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Fresh Capital is So Close: Another Call to Modify Control Rules

The economy continues to suffer, and taxpayers' funds are apparently the preferred solution to address the financial institutions' crisis. A significant amount of private capital is also available to assist in this process. However much of that capital sits on the sidelines because of the "Hobson's" choice created by current bank control rules: an investor can either be passive, or manage its investment and become a bank or savings and loan holding company. In today's environment, where many longstanding rules are being changed literally overnight, holding company and control statutes and rules, many of which are at least 50 years old, should be modernized where they have not served verifiable supervisory objectives.

In this regard, mountains of new legislative proposals have and will continue to emerge with the goal of stimulating the stagnant economy. There will be attempts to reorganize, recalibrate, rename and restructure the current regulatory apparatus. We hope that Congress avoids the temptation to tackle wholesale regulatory restructuring first. Without months or perhaps years of study by congressional committees and/or presidential commissions, there will never be a full appreciation of what went wrong and, as importantly, how rearranging the current regulatory framework might avoid such missteps in the future. While there are many anecdotal opinions about the causes and blame for this crisis, the truth is that more regulation, regulators or shuffling the deck chairs to create new regulatory agencies cannot alone solve the issues that the financial services industry and the economy are confronting. It would be far too easy to simply change the regulatory structure, declare victory and create the illusion that the financial system was fully repaired.

On August 29, 2008, in an article in the *American Banker* entitled, "**Update the Rules for Private-Equity Stakes,**" we suggested a reevaluation of bank control rules and offered several ideas for consideration. On September 22, the Federal Reserve Board released new guidelines on private equity investments that increased to 33 1/3% the amount of equity that could be contributed and the extent of board representation that could be accepted without triggering holding company limitations. Since then, not much more has happened to change or standardize the regulatory framework to make the financial system more hospitable to private capital, and much of the private capital that has evidenced an interest in financial institutions continues to sit on the sidelines. The numbers of private equity transactions that have occurred in the last year include a handful of passive investments, club deals, private equity "silos," and "shelf" or "inflatable" charter transactions, but they represent a small part of the private capital that could be available to the financial system with a modest modernization of control and holding company rules. Now is the time to act to broaden the investment path since the opportunity to access this private capital will not necessarily be there forever.

Below we offer the following thoughts for consideration, the enactment of which, we believe, would literally produce money in the bank. These proposals will require amendments of existing statutes, but there will certainly be a variety of legislative proposals moving through Congress that can provide the vehicle for such change:

1. New control thresholds should be established with the presumption of control set at 33 1/3%, rather than 10% of voting stock, and conclusive control and holding company status increased from 25% to 50%.
 - *In today's markets, the ability of an investor to actually unduly influence and control a company with 10.1% of the voting stock is remote. The requirement that such an investor execute a rebuttal of control agreement to avoid control does more to discourage new capital and insulate current bank management than protect banks from influence and control by parties that have not been vetted by federal regulators.*
2. Control thresholds, acting in concert aggregation rules and passivity standards and agreements utilized by the four banking agencies should be standardized and modernized so that a non-controlling investor can (i) satisfy a single set of rules no matter how many different kinds of bank charters the target company controls; (ii) exercise its rights as a shareholder without the threat of violating passivity or acting in concert prohibitions; (iii) communicate views, expertise and insights on (a) management candidates, and (b) operating and financial management policies and technologies; and (iv) publicly differ with management, including conducting a proxy contest, as long as the investor does not attempt to obtain 50% or more of the board of directors.
 - *Companies in many industries have dissident shareholders who do not and cannot control the companies unless they can control the board of directors. There does not appear to be a supervisory principle that requires bank management alone to be "protected" from their shareholders. The current concept of "acting in concert" used by some agencies includes presumptions that a wide variety of parties act in concert, which does not reflect reality.*
3. Rules that treat non-voting and convertible instruments as the underlying voting stock for purposes of determining control of a bank should be amended to treat such instruments as voting stock only if the conversion of those instruments and the control that they can provide is clear and imminent.
 - *Non-voting debt and equity instruments may not necessarily translate into board representation or the ability to influence and control a bank. Applicable rules, which indicate when control may arise through the ownership of such instruments, should be narrowed accordingly.*
4. A distinction should be drawn between control of a parent holding company and control of the bank subsidiary for purposes of applying bank control and holding company rules. For example, investors should be permitted to recapitalize diversified companies that control a bank (e.g., dozens of industrial companies control credit card national banks and industrial loan companies, but are not regulated as bank holding companies) where the business plan or operations of the bank are not at issue and are not intended to be effected and/or changed by the investor.
 - *New capital injections by investors into a parent company, which may be several corporate levels above its subsidiary bank, need not necessarily have any impact on or change the operations of the bank, except perhaps to strengthen financially the entire corporate family. The assumption that a significant capital infusion at the parent level will necessarily change control of the subsidiary bank belies, to some degree, the requirement that a bank have a separate*

board of directors that represents its best interests. New capital investors should be permitted to enter into regulatory “safe harbor” agreements that avoid bank control and holding company regulation by limiting their ability to change the board and operations of bank subsidiaries.

5. Federal bank regulators should again be given discretion to waive certain federal and state restrictions, which might otherwise be applicable to controlling investors or holding companies, in cases where the new capital invested resolves a troubled bank situation.
 - *The authority to waive the applicability of certain state or federal laws (e.g., capital and liquidity requirements, permissible activities, geographic restrictions) with respect to the acquired bank and its subsidiaries for some transitional period of time was a valuable regulatory tool that attracted capital and investors in the banking crisis of the 1980’s and ‘90’s. There is no evidence that the use of this discretion by regulators led to any bank failures or relaxation of core regulatory principles. Congress would be well served by delegating the day-to-day business of exercising regulatory discretion to the regulators.*
6. Federal law should be amended to (i) extend the statutory grace period from two to five years in which a new holding company must conform its business activities and investments to that of a regulated bank or savings and loan holding company (with annual extensions permitted thereafter), and (ii) permit a limited expansion of non-financial activities during that period by an investor that recapitalizes a capital deficient bank.
 - *If the supervisory principle at issue is simply how long an investor can take to conform its activities to the limitations of the bank and savings and loan holding company acts rather than a concern for the safety and soundness of the subsidiary bank, as it appears to be, the need for capital in the financial services industry suggests that investors willing to put new money at risk and reduce the burden on the American taxpayer should be provided the incentive to do so by being given additional time to conform their activities. In addition, the grandfathering of only those activities conducted at the time of the investor’s registration as a holding company is not enough of an inducement for active private equity and hedge fund investors to commit new capital since their core businesses usually involve investing in and acquiring other companies. The fact that Congress has permitted financial holding companies to engage in merchant banking reinforces the view that such investment activities are not inherently unsafe and unsound, and it provides a basis for Congress to expand the range of activities that may be conducted during the grandfathered activity period.*
7. The use of general source of strength, CALMAs (Capital and Liquidity Maintenance Agreements), SASAs (Savings Association Support Agreements) and other holding company financial support requirements should be limited or ended. One size regulation no longer fits all. The breadth and depth of holding company regulation should be customized, among other things, based upon (i) the capitalization of the underlying bank, (ii) meaningful risk management evaluations of a holding company and its activities, (iii) the extent to which the bank is segregated in the family of companies owned by the holding company, and (iv) the degree of affiliated transactions contemplated between the bank and sister companies.
 - *Regulatory concerns regarding the impact of non-banking activities, the holding company’s access to capital, the financial pressure that the holding company puts on the bank to pay dividends, and the financial effect of affiliated transactions (none of which appear to have been significant causes in the current financial crisis) can and should be individually regulated based*

on the nature of the investor, the capital it brings to the table and the inter-relationship between its other activities and the bank. History suggests that source of strength agreements rarely produce additional capital when it is needed, except in situations where the capital would have been forthcoming in any event. Regulators already have sufficient legal authority to address capital deficiencies on a case-by-case basis (e.g., capital directives, prompt corrective action, which includes capital restoration plan guarantees, etc.) **when** they actually occur. A request for a future capital commitment at the time a controlling investment or acquisition is made simply creates insurmountable barriers for many potential investors who cannot, as fiduciaries, make such open-ended commitments.

8. Control and holding company filing requirements should be streamlined to focus on the most functional data that regulators need, and approvals should be required to be issued promptly once the application is considered complete.

- *The information that is required for holding company and control applications should be reevaluated periodically using a modern, zero-based approach. For many years, the opening of a bank branch, which is nearly automatic now, required extensive filings and agency hearings. Similarly, as regulators become more facile through the repetitive handling of transactions, the processing and approval of them should become more and more efficient. Every day that it takes to process and approve an application increases the cost of the transaction for companies that need to husband their capital and, in this environment, affects the interests of US taxpayers.*

* * *

If the government is serious about trying to minimize the use of taxpayers' money, a fresh look at control rules can lead to changes that will produce new capital for banks from private sources. Policymakers who feel comfortable with the current rules should ask themselves two questions: (i) if we did not have a bank control and holding company regulatory infrastructure, would we create the one we have today; and (ii) would the banking system that has operated under strict control and holding company restrictions be in any worse shape today if the ideas that we offer had been in place?

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