SULLIVAN & CROMWELL LLP

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Federal Banking Agencies Provide "No-Action" Relief for Bank Extensions of Credit to Portfolio Companies of Institutional Investors Owning More Than 10% of the Bank's Stock

SUMMARY

On December 27, 2019, the Board of Governors of the Federal Reserve System (the "Board" or the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC") (collectively, the "Agencies") issued a "Statement Regarding Status of Certain Investment Funds and Their Portfolio Investments for Purposes of Regulation O and Reporting Requirements under Part 363 of FDIC Regulations" (the "Statement"). The Statement establishes a "no-action" position for bank extensions of credit to portfolio companies of certain institutional investors that would otherwise violate the limitations and restrictions of Regulation O on bank extensions of credit to the "related interests" of "principal shareholders."

STATUTORY AND REGULATORY REGIME

Under Section 22(h) of the Federal Reserve Act (12 U.S.C. § 375b), and the implementing Federal Reserve regulations (Regulation O; 12 C.F.R. Part 215), extensions of credit by banks to executive officers, directors, "principal shareholders" and "related interests" of all such persons ("insiders") must comply with certain individual and aggregate lending limits and qualitative standards (such as "comparable terms" and "risk of repayment"). In addition, large extensions of credit by banks to insiders must be approved in advance by a majority of disinterested directors.

The term "principal shareholder" is defined by the statute as including any person that directly or indirectly, or acting through or in concert with one or more persons, controls more than 10 percent of any class of

voting securities of a bank or company. The term "related interest" is defined by the statute as including any company "controlled" by a person. "Control" is defined with a three-pronged test that includes the "power to exercise a controlling influence over the company's management or policies."[1] Section 215.2 of Regulation O provides that "control" is "presumed" to exist at the 10% (and less than 25%) ownership level (if no other person has a greater ownership level), but that presumption can be rebutted. Accordingly, a 10% shareholder is irrefutably a "principal shareholder" and subject to the Regulation O limitations, but the presumption of control at that 10% ownership level for a "related interest" can be rebutted to avoid the application of Regulation O to extensions of credit to a particular related interest (or interests).

BACKGROUND

Over the last few years, institutional investor fund complexes have acquired more than 10 percent of a class of voting securities of a wide range of public companies, including banking organizations. This reflects the large secular movement from active to passive investing. Upon acquiring more than 10 percent of a class of voting securities of a banking organization, a fund complex would be a "principal shareholder" of the banking organization.

With respect to every other company in which a principal shareholder fund complex owns 10 percent or more of a class of voting securities, that company would generally be presumed to be a "related interest" of the fund complex. In that event, both the fund complex and its presumptively "controlled portfolio companies" would be considered insiders of the bank. Accordingly, the bank's lending to not only the fund complex but also its controlled portfolio companies would be subject to the strict lending limits and other restrictions and standards of Regulation O.

As the Statement notes, a number of banks have advised the Agencies that the treatment of fund complex-controlled portfolio companies as "related interests" under Regulation O would require the sudden and disruptive unwinding of substantial preexisting lending relationships and reduce credit availability to a wide swath of financial and non-financial companies.

ANALYSIS

The Statement provides that the "[Board], in consultation with the [OCC] and the [FDIC] … is actively considering whether to amend Regulation O to address the treatment of extensions of credit to fund complex-controlled portfolio companies under Regulation O." In the absence of a positive determination, however, banks are concerned that there could be a violation of law. Moreover, under Section 363.2 of the

[1] The literal definition of "controlling influence" in Section 22(h) differs to some extent from that in the Bank Holding Company Act. The Statement does not refer to this difference or the Board's recent proposed guidance on "control" under the Bank Holding Company Act.

FDIC's Regulations (12 C.F.R. § 363.2), banks would have to report any such violation as of their financial year-end.

In response to this situation, the Statement serves as a "no-action" position by "articulat[ing] supervisory expectations with respect to the application of Regulation O in this specific context in order to provide banks flexibility to lend to certain fund complex-controlled portfolio companies," subject to satisfaction of four eligibility criteria. During the pendency of the "consider[ation] whether to amend Regulation O to address these issues, the federal banking agencies would not take action against banks or fund complexes with respect to extensions of credit by the banks to fund portfolio companies that otherwise would violate Regulation O." This no-action position is unusually robust in providing that the Agencies would take no action, whereas the typical no-action letter refers to the "staff's not recommending action."

Three of the four eligibility criteria apply to the fund complex:

1. The fund complex does not directly or indirectly control 15 percent or more of any class of voting securities of the bank.
2. The fund complex does not have or seek to have any representative serve as an officer, agent or employee of the bank.
3. The fund complex does not exercise or attempt to exercise a controlling influence over the management or policies of the bank, including attempting to influence the dividend policies, loan, credit, or investment decisions or policies, pricing of services, personnel decisions, operations activities, or any other similar activities or decisions of the bank.

The fourth criterion applies to the bank:

4. The bank does not knowingly make an extension of credit to a fund complex-controlled portfolio company, unless the terms of such extension of credit are on substantially the same terms as those prevailing for comparable transactions with unaffiliated third parties and do not involve more than normal risk of repayment or present other unfavorable features.

Importantly, "[f]or purposes of this Regulation O relief only, the federal banking agencies will presume that a fund complex that (1) has provided passivity commitments to the Board in connection with a legal opinion issued by the Board's General Counsel, (2) has provided a rebuttal of control to the OCC, or (3) has entered into a passivity agreement with the FDIC, in each case permitting the fund complex to directly or indirectly acquire up to 15 percent of the shares of a bank without making a filing under the Change in Bank Control Act, Bank Holding Company Act, or Home Owners' Loan Act, meets the eligibility criteria with respect to its investment in the bank." A number of fund complexes already comply with this condition.

The relief covers only extensions of credit to portfolio companies, and does not extend to any extension of credit to the fund complexes themselves. This no-action relief will apply until January 1, 2021, unless amended prior to that time.

The Statement further provides that the Agencies will not take action against an insured depository institution for failure to report, for purposes of Section 363.2 of the FDIC's regulations, extensions of credit to portfolio companies that otherwise would violate Regulation O but are covered by this Regulation O no-action position.

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