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COMMERCIAL BANKING IN THE UNITED STATES: INCREASED INVESTMENT OPPORTUNITIES FOR CHINA-BASED INSTITUTIONS

By David C. Kenny

Introduction

Commercial banks and other financial institutions in China will be interested in the US Federal Reserve Board's recent release of its "Policy Statement on Equity Investments in Banks and Bank Holding Companies." This statement liberalizes US policies permitting private equity funds, sovereign wealth funds, non-US banking organizations and other entities (investors) to make sizable but *noncontrolling* investments in US banks, bank holding companies and financial holding companies. *Controlling* investments in US commercial banking organizations are limited to bank and financial holding companies (BHCs) approved and regulated by the Federal Reserve and limited by law to the business of investing in banks and other financial service firms. Most investors do not wish to submit to the restrictions and regulations imposed on a BHC. This new policy statement will thus be helpful to investors that would like to make large investments in US banking organizations *without* becoming controlling BHCs. The policy statement may be found at 12 Code of Federal Regulations Section 225.144, September 22, 2008, or at the Federal Reserve's website at www.federalreserve.gov.

Importance for China

This new policy statement has special significance for China-based bank and nonbank investors because the Federal Reserve has over the past year also shown increased flexibility by approving several applications by China-based banks to expand their operations in the United States. Until last year the Federal Reserve had not approved a China-based bank's US expansion for more than 17 years. The existing Bank of China and Bank of Communications branches in the United States were all established before 1991. On November 8, 2007 the Federal Reserve approved an application by China Merchants Bank to open a new branch office in New York, and in October 2007 the Federal Reserve allowed China Minsheng Banking Corp., Ltd. to make a minority investment in UCBH Holdings, Inc., the parent BHC of United Commercial Bank of San Francisco, California. In August 2008 the Federal Reserve approved a New York branch application by the Industrial and Commercial Bank of China (ICBC). Significantly, the Federal Reserve's ICBC approval included a waiver of certain US law restrictions on the nonbanking investments and activities of one of ICBC's major shareholders, Central SAFE Investments Limited (also known as Huijin); this waiver could facilitate future investments by China-based banks owned by Huijin

(such as Bank of China) or by China Investment Corporation. A New York branch application was also filed by China Construction Bank in early October 2008 and is now pending with the Federal Reserve.

Key Approval Standard

To approve a non-US bank's application for a US branch or for a *controlling* investment in a US banking organization, the Federal Reserve is required by law to determine, among other things, whether the system of bank regulation of the non-US bank's home country subjects the applicant non-US bank to comprehensive and consolidated supervision and regulation (CCSR). In approving both the China Merchants Bank and the ICBC branches, the Federal Reserve relied on an exception in the applicable law that allows it to approve a non-US bank *branch* if the applicant's home country (China in those two cases) has not yet achieved CCSR but is "actively working to establish" CCSR. Significantly, this exception applies only to *branch* applications and does *not* apply to applications to make a *controlling* equity investment in a US banking organization.

While the Federal Reserve action did not involve any changes to the governing statute – the US Bank Holding Company Act – or to its implementing federal administrative regulation – Federal Reserve Board Regulation Y – the new policy statement identifies ways in which China-based and other investors can make significant noncontrolling investments in US banks and BHCs. The policy statement addresses board seats, voting and nonvoting shareholding levels, consultation and communication with management, and business relationships.

Increased Board of Director Representation

A noncontrolling investor may have one board seat in the investee bank whether or not another shareholder holds a greater percentage of voting shares. Such an investor may have two board seats if (a) those two seats are proportional to the investor's "total interest" in the investee, (b) those two seats do not exceed 25 percent of total board seats and (c) another shareholder is a BHC that controls the investee under applicable Federal Reserve rules. Directors placed in such seats by noncontrolling investors may not serve as chairperson of the board or as chairperson of any board committee, but may serve as members of board committees as long as directors nominated by a particular investor do not exceed 25 percent of the members of any single committee.

Larger Total Equity Investments

As a liberalization of the traditional 25 percent ownership limit, the policy statement provides that the Federal Reserve will generally not find an investor to exert a controlling influence over a US banking organization if the investor holds a combination of voting and nonvoting shares amounting to less than 33 percent of the total equity of the investee and such holdings (a) do not include more than 15 percent of any class of voting securities or (b) do not include conversion rights that would allow the investor to exceed the 33 percent limit.

With respect to the important issue of conversion of nonvoting shares into voting shares, the Federal Reserve restated its longstanding policy of counting such shares as voting shares if they are convertible at the election of the shareholder or automatically convertible after the passage of a set period of time. Significantly, however, the Federal Reserve reminded investors in the policy statement that in appropriate cases it will *not* count convertible shares as voting shares if the conversion rights could be exercised by only certain classes of *transferees* of the original investor. This feature would allow an investor to make a large convertible preferred share investment in a large troubled US banking organization with the opportunity to make a later profit on that investment through the sale of the convertible securities to smaller investors after the share price of the troubled US bank had recovered.

More Open Investor Communications With Management

The Federal Reserve has frequently obtained so-called passivity commitments from investors to ensure that their larger investments do not entail control. Among these commitments are ones limiting the communication between a noncontrolling investor and senior management and/or shareholders of the investee banking organization. The policy statement provides examples of permitted communication topics including communications involving (a) dividend policy, (b) capital planning, (c) new business lines, (d) mergers and acquisitions and (e) changes in senior management personnel. However, the policy statement stresses that, while such topics may be communicated, they may not be made the subject of covenants in investment agreements or of proxy solicitations supported by the investor.

Increased Business Relationships

The policy statement also changes the Federal Reserve's traditional policy prohibiting a noncontrolling investor from having any type of material business relationship with the investee banking organization. Subject to qualitative and quantitative parameters negotiated with the Federal Reserve, such business relationships should be increasingly permissible in the future.

The Negotiation of Noncontrolling Relationships With the Federal Reserve

The new policy statement makes frequent reference to the Federal Reserve's 1982 "Policy Statement on Nonvoting Equity Investments by Bank Holding Companies," which calls for consultation with the Federal Reserve Board's Washington legal staff prior to the execution of investment agreements by which an investor could obtain 5 percent or more of the voting equity of a US banking organization. Under this procedure the parties normally agree upon a term sheet and draft agreements incorporating those terms. However, before the completion and signing of such agreements, a determination would be obtained from the Federal Reserve Board legal staff that, in light of all facts and circumstances, the investor would be a noncontrolling minority investor. The recent policy statement reaffirms that process, and Squire, Sanders & Dempsey L.L.P. has gained much experience over the years conducting such consultations and

obtaining favorable noncontrol determinations for a series of sizable minority investments by private equity funds, non-US banks and sovereign wealth funds.

Conclusion

As recently reported in the press, various parts of the US government, including Congress, the Federal Reserve, the Treasury Department and the Federal Deposit Insurance Corporation, are working to stabilize and strengthen the US commercial banking system. Thus far only the Federal Reserve policy statement described above and the previously mentioned nonbanking exemptions granted to Huijin in connection with the ICBC New York branch approval give additional flexibility directly to China-based banks to expand in the United States. Hopefully the next step will be a Federal Reserve finding of full CCSR in the China-based commercial bank regulatory system, thereby allowing China-based banks to take *controlling* investment positions in US banking organizations. If the Federal Reserve so desired, a finding of full CCSR could be made as part of its decision in the pending China Construction Bank branch application. However, until such a full CCSR finding is made, China-based investors will be able to structure significant noncontrolling investments by following the liberalizations described above as contained in the Federal Reserve's policy statement of September 22.

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Originally published in the Jiangsu Province Industrial Overseas Development and Planning Association newsletter. Reproduced and translated with permission from the Jiangsu Province Development and Reform Commission.

April 2009