

## **§ 225.144 Policy statement on equity investments in banks and bank holding companies**

(a) Introduction and guiding principles. For many years, bank holding companies, nonbank financial companies, private equity funds, and other firms have made minority equity investments in banks and bank holding companies. These investments often raise a common set of questions about the extent to which the investment would cause the investor to become subject to supervision, regulation, and the other requirements applicable to bank holding companies under the Bank Holding Company Act (“BHC Act” or the “Act”) and the Board’s Regulation Y. In general, the BHC Act applies to any company that controls a bank or bank holding company (“banking organization”). The BHC Act provides that a company has control over a banking organization if (i) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the banking organization; (ii) the company controls in any manner the election of a majority of the directors or trustees of the banking organization; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization.<sup>1</sup> Minority equity investments in banking organizations are designed not to trigger either of the first two prongs of the definition of control. These investments often raise questions, however, regarding whether the investor will be able to exercise a controlling influence over the management or policies of a banking organization.<sup>2</sup>

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<sup>1</sup> 12 U.S.C. § 1841(a)(2).

<sup>2</sup> Contemporaneous minority investments in the same banking organization by multiple different investors also often raise questions about whether the multiple investors are a group acting in concert for purposes of the Change in Bank Control

The text and legislative history of the control definition in the BHC Act make manifest that possession by an investor of a modicum of influence over a banking organization would not amount to a controlling influence. At the same time, the definition does not require that an investor have absolute control over the management and policies of a banking organization. Instead, the Act requires that an investor be able to exercise an amount of influence over a banking organization's management or policies that is significant but less than absolute control in fact of the banking organization. Notably, the primary definition of control in the Act is based on ownership of 25 percent or more of the voting shares of a banking organization – an amount that does not provide an investor in most cases with complete control over decisions but would allow the investor to play a significant role in the decisionmaking process.

In assessing whether an investor has the ability to exercise a controlling influence over a banking organization, the Board has been especially mindful of two key purposes of the BHC Act. First, the BHC Act was intended to ensure that companies that acquire control of banking organizations have the financial and managerial strength, integrity, and competence to exercise that control in a safe and sound manner. The BHC Act is premised on the principle that a company that controls a banking organization may reap the benefits of its successful management of the banking organization but also must be prepared to provide additional financial and managerial resources to the banking organization to support the company's exercise of control. In this way, the Act ties the potential upside benefits of having a controlling influence over the management and policies of a banking organization to responsibility for the potential downside results of

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Act or are a single association for purposes of the BHC Act. These questions are beyond the scope of this policy statement.

exercising that controlling influence. By tying control and responsibility together, the Act ensures that companies have positive incentives to run a successful banking organization but also bear the costs of their significant involvement in the banking organization's decisionmaking process, thus protecting taxpayers from imprudent risk-taking by companies that control banking organizations. Minority investors in banking organizations typically seek to limit their potential downside financial exposure in the event of the failure of the banking organization. Concomitantly, the BHC Act requires that minority investors seeking this protection limit their influence over the management and policies of the banking organization.

Second, the BHC Act was intended to limit the mixing of banking and commerce. In particular, the Act effectively prevents commercial firms and companies with commercial interests from also exercising a controlling influence over a banking organization. Many minority investors in banking organizations own commercial investments that conflict with this limitation.

(b) Historical background. In 1982, the Board issued a Policy Statement on Nonvoting Equity Investments by Bank Holding Companies (the "1982 Policy Statement") to provide guidance on the Board's interpretation of the "controlling influence" prong of the control definition in the BHC Act.<sup>3</sup> That statement for the first time outlined the policies that the Board would consider in reviewing whether a minority investment in a banking organization would result in the exercise by the investor of a controlling influence over the management or policies of the banking organization. The 1982 Policy Statement focused on issues of particular concern in the 1980s in the context of investments by bank holding companies in out-of-state banking organizations. For example, the 1982 Policy

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<sup>3</sup> See 68 Federal Reserve Bulletin 413 (July 1982) (codified at 12 CFR 225.143).

Statement primarily addressed investments that included a long-term merger or stock purchase agreement between the investor and the banking organization that would be triggered on a change in the interstate banking laws, and so-called “lock-up” arrangements designed to prevent another company from acquiring the banking organization without the permission of the investor.

Many aspects of the 1982 Policy Statement have broader applicability, however, and have served as the foundation for the Board’s review more generally of whether a minority investment in a banking organization would give the investor a controlling influence over the management or policies of the banking organization. In this regard, the 1982 Policy Statement identified a number of structural measures that the Board believed would limit the ability of an investor to exercise a controlling influence over a banking organization. These included restricting the use of covenants that constrain the discretion of banking organization management, limiting the amount of voting and nonvoting shares of the banking organization acquired by the investor, and limiting the ability of the investor to transfer large blocks of voting shares.

The Board made clear in the 1982 Policy Statement that the complexity of legitimate business arrangements precluded establishing rigid rules designed to cover all situations and that decisions regarding the presence or absence of control must take into account the specific facts and circumstances of each case. Accordingly, since the 1982 Policy Statement, the Board has determined whether an equity investor in a banking organization has a controlling influence over the management or policies of the banking organization by considering carefully all the facts and circumstances surrounding the investor’s investment in, and relationship with, the banking organization. Large minority investors in a banking organization typically have avoided acquiring a controlling influence over the banking organization by providing the Board with a set of

passivity commitments and by avoiding certain control-enhancing mechanisms. Specifically, minority investors have avoided acquiring control over a banking organization by, among other things:

- restricting the size of their voting and total equity investment in the banking organization;
- avoiding covenants that would enable the investor to restrict the ability of the banking organization's management to determine the major policies and operations of the banking organization;
- not attempting to influence the banking organization's process for making decisions about major policies and operations;
- limiting director and officer interlocks with the banking organization; and
- limiting business relationships between the investor and the banking organization.

(c) Specific approaches to avoid control. Since issuing the 1982 Policy Statement, the Board has reviewed a significant number of noncontrolling investments in banking organizations and now believes it would be useful and appropriate to update its guidance in this area. The Board continues to believe that investors may acquire a minority equity investment in a banking organization without exercising a controlling influence over the banking organization within the meaning of the BHC Act. Based on its experience in assessing minority investments in banking organizations, the Board has reviewed the consistency of a number of features of these investments with the Act. In particular, the Board has reviewed its experience with director interlocks, limits on the amount of nonvoting shares that can be held in combination with voting shares, and the scope of discussions that minority investors may have with management of the banking organization. As noted, the Board continues to believe that a determination

whether an investor has a controlling influence over a banking organization depends on all the facts and circumstances of each case.<sup>4</sup>

(1) Director representation. The Board generally has not permitted a company that acquires between 10 and 24.9 percent of the voting stock of a banking organization (a “minority investor”) to have representation on the board of directors of the banking organization. The principal exception to this guideline has been in situations in which the investor owns less than 15 percent of the voting stock of the banking organization and another person (or group of persons acting together) owns a larger block of voting stock of the banking organization.

The Board has reexamined its precedent in this area and, based on its experience with minority investors and director representation, believes that a minority investor generally should be able to have a single representative on the board of directors of a banking organization without acquiring a controlling influence over the management or policies of the banking organization. Typically, boards of directors of banking organizations have 9 or 10 members. Although having a representative on the board of the banking organization enhances the influence of a minority investor, the Board’s experience has shown that, in the absence of other indicia of control, it would be difficult for a minority investor with a single board seat to have a controlling influence over the management or policies of the banking organization.<sup>5</sup>

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<sup>4</sup> The Board will use the principles outlined in this policy statement to analyze investments by bank holding companies in nonbanking firms as well.

<sup>5</sup> In addition to formal representation on the board of directors of a banking organization, minority investors also frequently seek to have a representative attend meetings of the board of directors of the banking organization in the capacity of a nonvoting observer. Attendance by a representative of a minority investor as an observer at meetings of the board of directors of a banking organization allows the investor access to information and a mechanism for

Moreover, a minority investor that has up to two representatives on the board of directors of the banking organization is unlikely, absent other indicia of control, to be able to exercise a controlling influence over the banking organization when the investor's aggregate director representation is proportionate to its total interest in the banking organization<sup>6</sup> but does not exceed 25 percent of the voting members of the board,<sup>7</sup> and another shareholder of the banking organization is a bank holding company that controls the banking organization under the BHC Act.<sup>8</sup> The presence of another larger, controlling shareholder of the banking organization that has been approved by the Board, is subject to supervision and regulation by the Board, and is obligated to serve as a source of

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providing advice to the banking organization but has not in previous situations allowed the investor to exercise a controlling influence over the management or policies of the banking organization as long as the observer does not have any right to vote at meetings of the board.

<sup>6</sup> An investor's total interest is equal to the greater of the investor's voting interest or total equity interest in the banking organization.

<sup>7</sup> For example, an investor with a 10 percent voting interest and a 20 percent total equity interest generally could have two representatives on the board of directors of the banking organization if the investor's director representation does not exceed 20 percent of the board seats. On the other hand, an investor with a 15 percent voting interest and a 33 percent total equity interest generally could have two representatives on the board of directors of the banking organization if the investor's director representation does not exceed 25 percent (rather than 33 percent) of the board seats.

<sup>8</sup> In determining what amount of director representation is proportional to an investor's voting interest in a banking organization, the investor should round to the nearest whole number. For example, the Board would consider a minority investor that owns 15 percent of the voting stock of a banking organization to have proportionate director representation if it had two representatives on a board of directors with 10 or more members (but not on a board of directors with 9 or fewer members).

strength for the banking organization should serve as a powerful countervailing force to whatever influence the minority investor may have as a result of its investment and proportional director representation.

The Board continues to believe that a representative of a minority investor that serves on the board of directors of the banking organization should not serve as the chairman of the board of the banking organization or as the chairman of a committee of the board of the banking organization. The Board generally believes, however, that representatives of a noncontrolling minority investor may serve as members of committees of the board of the banking organization when those representatives do not occupy more than 25 percent of the seats on any committee and do not have the authority or practical ability unilaterally to make (or block the making of) policy or other decisions that bind the board or management of the banking organization.

(2) Total equity. The three-prong control test in the BHC Act makes no explicit reference to nonvoting equity investments. Nevertheless, the Board has long subscribed to the view that the overall size of an equity investment, including both voting and nonvoting equity, is an important indicator of the degree of influence an investor may have. Accordingly, the Board traditionally has taken account of the presence and size of nonvoting equity investments in its controlling influence analysis. For example, in the 1982 Policy Statement, the Board set forth a guideline that nonvoting equity investments that exceed 25 percent of the total equity of a banking organization generally raise control issues under the BHC Act.<sup>9</sup> The Board has recognized in a few limited circumstances, however, that ownership by a minority investor of 25 percent or more of a banking organization's total equity may not confer a controlling influence, usually in situations when

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<sup>9</sup> 12 CFR 225.143(d)(4) and (d)(5).

another controlling investor is present or other extenuating circumstances indicate that the exercise of a controlling influence by the minority investor is unlikely.

The Board continues to believe that an investor that makes a very large equity investment in a banking organization is likely to have a controlling influence over the banking organization's management or policies. Investors with large equity investments have a powerful incentive to wield influence over the banking organization in which they have invested. They have a substantial amount of money at stake in the enterprise, are among the first to absorb losses if the banking organization has financial difficulties, and participate in the profits of the banking organization going forward. Moreover, a banking organization is likely to pay heed to its large shareholders to help ensure it has the ability to raise equity capital in the future and to prevent the negative market signal that would be created by the sale of a large block of equity by an unhappy existing shareholder.

On the other hand, the Board recognizes that nonvoting equity does not provide the holder with voting rights that empower the holder to participate directly in the selection of banking organization management or otherwise in the banking organization's decisionmaking process. Moreover, as noted above, the BHC Act defines control in terms of ownership of 25 percent or more of a class of voting securities but does not impose an express limit on ownership of nonvoting shares. The Board continues to believe that, in most circumstances, an investor that owns 25 percent or more of the total equity of a banking organization owns enough of the capital resources of a banking organization to have a controlling influence over the management or policies of the banking organization. The Board continues to recognize, however, that the ability of an investor to exercise a controlling influence through nonvoting equity instruments depends significantly on the nature and extent of the investor's overall investment in the banking organization and on the capital structure of the banking organization.

In particular, the Board would not expect that a minority investor would have a controlling influence over a banking organization if the investor owns a combination of voting shares and nonvoting shares that, when aggregated, represents less than one-third of the total equity of the organization (and less than one-third of any class of voting securities, assuming conversion of all convertible nonvoting shares held by the investor) and does not allow the investor to own, hold, or vote 15 percent or more of any class of voting securities of the organization. In these situations, the limitation on voting rights reduces the potential that the investor may exercise influence that is controlling.

In previous cases, investors that have acquired nonvoting shares often have sought the right to convert those shares to voting shares under various circumstances. The Board continues to believe that nonvoting shares that may be converted into voting shares at the election of the holder of the shares, or that mandatorily convert after the passage of time, should be considered voting shares at all times for purposes of the BHC Act. However, in previous cases, the Board has recognized that nonvoting shares that are convertible into voting shares carry less influence when the nonvoting shares may not be converted into voting shares in the hands of the investor and may only be transferred by the investor: (i) to an affiliate of the investor or to the banking organization; (ii) in a widespread public distribution; (iii) in transfers in which no transferee (or group of associated transferees) would receive 2 percent or more of any class of voting securities of the banking organization; or (iv) to a transferee that would control more than 50 percent of the voting securities of the banking organization without any transfer from the investor. Ownership of this form of nonvoting, convertible shares, within the limits discussed above, allows investors to provide capital to a banking organization in a way that is useful to the organization, minimizes the opportunity for the investor to exercise a controlling influence over the organization, and

allows the investor to exit the investment without conveying control to another party outside the parameters of the BHC Act.

(3) Consultations with management. In many previous cases, minority investors have agreed not to attempt to influence the operations, management, or strategies of the banking organization in which they have invested; not to threaten to sell their shares in the banking organization as a method for influencing decisions of banking organization management; and not to solicit proxies on any matter from the other shareholders of the banking organization. These commitments were designed to limit the exercise by a minority investor of a controlling influence over the management or policies of a banking organization.

The Board believes that it would be useful to provide additional guidance on the extent of communications between a minority investor and a banking organization's management that would be consistent with a noncontrol determination. The Board believes that a noncontrolling minority investor, like any other shareholder, generally may communicate with banking organization management about, and advocate with banking organization management for changes in, any of the banking organization's policies and operations. For example, an investor may, directly or through a representative on a banking organization's board of directors, advocate for changes in the banking organization's dividend policy; discuss strategies for raising additional debt or equity financing; argue that the banking organization should enter into or avoid a new business line or divest a material subsidiary; or attempt to convince banking organization management to merge the banking organization with another firm or sell the banking organization to a potential acquirer. These communications also generally may include advocacy by minority investors for changes in the banking organization's management and recommendations for new or alternative

management.<sup>10</sup> Although these types of discussions represent attempts by an investor to influence the management or policies of the banking organization, discussions alone are not the type of controlling influence targeted by the BHC Act.

To avoid the exercise of a controlling influence, in all cases, the decision whether or not to adopt a particular position or take a particular action must remain with the banking organization's shareholders as a group, its board of directors, or its management, as appropriate. The role of the minority investor in these decisions must be limited to voting its shares in its discretion at a meeting of the shareholders of the banking organization (directly or by proxy, including in connection with a proxy solicitation launched by another shareholder), and by exercising voting privileges as a member of the board of directors of the banking organization (to the extent permitted as discussed above). Importantly, communications by minority investors should not be accompanied by explicit or implicit threats to dispose of shares in the banking organization or to sponsor a proxy solicitation as a condition of action or non-action by the banking organization or its management.

(4) Other indicia of control. (i) Business relationships. The Board traditionally has prohibited a noncontrolling minority investor in a banking organization from having any material business transactions or relationships with the banking organization. The Board historically has taken the view that a major supplier, customer, or lender to a banking organization can exercise considerable influence over the banking organization's management and policies – especially

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<sup>10</sup> As discussed later in this policy statement, a minority investor may not have a contractual right to determine (or a veto right over) any of the major policies and operations of the bank or the composition of the bank's management team.

when coupled with a sizeable voting stock investment – by threatening to terminate or change the terms of the business relationship.

The Board has recognized over the years, however, that not all business relationships – even when accompanied by a material investment – provide the investor a controlling influence over the management or policies of the banking organization. Accordingly, the Board has frequently allowed business relationships that were quantitatively limited and qualitatively nonmaterial, particularly in situations where an investor’s voting securities percentage in the banking organization was closer to 10 percent than 25 percent. The Board continues to believe that business relationships should remain limited and will continue to review business relationships on a case-by-case basis within the context of the other elements of the investment structure. In that review, the Board will pay particular attention to the size of the proposed business relationships and to whether the proposed business relationships would be on market terms, non-exclusive, and terminable without penalty by the banking organization.

(ii) Covenants. Because the BHC Act explicitly defines control (and many of its other thresholds) in terms that include a percentage of voting securities, companies often have structured their investments in banking organizations in the form of nonvoting securities and have attempted to substitute contractual agreements for the rights that normally are obtained through voting securities. The Board has taken and continues to hold the view that covenants that substantially limit the discretion of a banking organization’s management over major policies and decisions suggest the exercise of a controlling influence.<sup>11</sup> In particular, the Board has been concerned about covenants or contractual terms that place restrictions on, or otherwise inhibit, the banking organization’s ability to make

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<sup>11</sup> See 12 CFR 225.143(d)(2).

decisions about the following actions: hiring, firing, and compensating executive officers; engaging in new business lines or making substantial changes to its operations; raising additional debt or equity capital; merging or consolidating; selling, leasing, transferring, or disposing of material subsidiaries or major assets; or acquiring significant assets or control of another firm.<sup>12</sup>

On the other hand, the Board generally has not viewed as problematic for control purposes those covenants that give an investor rights permissible for a holder of nonvoting securities as described in section 2(q)(2) of Regulation Y.<sup>13</sup> These would include covenants that prohibit the banking organization from issuing senior securities or borrowing on a senior basis, modifying the terms of the investor's security, or liquidating the banking organization. Noncontrolling covenants also could include covenants that provide the investor with limited financial information rights and limited consultation rights.

(d) Conclusion. As noted above, whether a minority investor in a banking organization has a controlling influence over the management or policies of the banking organization depends on all the facts and circumstances surrounding the investor's investment in, and relationship with, the banking organization. This policy statement sets forth some of the most significant factors and principles the

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<sup>12</sup> For an investment to be eligible for inclusion in a banking organization's regulatory capital, it must not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. 12 CFR part 208, App. A, §II and 12 CFR part 225, App. A, §II.(i). As described in 12 CFR 250.166(b)(3), such provisions include terms that could adversely affect the banking organization's liquidity or unduly restrict management's flexibility to run the organization, particularly in times of financial difficulty, or that could limit the regulator's ability to resolve problem bank situations.

<sup>13</sup> 12 CFR 225.2(q)(2).

Board will consider in determining whether investments in a banking organization are noncontrolling for purposes of the BHC Act.

Importantly, controlling-influence determinations depend not just on the contractual rights and obligations of the investor and the banking organization; they also depend on the amount of influence the investor in fact exercises over the banking organization. Accordingly, the Board has and will continue to monitor carefully minority investments in banking organizations to ensure that investors do not, in fact, exercise a controlling influence over the management or policies of the banking organizations in which they invest. The Board also continues to evaluate its policies in this area and will modify them as appropriate going forward to ensure that minority investments in banking organizations remain consistent with the BHC Act.