company Act. The statutory definitions of control include acquiring 25 percent or more of the voting shares of a bank or bank holding company,

controlling the election of a majority of the board of directors or having the power to exercise a controlling influence over the management or policies of the bank or bank holding company. This last prong of the definition opened the door to more than 25 years of Fed interpretation of the meaning of this phrase, including regulatory presumptions of control in Regulation Y, Fed policy statements on control and numerous interpretations in the context of individual cases.

In making these interpretations, the Fed has frequently been more conservative than the industry has believed was necessary. Thus, there has been an ongoing effort for many years to persuade the Fed to liberalize these standards in various contexts. Last year, the Fed announced that it would review the control tests in a review of Regulation Y. The result was the September policy statement, which will be published as a Board interpretation of Regulation Y at 12 CFR 225.144.

While there are many threads to this debate, including the application of the control tests to foreign banks abroad, the primary impetus to the Policy Statement was the Fed's openness to permitting nonbanking companies like private equity funds to make more significant investments in banks without thereby becoming subject to the requirements of the Bank Holding Company Act. The need of the U.S. banking industry for capital was no doubt a factor in the Fed's deliberations.

The result is that the Fed has made changes to its current policies that will make it easier for a nonbanking firm or fund to make investments in banks without becoming bank holding companies. They also liberalize the ability of bank holding companies and foreign banks to make investments in nonbanking firms under the authority of section 4(c)(6) of the BHCA, i.e., without having to rely on independent authority under the BHCA to engage in the activities of the firms they invest in, such as activities that are financial in nature. Section 4(c)(6) permits a bank holding company to hold up to 5 percent of the voting shares of a company regardless of the nature of the company's business, subject to the restrictions that the Fed has developed over the years. Not only will foreign banks now be able to hold more equity in such firms, but the traditional Fed restrictions intended to ensure that such investments be "passive" in nature have been relaxed to a certain extent.

III. Summary of the Principal Changes and Concepts in the Policy Statement

I will now run through the three principal changes in the Policy Statement. A more detailed analysis of the policy statement is set forth in Mayer Brown's alert which is included in the handouts.

First, with respect to the amount of equity, before the issuance of the Policy Statement, the Board's general position was that nonvoting equity investments that

exceed 25 percent of the “total equity” of a banking organization raise control issues under the BHCA. The Policy Statement now recognizes the conditional ability of an investor to acquire up to 33 percent of total equity (and up to 15 percent of any class of voting securities) without the investor having a controlling influence. Thus, a private equity fund may hold up to 33 percent of the equity of a bank without being deemed, on that basis alone, to exercise a controlling influence over the bank. By the same token, a bank holding company could possibly hold up to 33 percent of the nonvoting equity of a US nonbanking firm, subject to the 5 percent limit on voting securities in section 4(c)(6).

Second, with respect to board representation, before the issuance of the Policy Statement, the Board generally has not permitted a company that acquires between 10 and 24.9 percent of the voting stock of a banking organization to have representation on the organization’s board of directors. The principal exception to this guideline has been in situations in which the investor owned less than 15 percent of the banking organization’s voting stock and another person (or group of persons acting together) owned a larger block of the organization’s voting stock. The Policy Statement liberalizes the ability of a noncontrolling investor to have representatives on the board. For example, a minority investor who may hold up to 24.9 percent of the bank’s voting securities may generally be able to have a representative on the board of a bank, absent other indicia of control. In addition, a

minority investor generally should be able to have up to two representatives on the bank's board, subject to certain conditions including that another shareholder of the banking organization is a bank holding company that controls the bank.

A timely example of the new policy in practice is the Fed's recent approval of Mitsubishi UFJ Financial Group's noncontrolling investment in 24.9 percent of the voting shares of Morgan Stanley. Mitsubishi UFJ has the right to have one director on Morgan Stanley's board. Under the old policy the presence of the director, in the absence of any larger shareholders, would have been inconsistent with the Fed's determination that the investment is noncontrolling.

Subject to the fact that section 4(c)(6) does not apply to investments in more than 5 percent of the voting securities of a company, these changes also expand the ability of bank holding companies and foreign banks to have a voice on a nonbanking firm's board of directors without being deemed to exercise a controlling influence over the firm. The changes should also facilitate partnering in bank investments between, for example, a private equity fund and another bank holding company, so long as the bank holding company investor controls the bank.

Third, with respect to communications, the Board has provided new guidance on the extent to which consultations between a passive investor and management of the bank in which the investment was made would be consistent

with a “noncontrol” determination. The Policy Statement provides that a noncontrolling minority investor may communicate generally with bank management about, and advocate with management for changes in, any of the bank’s policies and operations. Thus, the Policy Statement provides greater certainty to private equity funds and other investors about the extent to which they can advise a banking organization without being deemed to be a “nonpassive” investor. For example, the investor may directly or through a representative on a bank’s board of directors argue that the bank should enter into or avoid a new business line or divest a material subsidiary and attempt to convince bank management to merge the bank with another firm or sell the bank to a potential acquirer. Foreign banks and bank holding companies can also rely on these principles with respect to nonbanking companies in which they make nonvoting equity investments.

At least two basic principles, however, remain unaffected by the Policy Statement. First, the Policy Statement did not – and, of course, could not – change the basic BHCA statutory thresholds for banking organization “control,” such as ownership or control of 25 percent or more of the voting shares of a banking organization, which will continue to have an inhibiting effect on outside investments in banking organizations. Second, the Policy Statement made it clear that the determination of the presence or absence of “control” through a

"controlling influence" still is very much a facts-and-circumstances inquiry that does not lend itself to a statement of broad principles of control or non-control.

IV. Other Observations

I would like to close with some observations on the developments in the current crisis and their possible import for the US nonbanking activities of foreign banks. One of the most significant developments is the difficulties of independent investment banks and the various prognostications that the independent investment banking model is dead. Almost as dramatic as the disappearance from the scene of Bear Stearns and Lehman Brothers are the decisions by Goldman Sachs and Morgan Stanley to become bank holding companies subject to the nonbanking restrictions of the BHCA. What does all this mean for the future?

One important point is the impact on the traditional role of the independent investment banks in leading the way on product and activity innovations. Putting aside for the moment the overall change in climate and the likelihood of greater regulation, now that the independent investment banking model may be disappearing, and the major surviving investment banks are now all subject to Fed supervision, will the Fed be less willing in the future to expand the permissible activities of FHC's? In expanding those powers, the Fed often has looked to the activities of competitors such as investment banks. That impetus may be much

reduced going forward. Last year at this conference we spoke about new initiatives for FHC's in the energy area that the Fed was working on, and these activities, energy management agreements and tolling activities, have since been approved. Bear Stearns and other investment banks were active in these areas. Will the Fed now become more cautious in expanding activities both because of the change in climate and because the FHC's will not have the competition of independent investment banks to point to? This could very well be the case.

Two other aspects of this are also worthy of note. The US investment banks may now all be in the Fed's fold. But it is still very easy for foreign banks to leave the fold. Those foreign banks that have branches or agencies can still debank and cease to be subject to the BHCA. Will some foreign banks pursue this option and seek to become new forces for innovation in the US markets, assuming their home country authorities do not limit the scope of their activities through U.S. affiliates? In addition, competition from markets offshore could continue to push the Fed to liberalize in the U.S. Will greater coordination of regulatory policy on a global basis reduce the opportunities for such "regulatory arbitrage?"

It is somewhat ironic that in the midst of a financial crisis of historic proportions, in which many have seen lack of adequate regulation as a major cause, the Fed loosened long established restrictions on noncontrolling investments in

banks. The question now is whether the Fed will take further steps in the years ahead to expand the permissible activities of FHCs or otherwise lighten regulation under the BHCA or whether the calls for increased regulation more generally will put a halt for the foreseeable future to the willingness of the Fed to take such steps.