FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 77-20
February 3, 1977

INTERPRETATION OF REGULATION Y

Acquisition of Shares Pursuant to Section 4(c) (6)
Of the Bank Holding Company Act

TO ALL MEMBER BANKS,
BANK HOLDING COMPANIES,
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has issued an interpretation of its Regulation Y, "Bank Holding Companies," in connection with a proposal under which a number of bank holding companies would each purchase a stock interest representing less than 5 percent of the voting shares of an insurance company that would engage in underwriting or reinsuring credit life and credit accident and health insurance sold in connection with extensions of credit by each stockholder. The Board has determined that a bank holding company wishing to become a stockholder in the company would be required to obtain the Board's prior approval to do so, and that the exemption from such approval provided by section 4(c) (6) of the Bank Holding Company Act was intended to be limited to passive investments.

Enclosed is a copy of the interpretation. Any inquiries thereon may be directed to our Regulations Department at (214) 651-6169. Additional copies of the interpretation will be furnished upon request to the Secretary's Office of this Bank (214) 651-6267.

Sincerely yours,

Robert H. Boykin

First Vice President

Enclosure

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BANK HOLDING COMPANIES

INTERPRETATION OF REGULATION Y

SECTION 225.137 — ACQUISITIONS OF SHARES PURSUANT TO §4(c)(6) OF THE BANK HOLDING COMPANY ACT

(a) The Board has received a request for an interpretation of §4 (c) (6) of the Bank Holding Company Act ("Act")* in connection with a proposal under which a number of bank holding companies would purchase interests in an insurance company to be formed for the purpose of underwriting or reinsuring credit life and credit accident and health insurance sold in connection with extensions of credit by the stockholder bank holding companies and their affiliates.

(b) Each participating holding company would own no more than 5 percent of the outstanding voting shares of the company. However, the investment of each holding company would be represented by a separate class of voting security, so that each stockholder would own 100 percent of its respective class. The participating companies would execute a formal "Agreement Among Stockholders" under which each would agree to use its best efforts at all times to direct or recommend to customers and clients the placement of their life, accident, and health insurance directly or indirectly with the company. Such credit-related insurance placed with the company would be identified in the records of the company as having been originated by the respective stockholder. A separate capital account would be maintained for each stockholder consisting of the original capital contribution increased or decreased from time to time by the net profit or loss resulting from the insurance business attributable to each stockholder. Thus, each stockholder would receive a return on its investment based upon the claims experience and profitability of the insurance business that it had itself generated. Dividends declared by the board of directors of the company would be payable to each stockholder only out of the earned surplus reflected in the respective stockholder's capital account.

(c) It has been requested that the Board issue an interpretation that §4(c)(6) of the Act provides an exemption under which participating bank holding companies may acquire such interests in the company without prior approval of the Board.

(d) On the basis of a careful review of the documents submitted, in the light of the purposes and provisions of the Act, the Board has concluded that §4(c)(6) of the Act is inapplicable to this proposal and that a bank holding company must obtain the approval of the Board before participating in such a proposal in the manner described. The Board's conclusion is based upon the following considerations:

(1) Section 2(a)(2)(A) of the Act provides that a company is deemed to have control over a second company if it owns or controls "25 per centum or more of any class of voting securities" of the second company. In the case presented, the stock interest of each participant would be evidenced by a different class of stock and each would, accordingly, own 100 percent of a class of voting securities of the company. Thus, each of the stockholders would be deemed to "control" the company and prior Board approval would be required for each stockholder's acquisition of stock in the company.

The Board believes that this application of §2(a)(2)(A) of the Act is particularly appropriate on the facts presented here. The company is, in practical effect, a conglomeration of separate business ventures each owned 100 percent by a stockholder the value of whose economic interest in the company is determined by reference to the profits and losses attributable to its respective class of stock. Furthermore, it is the Board's opinion that this application of §2(a)(2)(A) is not inconsistent with §4(c)(6). Even assuming that §4(c)(6) is intended to refer to all outstanding voting shares, and not merely the outstanding shares of a particular class of securities, §4(c)(6) must be viewed as permitting ownership of 5 percent of a company's voting stock only when that ownership does not constitute "control" as otherwise defined in the Act. For example, it is entirely possible that a company could exercise a controlling influence over the management and policies of a second company, and thus "control" that company under the Act's definitions, even though it held less than 5 percent of the voting stock of the second company. To view §4(c)(6) as an unqualified exemption for holdings of less than 5 percent would thus create a serious gap in the coverage of the Act.

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*Section 4(c)(6) of the Act provides an exemption from the Act's prohibitions on ownership of shares in nonbanking companies for "shares of any company which do not include more than 5 per centum of the outstanding voting shares of such company."

(2) The Board believes that §4(c)(6) should properly be interpreted as creating an exemption from the general prohibitions in §4 on ownership of stock in nonbank companies only for passive investments amounting to not more than 5 percent of a company's outstanding stock, and that the exemption was not intended to allow a group of holding companies, through concerted action, to engage in an activity as entrepreneurs. Section 4 of the Act, of course, prohibits not only owning stock in nonbank companies, but engaging in activities other than banking or those activities permitted by the Board under §4(c)(8) as being closely related to banking. Thus, if a holding company may be deemed to be engaging in an activity through the medium of a company in which it owns less than 5 percent of the voting stock it may nevertheless require Board approval, despite the §4(c)(6) exemption.

(e) To accept the argument that §4(c)(6) is an unqualified grant of permission to a bank holding company to own 5 percent of the shares of any nonbanking company, irrespective of the nature or extent of the holding company's participation in the affairs of the nonbanking company would, in the Board's view, create the potential for serious and widespread evasion of the Act's controls over nonbanking activities. Such a construction would allow a group of 20 bank holding companies — or even a single bank holding company and one or more nonbank companies — to engage in entrepreneurial joint ventures in businesses prohibited to bank holding companies, a result the Board believes to be contrary to the intent of Congress.

(f) In this proposal, each of the participating stockholders must be viewed as engaging in the business of insurance underwriting. Each stockholder would agree to channel to the company the insurance business it generates, and the value of the interest of each stockholder would be determined by reference to the profitability of the business generated by that stockholder itself. There is no sharing or pooling among stockholders of underwriting risks assumed by the company, and profit or loss from investments is allocated on the basis of each bank holding company's allocable underwriting profit or loss. The interest of each stockholder is thus clearly that of an entrepreneur rather than that of an investor.

(g) Accordingly, on the basis of the factual situation before the Board, and for the reasons summarized above, the Board has concluded that §4(c)(6) of the Act cannot be interpreted to exempt the ownership of 5 percent of the voting stock of a company under the circumstances described, and that a bank holding company wishing to become a stockholder in a company under this proposal would be required to obtain the Board's approval to do so.