

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. 9323 ]  
July 15, 1982 ]

**NONVOTING EQUITY INVESTMENTS BY BANK HOLDING COMPANIES**

**Board of Governors' Policy Statement**

*To All Bank Holding Companies, and Others Concerned,  
in the Second Federal Reserve District:*

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued a policy statement setting forth its concerns and providing guidance with respect to investments by bank holding companies in nonvoting shares of other bank holding companies or banks. The statement notes considerations the Board will take into account in determining whether such investments are consistent with the Bank Holding Company Act, and describes the general scope of arrangements to be avoided in these agreements.

The Board's statement was occasioned by the fact that, in recent months, a number of bank holding companies have made substantial equity investments in banks or bank holding companies located across state lines, in expectation of statutory changes that might make interstate banking permissible.

In issuing its statement, the Board said:

Because of the evident interest in these types of investments and because they raise substantial questions under the Bank Holding Company Act, the Board believes it is appropriate to provide guidance regarding the consistency of such arrangements with the Act.

The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

While investments in nonvoting shares can be consistent with the Act, the statement said, some agreements reviewed by the Board raise substantial problems regarding control. The statement provides examples of the problem features of some agreements. As guidance for bank holding companies contemplating such investments, the Board statement points to a number of provisions that might avoid control questions, by preserving the discretion of management over the policies and decisions of a banking organization.

These provisions, spelled out in the Board's statement, are:

1. Covenants to these investment agreements that are not restrictive, and leave management free to conduct banking and permissible nonbanking activities.
2. Provisions giving management of the bank whose shares are being acquired the right to "call" (buy back) equity investments and options and warrants, so as to eliminate any restrictions on its policies, thus making these agreements similar to loans whose restrictive covenants can be discharged by repayment.
3. Agreements involving rights to less than 25 percent of the voting shares of a bank that require a widely dispersed public offering in the event of sale by the investing bank holding company.

The Board indicated certain provisions that are nevertheless to be avoided regardless of other provisions:

- A. Agreements that enable the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 percent of any class of the voting shares of a banking organization;
- B. Agreements that allow the investing company to direct the use of its investment for certain ends, such as the purchase and redemption of voting shares; and
- C. The acquisition of more than 5 percent of the voting shares of a bank holding company that simultaneously with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

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The Board has instructed its staff to monitor agreements respecting investments by bank holding companies in nonvoting shares of banking organizations and to bring to the Board's attention those that raise problems of consistency with the Act. The Board requests bank holding companies to submit such proposals to the Board for review prior to being made final.

Enclosed — for bank holding companies — is the complete text of the policy statement issued by the Board of Governors setting forth its position regarding nonvoting equity investments by bank holding companies; it will be published in the *Federal Register*, and will be furnished to others upon request directed to the Circulars Division of this Bank. Questions thereon may be directed to our Domestic Banking Applications Department (Tel. No. 212-791-5861).

ANTHONY M. SOLOMON,  
*President.*

Board of Governors' Policy Statement

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued a policy statement setting forth its views and providing guidance with respect to investments by bank holding companies in nonvoting shares of other bank holding companies or banks. The statement notes that the Board will take into account the economic and financial characteristics of the investments, as well as the Federal Reserve's general policy of encouraging the growth of bank holding companies. The Board's statement was developed by the fact that, in recent months, a number of bank holding companies have made substantial equity investments in banks or other bank holding companies. These investments have the potential to change the important characteristics of the banks.

In issuing this statement, the Board and the Board of Governors believe that these types of investments and because they raise important questions under the Bank Holding Company Act, the Board believes it appropriate to provide guidance regarding the propriety of such investments with the Act.

The Board recognizes that the complexity of the business structure of bank holding companies often raises questions over all situations and that decisions regarding the exercise of control in any particular case are not always clear. The Board's statement is intended to provide guidance in the exercise of control in the general case and to account for the effect of the structure of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

While investments in nonvoting shares can be consistent with the Act, the statement and some agreements reviewed by the Board raise several problems regarding control. The statement provides examples of the problem factors of such agreements. As guidance for bank holding companies contemplating such investments, the Board statement points to a number of provisions that might avoid control questions, by preserving the discretion of management over the policies and actions of a banking organization.

These provisions, spelled out in the Board's statement, are:

1. Covenants that invest investment agreements that are not restrictive, and leave management free to conduct banking and provide nonbanking activities.
2. Provisions giving management of the bank whose shares are being acquired the right to "call" (buy back) equity investments and options and warrants, so as to eliminate any restrictions on its policies, thus insuring that agreements similar to loans whose restrictive covenants can be discharged by repayment.
3. Agreements involving rights to less than 50 percent of the voting shares of a bank that require a wholly dispersed public offering in the event of sale by the investing bank holding company.

The Board indicated certain provisions that are nevertheless to be avoided regardless of other provisions:

- A. Agreements that enable the investing bank holding company (or its designee) to elect to any manner the voting of more than 5 percent of any class of the voting shares of a bank or organization.
- B. Agreements that allow the investing company to direct the use of its investment for certain ends, such as the purchase and redemption of voting shares, and
- C. The acquisition of more than 5 percent of the voting shares of a bank holding company that simultaneously with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and have to voting shares when transferred to a third party.

FEDERAL RESERVE SYSTEM

12 C.F.R. Part 225

Bank Holding Companies and Change in Bank Control

Statement of Policy on Nonvoting Equity Investments  
by Bank Holding Companies

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy Statement.

SUMMARY: In recent months, a number of bank holding companies have made substantial equity investments in banks or bank holding companies located in states other than the home state of the investing bank holding company and have entered into various merger or asset acquisition agreements with these companies or banks that are to be consummated in the event interstate banking is permitted. These investments are accompanied by rights to a substantial amount of the voting shares of the acquiree bank holding company or its subsidiary bank(s). Because of the evident interest in such investments or agreements and because they raise major questions under the Bank Holding Company Act, the Board has issued this statement to provide guidance regarding the consistency of such agreements with the Act.

DATE: July 8, 1982.

FOR FURTHER INFORMATION CONTACT: James V. Mattingly, Jr., Associate General Counsel (202/452-3430) or Kathleen O'Day, Senior Attorney (202/452-3786) or Scott Alvarez, Attorney (202/452-3583) Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

Pursuant to its authority under the Bank Holding Company Act (12 U.S.C. §§ 1841 et seq.) and section 225.2 of Regulation Y (12 C.F.R. § 225.2), the Board issues the following policy statement to be codified at § 225.143:

[Encl. Cir. No. 9323]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
POLICY STATEMENT ON NONVOTING EQUITY INVESTMENTS BY  
BANK HOLDING COMPANIES

I. Introduction

In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding company (the "acquiree") located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the Bank Holding Company Act (the "Act"), the Board believes it is appropriate to provide guidance regarding the consistency of such arrangements with the Act.

This statement sets out the Board's concerns with these investments, the considerations the Board will take into account in determining whether the investments are consistent with the Act, and the general scope of arrangements to be avoided by bank holding companies. The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

## II. Statutory and Regulatory Provisions

Under section 3(a) of the Act, a bank holding company may not acquire direct or indirect ownership or control of more than 5 per cent of the voting shares of a bank without the Board's prior approval. (12 U.S.C. § 1842(a)(3)). In addition, this section of the Act provides that a bank holding company may not, without the Board's prior approval, acquire control of a bank: that is, in the words of the statute, "for any action to be taken that causes a bank to become a subsidiary of a bank holding company." (12 U.S.C. § 1842(a)(2)). Under the Act, a bank is a subsidiary of a bank holding company if:

1. the company directly or indirectly owns, controls, or holds with power to vote 25 per cent or more of the voting shares of the bank;
2. the company controls in any manner the election of a majority of the board of directors of the bank; or
3. the Board determines, after notice and opportunity for hearing, that the company has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the bank. (12 U.S.C. § 1841(d)).

In intrastate situations, the Board may approve bank holding company acquisitions of additional banking subsidiaries. However, where the acquiree is located outside the home state of the investing bank holding company, section 3(d) of the Act prevents the Board from approving any application that will permit a bank holding company to "acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank." (12 U.S.C. § 1842(d)(1)).

### III. Review of Agreements

In apparent expectation of statutory changes that might make interstate banking permissible, bank holding companies have sought to make substantial equity investments in other bank holding companies across state lines, but without obtaining more than 5 per cent of the voting shares or control of the acquiree. These investments involve a combination of the following arrangements:

1. options on, warrants for, or rights to convert nonvoting shares into substantial blocks of voting securities of the acquiree bank holding company or its subsidiary bank(s);
2. merger or asset acquisition agreements with the out-of-state bank or bank holding company that are to be consummated in the event interstate banking is permitted;
3. provisions that limit or restrict major policies, operations or decisions of the acquiree; and
4. provisions that make acquisition of the acquiree or its subsidiary bank(s) by a third party either impossible or economically impracticable.

The various warrants, options, and rights are not exercisable by the investing bank holding company unless interstate banking is permitted, but may be transferred by the investor either immediately or after the passage of a period of time or upon the occurrence of certain events.

After a careful review of a number of these agreements, the Board believes that investments in nonvoting stock, absent other arrangements, can be consistent with the Act. Some of the agreements reviewed appear consistent with the Act since they are limited to investments

of relatively moderate size in nonvoting equity that may become voting equity only if interstate banking is authorized.

However, other agreements reviewed by the Board raise substantial problems of consistency with the control provisions of the Act because the investors, uncertain whether or when interstate banking may be authorized, have evidently sought to assure the soundness of their investments, prevent takeovers by others, and allow for sale of their options, warrants, or rights to a person of the investor's choice in the event a third party obtains control of the acquiree or the investor otherwise becomes dissatisfied with its investment. Since the Act precludes the investors from protecting their investments through ownership or use of voting shares or other exercise of control, the investors have substituted contractual agreements for rights normally achieved through voting shares.

For example, various covenants in certain of the agreements seek to assure the continuing soundness of the investment by substantially limiting the discretion of the acquiree's management over major policies and decisions, including restrictions on entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters. By their terms, these covenants suggest control by the investing company over the management and policies of the acquiree.

Similarly, certain of the agreements deprive the acquiree bank holding company, by covenant or because of an option, of the right to sell, transfer, or encumber a majority or all of the voting shares of its subsidiary bank(s) with the aim of maintaining the integrity of the investment and preventing takeovers by others. These long-term restrictions on

voting shares fall within the presumption in the Board's Regulation Y that attributes control of shares to any company that enters into any agreement placing long-term restrictions on the rights of a holder of voting securities. (12 C.F.R. § 225.2(b)(4)).

Finally, investors wish to reserve the right to sell their options, warrants or rights to a person of their choice to prevent being locked into what may become an unwanted investment. The Board has taken the position that the ability to control the ultimate disposition of voting shares to a person of the investor's choice and to secure the economic benefits therefrom indicates control of the shares under the Act.<sup>1/</sup> Moreover, the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, may result in such a substantial position of leverage over the management of the acquiree as to involve a structure that inevitably results in control prohibited by the Act.

#### IV. Provisions That Avoid Control

In the context of any particular agreement, provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control. The Board believes that such agreements will not be consistent with the Act unless provisions are included that will preserve management's discretion over the policies and decisions of the acquiree and avoid control of voting shares.

As a first step towards avoiding control, covenants in any agreement should leave management free to conduct banking and permissible nonbanking activities. Another step to avoid control is the right of the acquiree to "call" the equity investment and options or warrants

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<sup>1/</sup> See Board letter dated March 18, 1982, to C.A. Cavendes, Sociedad Financiera.

to assure that covenants that may become inhibiting can be avoided by the acquiree. This right makes such investments or agreements more like a loan in which the borrower has a right to escape covenants and avoid the lender's influence by prepaying the loan.

A measure to avoid problems of control arising through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree would be a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of these rights if the right of first refusal is not exercised.

In this connection, the Board believes that agreements that involve rights to less than 25 per cent of the voting shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the Act than agreements involving a greater percentage. This guideline is drawn by analogy from the provision in the Act that ownership of 25 per cent or more of the voting securities of a bank constitutes control of the bank.

The Board expects that one effect of this guideline would be to hold down the size of the nonvoting equity investment by the investing company relative to the acquiree's total equity, thus avoiding the potential for control because the investor holds a very large proportion of the acquiree's total equity. Observance of the 25 per cent guideline will also make provisions in agreements providing for a right of first refusal or a public and widely dispersed offering of rights to the acquiree's shares more practical and realistic.

Finally, certain arrangements should clearly be avoided regardless of other provisions in the agreement that are designed to avoid control.

These are:

1. agreements that enable the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 per cent of the voting shares of the acquiree;
2. agreements whereby the investing company has the right to direct the acquiree's use of the proceeds of an equity investment by the investing company to effect certain actions, such as the purchase and redemption of the acquiree's voting shares; and
3. the acquisition of more than 5 per cent of the voting shares of the acquiree that "simultaneously" with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

V. Review by the Board

This statement does not constitute the exclusive scope of the Board's concerns, nor are the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board has instructed its staff to review agreements of the kind discussed in this statement and to bring to the Board's attention those that raise problems of consistency with the Act. In this regard, companies are requested to notify the Board of the terms

of such proposed merger or asset acquisition agreements or nonvoting equity investments prior to their execution or consummation.

Board of Governors of the Federal Reserve System, July 8, 1982.

(signed) William W. Wiles

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William W. Wiles  
Secretary of the Board

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