

Private Equity Investments in Financial Services Firms: Threading the Regulatory Needle

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Introduction

Financial services firms, especially bank and thrift holding companies, have been actively seeking and raising capital to replenish capital lost in the credit crisis, take advantage of distress among their competitors, and meet higher regulatory capital requirements. The values of financial services firms' stocks dropped dramatically as a result of the credit crisis which created opportunities for investors to purchase significant equity stakes at relatively low prices. These opportunities allowed bank and thrift holding companies to attract new capital, often on terms that were highly dilutive to existing holders. In some cases, the capital was necessary for survival. In many others, it provided the means to enhance the holding company's franchise and to expand organically and by acquisition.

The desirability of private capital was driven by other factors as well. Many applicants for the Troubled Asset Relief Program (TARP) established under the Emergency Economic Stabilization Act of 2008¹ were required to raise a matching amount of equity in order to receive capital injections from the U.S. Department of the Treasury under TARP. Many private equity firms viewed acquisitions of assets and liabilities of failed banks from the Federal Deposit Insurance Corporation (FDIC) as an attractive way to enter the banking business. Two of the larger early bank failures, BankUnited, FSB in

Coral Gables, Florida and IndyMac Bank, F.S.B. in Pasadena, California, were acquired by private equity groups from the FDIC, as receiver, in this manner.² The concept of matching private capital is also included in the Treasury's new Small Business Lending Fund established under Title IV of the Small Business Jobs Act of 2010.³

Private equity investors that desire to make investments in bank or thrift holding companies face several important regulatory hurdles: navigating the requirements of the Bank Holding Company Act of 1956 (the BHC Act)⁴ and the Change in Bank Control Act (the CIBC Act)⁵, and designing investment structures that comply with guidance issued by the Board of Governors of the Federal Reserve System (Federal Reserve) and the FDIC.

Investments must be significant enough to warrant the initial diligence and the post-investment administration and have a meaningful effect on private equity funds' total returns to their investors. At the same time, most private equity firms, unless these investors are bank holding companies or are willing to and can become bank holding companies under the BHC Act, cannot "control" or "exercise a controlling influence over the management and policies" of the banks in which they invest. The BHC Act requires any company that seeks to "control" or "exercise a controlling influence" over a bank to

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obtain prior approval from the Federal Reserve and be regulated on an ongoing basis as a bank holding company.⁶ Generally, private equity firms do not want to become bank holding companies either because of the added regulation or because their other investments are not permissible for bank holding companies.

Investors seeking entrance into the industry have sought structures that satisfy the concerns of the bank regulators, but provide flexibility in a period of uncertainty. For instance, some investors attempted to structure “blind pools” (*i.e.*, investment vehicles similar in effect to “blank check” offerings that raise capital for unspecified purposes) in compliance with Federal Reserve and FDIC policies to raise capital for “shelf charter” banks⁷ that could be used to bid upon failed banks. Some sought pre-clearance from the OTS to form federal thrifts in order to bid on failed banks. Regardless of the path chosen, the FDIC had to approve the new entity to bid on failed institutions. Investors also sought to invest in or acquire smaller banks to use as vehicles for expansion through open bank and FDIC-assisted acquisitions, which were dubbed “inflatable charters.”⁸

The Federal Reserve’s Policy Statement on Equity Investments in Banks and Bank Holding Companies (the Federal Reserve Policy Statement)⁹ and FDIC’s Final Statement of Policy on Qualifications for Failed Bank Acquisitions (the FDIC Policy Statement)¹⁰ provide the current regulatory framework for such investments.

This article discusses some of the specific challenges encountered by private equity investors under the BHC Act, the CIBC Act, and the Federal Reserve and FDIC Policy Statements, as well as other issues that arise in connection with private equity investments in depository institutions and their holding companies.

Control

Whether or not a private equity firm is in “control” of a bank or bank holding company for BHC Act, CIBC Act, and other purposes is a factual and legal determination. Because most private equity firms either choose not to or cannot be bank holding companies, the Federal Reserve has to determine, in the case of investments in bank holding companies, that their investment will not result in their “control” of a bank for BHC Act purposes. This determination involves detailed factual presentations to the Federal Reserve about the organization, ownership, management, and principal investors in the private equity funds. The Federal Reserve’s analysis under the BHC Act takes into consideration the amount of bank or bank holding company voting securities to be purchased by the private equity investor (including any options, warrants, or other securities that may be converted into voting securities that the private equity investor acquires as part of the transaction) and the private equity investor’s percentage of voting ownership following its investment in the bank. Often, a company may acquire up to 24.9 percent of a bank’s or bank holding company’s common stock without triggering registration or regulation requirements under the BHC Act.¹¹

In addition to the BHC Act requirements, the CIBC Act also needs to be considered. A presumption of control under the CIBC Act is triggered in a public company by direct or indirect ownership of 10 percent or more of the institution’s outstanding common stock.¹² If the CIBC Act is triggered, the private equity investor must submit a notice to the Federal Reserve that includes not only extensive information about the private equity entity itself, but also detailed biographical and financial information (including fingerprints) from the individuals who control the private equity investor. Some private equity companies are unwilling to file a CIBC Act notice because of the intrusive nature of the notice and because, after approval, they will become an “institution-affiliated party” under Section 3(u) of the Federal Deposit Insurance Act (the FDI Act)¹³ and therefore will be subject to the

same potential regulatory liabilities as bank directors and officers. Other investors are willing to file a CIBC Act notice because, unlike the BHC Act, the CIBC Act does not impose any limitations on the investor's other activities or require the investor to serve as a source of strength to the bank. Often, a CIBC Act notice is necessary for the investors to invest a sufficient dollar amount in the financial institution.

Importantly, the Federal Reserve often takes into consideration other indicia of control besides voting stock as part of its control analysis. For example, the Federal Reserve usually scrutinizes the proposed size and composition of the target's board of directors following the proposed transaction. The Federal Reserve Policy Statement generally limits a private equity investor to one director on the bank's or bank holding company's board of directors.¹⁴ A board with mostly independent directors is important and private equity investors cannot be officers or board committee chairs of a bank holding company or its subsidiaries.

Since "control" can also include, in addition to share ownership and the election of directors, the power to exercise, directly or indirectly, a controlling influence over management or policies of the target institution, the Federal Reserve generally requires passivity and nonassociation commitments (the Federal Reserve Commitments) for entities that invest more than 5 percent to 10 percent or more in any class of voting securities of a bank or bank holding company. The Federal Reserve Commitments prevent such investors, either alone or acting in concert for purposes of the CIBC Act or as a group for purposes of the BHC Act, from influencing the management or policies of the institution.

Form of Investment

Private equity generally invests in banks through common stock. Prior to the Collins Amendment being enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-

Frank Act),¹⁵ convertible preferred stock was of interest to private equity investors. The Collins Amendment¹⁶ eliminates the use of cumulative preferred stock as Tier 1 capital for bank holding companies where it was a "restricted core capital element".¹⁷ Already investors have moved away from preferred stock because, early in the credit crisis, financial analysts and other industry participants adopted tangible common equity (TCE) as a standard of bank capital adequacy and strength, and preferred stock is not part of TCE, regardless of its terms.

Alternatively, some private equity investors have used nonvoting, convertible common stock to boost the bank's TCE while avoiding "control" of the bank for regulatory purposes. Instead of making an investment in a bank or bank holding company of only up to 24.9 percent voting securities, the Federal Reserve Policy Statement alternatively allows investors to invest up to 33 percent of the bank's or bank holding company's total equity, as long as not more than 14.9 percent is voting common equity.¹⁸ Warrants to purchase common stock are usually treated as shares of common stock for purposes of the Federal Reserve Policy Statement and for the Federal Reserve's control analysis. Preferred stock is often used as the nonvoting equity in these transactions, but is generally convertible to give the private equity investors the returns of the common stock, as well as a preferred position on dividends and liquidation. The Federal Reserve limits holding common shares received upon conversion of preferred stock. Generally, the investor must sell the common stock received upon such conversion. If a bank holding company's subsidiary bank fails, or regulators limit dividends payable by the holding company or its bank subsidiaries, the legal preferences of preferred stock may be meaningless.

Management

Often institutions need new management to attract capital and to turn the institution around. Because many of these institutions are subject to regulatory

enforcement actions or otherwise require regulatory approval under Section 32 of the FDI Act¹⁹ before replacing directors and executive officers, the investors and the financial institution may seek to have potential new managers act as consultants in advance of Section 32 approval. The Federal Reserve has expressed concern with such consulting arrangements because they raise potential questions of control by the private equity investor or the consultant prior to regulatory approval and are often expensive, especially relative to institutions with limited capital and liquidity. Equally important, the consultants lack the responsibility under the banking laws and to the institution's board of directors that a bank officer would have. Consulting arrangements raise especially complex issues in the process if there is any existing or prior affiliation between the consultant and the private equity firm.

Dilution to Existing Shareholders

Many financial institution recapitalizations involve substantial dilution to existing shareholders. Bank holding companies and investors have tried to reduce dilution through changing the number of shares or the price per share paid by the investors based upon the subsequent performance of an identified portfolio of target institution assets. The goal is to give the new investors protection from poorer than expected asset performance and to reward existing investors if the assets perform better than expected. These formulations raise concerns over "contingent capital", *i.e.*, capital that the Federal Reserve does not view as being available to absorb losses and which may impede the institution's ability to raise capital in the future. Alternatives exist for achieving similar results, but at the cost of complexity in the transaction documents and the regulatory process.

Review of Transaction Documents

The Federal Reserve's legal staff scrutinizes all transaction documents to ensure that an investor that is seeking a significant stake in a bank holding

company without becoming a bank holding company will not be able to exercise "control." Some common comments relate also to fairness of the transaction to the target institution. Among other things, in response to recent proposed transactions, the Federal Reserve has commented on:

- *Information Reporting.* The Federal Reserve does not permit non-controlling, non-bank holding company investors (including minority private equity investors) to have access to information provided by the target bank or bank holding company more frequently than quarterly, which would enable such investors to have information advantages over other non-controlling shareholders. Director representatives of such non-controlling non-bank holding company investors can, however, receive normal board packages and information.
- *Payment of Expenses.* The Federal Reserve discourages payment by the target bank holding company of investors' expenses, other than diligence expenses, before the investment closes. The Federal Reserve permits other reasonable deal expenses to be paid upon closing of the investment.
- *Deal Protection and Bust-Up Fees.* The Federal Reserve has made substantive determinations as to the reasonableness of bust-up fees and other termination terms and fees. The Federal Reserve may limit lock-up provisions that would prevent other investors from investing in the bank. There are methods for preserving the acquiror's investment and role in the capital raise in light of competing bids, however.

- *Preemptive Rights.* The Federal Reserve has expressed the concern that preemptive rights may limit the timely raising of capital if the investor is not required to exercise or lose such rights relatively quickly. However, preemptive rights arrangements can survive where thoughtfully drafted.

Silos

A “silo” is an investment structure pursuant to which a private equity firm or its principals form a new fund separate from its existing funds for use solely to make an investment in a bank, a thrift, or their holding companies. Silos have been the subject of much discussion and debate. A silo is intended to allow a private equity firm or its principals to invest in a financial institution without limiting the activities of related funds or exposing the related funds to the risk of a bank or thrift investment. Although the Federal Reserve approved a transaction by JLL Partners that appears to have involved a silo structure,²⁰ it indicated that it will not approve silos in the future.

The Office of Thrift Supervision (OTS) has been more amenable to silo structures and apparently has permitted a silo most recently in connection with investments in Saddle River Valley Bank by seven funds set up by J.C. Flowers for that specific bank investment.²¹ However, the Dodd-Frank Act will transfer to the Federal Reserve, by July 22, 2011, all authority to regulate thrift holding companies.²² As a result of the transfer of the OTS’s authority over thrift holding companies to the Federal Reserve, we anticipate that the Federal Reserve may apply its views on silo structures to thrift holding companies as well as bank holding companies. The FDIC Policy Statement reflects the FDIC’s dislike of silos, as well.

Forms of Offerings

Investments by private equity companies in banking organizations often take the form of several lead

private equity investors together with other institutional and individual investors. This permits the private equity funds to comply with the FDIC Policy Statement and, more importantly, to increase the dollar size of its investment without controlling the institution. In addition to the passivity commitments, the Federal Reserve requires non-association commitments to assure that the lead investors are not acting in concert or as a group such that all of their shares should be treated together for determining whether there is “control” for BHC Act or CIBC Act purposes. In addition, the Federal Reserve is especially interested in, and often requests detailed information with respect to, any (i) entity that invests over 5 percent in a bank or bank holding company, and (ii) investment funds with a large or dominant limited partner.

The Federal Reserve seeks to review, in advance, all private offerings of capital, whether to private equity firms, institutional investors or otherwise.

Investments also face sophisticated securities law issues to avoid any violation of the registration requirements under Section 5 of the Securities Act of 1933. Many are private investments in public equity (PIPEs) investments and some are concurrent private and public offerings.

The FDIC Policy Statement

The FDIC Policy Statement adds another layer of complexity to those investing in a bank recapitalization, *de novo* or shelf charter banks, or otherwise, if the bank or its investors want to participate in FDIC-assisted transactions. The FDIC will scrutinize the transactions and the investors for compliance with the following requirements, among others:

- at least one-third of the investments (which may be voting and non-voting equity securities) must agree to be bound by the FDIC Policy Statement;²³

- investors other than open-end mutual funds cannot sell or transfer their bank investments for three years following the acquisition without prior FDIC approval, except to affiliates that agree to be bound by the FDIC Policy Statement;²⁴
- opaque and silo structures are not permitted for the investors;²⁵
- offshore funds organized under secrecy law jurisdictions are subject to additional restrictions;²⁶
- the target bank must maintain a 10 percent Tier 1 common equity ratio for at least three years after the investment;²⁷ and
- if one or more investors own 80 percent of two or more FDIC-insured institutions, the stock must be pledged to FDIC to secure losses that may be incurred upon the failure of any of them.²⁸

Dispositions of banks that have participated in FDIC-assisted transactions or their assets are limited without prior FDIC approval under the FDIC loss-sharing agreements that have been a part of most FDIC failed bank resolutions in 2010. The loss-share provisions may also inhibit or complicate sales of shares in the acquiring bank or by its shareholders.

The FDIC Policy Statement requires additional planning, but the ability to engage in FDIC-assisted transactions may be rewarding. One recent blind pool offering, NBH, was structured to comply with the FDIC Policy Statement and recently announced the acquisition of the failed Hillcrest Bank in Kansas through its shelf charter bank,²⁹ along with an open bank transaction involving the formation of a *de novo* bank to purchase certain branches and related assets and liabilities of Midwest Bank.³⁰ This is a good example of investors' movement toward open

bank transactions, as well as the interest of blind pools in deploying their capital through open bank, as well as FDIC-assisted transactions.

Conclusion

The banking industry continues to require additional capital and there are considerable opportunities for both open and failed bank investments by private equity firms. Careful planning and structuring is needed in order to make such investments and obtain regulatory determinations of non-control or approval under the BHC Act, CIBC Act, and the FDIC and Federal Reserve Policy Statements within a reasonable timeframe. Although this article highlights a number of the issues involved, the regulatory agencies' positions and concerns often change as they see different structures and deal terms in proposed bank investments.

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¹ 12 U.S.C. § 5211 *et seq.*

² Jonathan Keeher and Linda Shen, *BankUnited Shuttered, Assets Sold to Kanas-Led Group*, Bloomberg News, May 21, 2009; Alison Veshkin, *IndyMac Bank's Sale to Other Investors Completed by FDIC*, Bloomberg News, March 20, 2009.

³ Pub. L. 111-240; H.R. 5297, 111th Cong (Sept. 27, 2010).

⁴ 12 U.S.C. § 1841 *et seq.*

⁵ 12 U.S.C. § 1817(j).

⁶ 12 U.S.C. § 1841(a)(2); 12 C.F.R. § 225.2(e).

⁷ *See, e.g.*, OCC Conditional Approvals Nos. 977 (Oct. 19, 2010); 960 (July 15, 2010); 950 (Mar. 25, 2010); 948 (Feb. 24, 2010); 936 (Oct. 23, 2009); 917 (July 31, 2009); 905 (May 29, 2009); 901 (Nov. 17, 2008).

⁸ *See* OCC Conditional Approval No. 872 (Aug. 27, 2008).

⁹ Policy Statement on Equity Investments in Banks and Bank Holding Companies, 12 C.F.R. § 225.144 (Sept. 22, 2008).

¹⁰ Final Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45440 (Sept. 2, 2009).

¹¹ 12 U.S.C. § 1841(a)(2)(A).

¹² 12 C.F.R. § 5.50(f) (national banks); 12 C.F.R. § 225.41(c) (bank holding companies and state member banks); 12 C.F.R. § 303.82(b) (state nonmember banks); 12 C.F.R. § 574.4(b) (federal savings associations).

¹³ 12 U.S.C. § 1813(u).

¹⁴ 12 C.F.R. § 225.144(c)(1).

¹⁵ 12 U.S.C. § 5301 *et seq.*

¹⁶ 12 U.S.C. § 5371.

¹⁷ 12 C.F.R. Part 225, Appendix A II. A. 1. a. iv

¹⁸ 12 C.F.R. § 225.144, n. 7.

¹⁹ 12 U.S.C. § 1831i.

²⁰ Order approving JLL Associates G.P. FCH, L.L.C., New York, New York to become a bank holding company and to acquire an interest in FC Holdings, Inc., Houston, Texas, and indirectly acquire FC Holdings of Delaware, Inc., Wilmington, Delaware; First Community Bank-The Woodlands, National Association, Tomball, Texas; First Community Bank Central Texas, N.A., Meridian; First Community Bank Fort Bend, N.A., Sugar Land; and First Community Bank San Antonio, N.A., San Antonio. (Nov. 6, 2007),

http://www.dallasfed.org/infoletters/2007/2007_1106a.html.

²¹ *See* OTS Order No. 2010-60 (Oct. 14, 2010).

²² 12 U.S.C. §§ 5401-5452.

²³ 74 Fed. Reg. 45440, 45446, *supra* n. 10.

²⁴ 74 Fed. Reg. 45440, 45447, *supra* n. 10.

²⁵ *Id.*

²⁶ *Id.*

²⁷ 74 Fed. Reg. 45440, 45446, *supra* n. 10.

²⁸ 74 Fed. Reg. 45440, 45446-7, *supra* n. 10.

²⁹ *See* OCC Conditional Approval Nos. 976 (Oct. 14, 2010); 948 (Feb. 24, 2010).

³⁰ *See* OCC Conditional Approval No. 973 (Oct. 7, 2010).