Financial Services & Products ADVISORY ■

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Federal Reserve Releases Guidance on Shareholder Protection Arrangements

On December 3, 2015, the Board of Governors of the Federal Reserve System released Supervision and Regulation Letter 15-15, "Supervisory Concerns Related to Shareholder Protection Arrangements" (SR 15-15), offering guidance regarding shareholder protection arrangements that are likely to raise supervisory issues at bank holding companies and savings and loan holding companies. This guidance makes explicit the Federal Reserve's emerging stance of disfavor towards such arrangements in recent years.

Specifically, the Federal Reserve's concern is that these shareholder protection arrangements would have negative implications on a holding company's capital or financial position, limit a holding company's financial flexibility and capital-raising capacity, or otherwise impair a holding company's ability to raise additional capital and impede the ability of a holding company to serve as a source of strength to its insured depository subsidiaries in violation of the Dodd-Frank Act and Regulations Y and LL.

Background

Pursuant to Section 616(d) of the Dodd-Frank Act and the Board's Regulations Y and LL, a holding company is required to serve as a source of financial strength for its insured depository subsidiaries and should not conduct its operations in an unsafe or unsound manner. Specifically, a holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks and thrifts during periods of financial stress or adversity.

The Federal Reserve reports that it has observed an increase in interest by some holding companies to establish arrangements that are designed to benefit certain shareholders, enhance short-term investor returns and/or provide a distinct disincentive for investors to acquire or increase ownership in a holding company's common stock and other capital instruments. In fact, these types of arrangements have been in place for many years, but the Federal Reserve likely became increasingly concerned about these arrangements following the financial crisis of 2008–2009. Many holding companies experiencing losses in recent years adopted tax benefit preservation plans (TBPPs) designed to preserve net operating losses within the requirements of Section 382 of the Internal Revenue Code. In essence, while these TBPPs are designed to protect valuable deferred tax assets under the Code, they also have the effect of deterring ownership changes, and therefore raise Federal Reserve concerns about a holding company's ability to raise capital.

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Summary of Key Points

- ***Examples:*** The following non-exhaustive list of shareholder protection arrangements have raised supervisory issues:
  - ***"Down-round"*** provisions where the holding company either (1) agrees to provide an investor with cash payments reflecting the difference between the price paid by the investor and a lower price per share paid by investors in subsequent transactions; or (2) agrees to provide an investor with additional shares of stock for minimal or no additional cost in the event that the holding company issues shares at a price below the price paid by the investor.
  - ***Poison pills*** where existing shareholders of the holding company are able to acquire additional shares at significant discounts off market value in a new offering if any shareholder crosses a specific ownership threshold (including TBPPs).
  - ***Transfer restrictions*** where (1) investors with less-than-majority control are granted the contractual right to restrict or prevent the holding company from issuing additional shares; or (2) the holding company's board of directors has the authority to nullify share purchases under certain circumstances, require the holding company to repurchase the shares of the company from a new owner of the shares or take other actions that would significantly inhibit secondary market transactions in the shares of the holding company.
- ***Applicability:*** The Federal Reserve may object to a shareholder protection arrangement based on the facts and circumstances and the features of the particular arrangement, regardless of the holding company's size.
- ***Examiner focus:*** The Federal Reserve may become aware of such a proposed or existing arrangement either in the context of an application process or other review of capital raising or expansion proposals, or through ongoing supervision of the company. Holding companies are encouraged to bring all such existing or proposed arrangements to the attention of relevant supervisory and applications staff when appropriate. Federal Reserve supervisory or applications staff are directed to consult with Board supervisory staff to determine appropriate action when a particular shareholder protection arrangement may impair the ability of a holding company to raise or maintain capital, particularly during a period of stress on the firm, or when provisions of the arrangement are in violation of applicable supervisory enforcement actions. Despite the obvious emphasis on ferreting out these arrangements, the Federal Reserve states that SR 15-15 is intended to guide supervisory actions going forward and is not intended to require holding companies or examiners to demonstrate that such an arrangement does not exist.
- ***Corrective action:*** The Federal Reserve may direct a holding company's board of directors to modify or remove a shareholder protection arrangement that gives rise to safetyandsoundness concerns. The corrective actions, if any, will vary depending on the facts and circumstances of the holding company, as well as applicable state and federal laws and regulations, corporate charter and bylaws and other considerations such as applicable holding company capital requirements.

Conclusion

SR 15-15 provides helpful guidance regarding which shareholder protection arrangements are likely to face supervisory concern, when such issues are likely to be discovered, the expected corrective action and mechanisms for compliance.

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