

Investments in U.S. Financial Institutions by Business Enterprises Domiciled in India

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Financial institutions in the United States have been hit hard by the subprime crisis and its related fallout. For many institutions, this has resulted in a need to raise capital that cannot be met through traditional capital markets channels. Simultaneously, foreign investors in India have shown interest in investing in the U.S. financial sector, sensing an opportunity to realize substantial returns when the markets stabilize. However, the U.S. regulatory framework applicable to an investment in various types of financial institutions can be complex, particularly for investments in financial groups that include a bank. Therefore, non-traditional investors and foreign business enterprises, as well as financial institutions that might seek to raise capital from such investors, need to understand the regulatory framework in order to plan for a viable transaction.

This article discusses the governing law, application process, and relevant considerations that U.S. regulators consider in approving an acquisition proposal by a foreign persons or groups. This article also focuses on the requirements for acquiring a national bank or a bank chartered by the state of New York.¹

OVERVIEW OF BANK REGULATION IN THE UNITED STATES

In the United States, supervisory and regulatory responsibilities for domestic banking institutions is divided among several different federal, and possibly state, regulatory agencies, depending on the type of charter (e.g., federal or state). These regulators include the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) at the federal level, as well as the banking departments of the various states (e.g., the New York State Banking Department (NYSBD)). The primary supervisor of a domestic banking institution is generally determined by the type of institution it is and the governmental authority that granted it permission to com-

mence business (commonly referred to as a charter). Banks that are chartered by a state government are referred to as state banks; banks that are chartered by the OCC, which is a bureau of the Department of the Treasury, are referred to as national banks.

The FRB has primary supervisory authority for state banks that elect to become members of the Federal Reserve System (state member banks). State banks that are not members of the Federal Reserve System (state nonmember banks) are supervised by the FDIC. In addition to being supervised by the FRB or FDIC, all state banks are supervised by their chartering state. The OCC supervises national banks (a type of federally chartered bank). All national banks must become members of the Federal Reserve System. This dual federal-state banking system has evolved partly out of the complexity of the U.S. financial system, with its many kinds of depository institutions and numerous chartering authorities. It also has resulted from a wide variety of federal and state laws and regulations designed to remedy problems that the U.S. commercial banking system has faced over its history.

Banks are often owned or controlled by another company. These companies are referred to as bank holding companies. The FRB has supervisory authority for all bank holding companies, regardless of whether the subsidiary bank of the holding company is a national bank, state member bank, or state nonmember bank.

Savings associations, another type of depository institution, have historically focused on residential mortgage lending. The OTS, which is a bureau of the Department of the Treasury, charters and supervises federal savings associations and also supervises companies that own or control a savings association. These companies are referred to as thrift holding companies.²

The FDIC insures the deposits of banks and savings associations up to certain limits established by law.³ As the insurer, the FDIC

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has special examination authority to determine the condition of an insured bank or savings association for insurance purposes.

We note that legislation currently pending in the U.S. Congress may significantly change many aspects of the regulation of financial services activities in the United States. However, we do not expect that the application and approval process for foreign banking organizations to acquire U.S. banks would be affected.

FORMATION OF A BANK HOLDING COMPANY

Section 3(a)(1) of the Bank Holding Company Act (BHCA) requires prior FRB approval for any action that causes a company to become a bank holding company.⁴ A company becomes a bank holding company by acquiring control of a bank. “Any action” that causes a company to become a bank holding company may include the merger or acquisition of a domestic bank.

The BHCA requires the FRB to consider various factors when acting on bank holding company acquisition proposals. These factors are: the competitive effects of the proposal in the relevant geographic markets; the financial and managerial resources and future prospects of the companies and banks involved in the proposal; the convenience and needs of the community to be served, including the records of performance under the Community Reinvestment Act (CRA)⁵ of the insured depository institutions involved in the transaction; the availability of information needed to determine and enforce compliance with the BHCA and other applicable federal banking laws; and, in the case of applications involving foreign banks, whether the foreign bank at issue is subject to comprehensive supervision and regulation on a consolidated basis by its home country supervisor.⁶ In considering these factors, the FRB will formulate a record that includes information provided by the applicant, confidential supervisory and examination information relative to the target bank, publicly reported financial and other information, and information collected from the applicant’s home country supervisor.

The foregoing considerations are discussed in greater detail below.

Competitive Considerations

Section 3 of the BHCA prohibits the FRB from approving a proposal that would result in a monopoly. The BHCA also prohibits the FRB from approving a proposed bank acquisition that would substantially lessen competition in any relevant banking market unless the anticompetitive effects of the proposal are clearly outweighed in the public interest by the probable effect of

the proposal in meeting the convenience and needs of the community to be served.⁷

Supervisory Considerations

Under Section 3 of the BHCA, the FRB may not approve an application involving a foreign bank unless the bank is “subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in the bank’s home country.”⁸

The BHCA also requires the FRB to determine that the applicant has provided adequate assurances that it will make available to the FRB such information about their operations and activities and those of their affiliates that the FRB deems appropriate to determine and enforce compliance with the BHCA.⁹

Financial and Managerial Resources

The BHCA requires that the FRB, in every case, take into consideration the “financial and managerial resources and future prospects of the company or companies and the banks concerned.”¹⁰ Regulation Y provides that the FRB will also consider whether the current and projected capital positions and levels of indebtedness of the applicant and its bank subsidiaries conform to the FRB’s standards and policies.¹¹

The BHCA also requires the FRB to consider the competence, experience, and integrity of the officers, directors, and principal shareholders of each company or bank in connection with an acquisition proposal.¹² Violations and alleged violations of law by an applicant are taken into consideration by the FRB in considering managerial resources. The FRB may also consider the adequacy of existing management programs, such as risk management programs used to identify, measure, and control corporate and business line risks, as well as the organization’s internal controls and audit procedures.¹³ Additionally, Regulation Y provides that the FRB will consider the compliance record of the applicant. As part of its review of banking organizations, the FRB seeks information on enforcement actions by governmental authorities of other countries.¹⁴ In the case of violations of law to which the applicant is found or pleads guilty, the FRB may consider the applicant’s cooperation with home country regulatory authorities, actions to ensure future compliance, and the applicant’s discipline of individuals responsible for the violation.¹⁵

SOURCE OF STRENGTH DOCTRINE

An important consideration in forming a bank holding company is the FRB’s requirement that the bank holding company must be willing to “serve as a source of financial and managerial

strength to its subsidiary banks.”¹⁶ The FRB uses this “source of strength doctrine” to require bank holding companies to downstream capital to faltering subsidiary banks. The downstreaming requirement could be limitless. While the need to invoke the source of strength doctrine has largely been mitigated through the statutory authority granted bank regulatory agencies to require bank holding companies to guarantee the capital levels of their subsidiary banks, up to 5 percent of the bank’s total assets, there remains the potential, albeit unlikely, prospect of the FRB invoking the source of strength doctrine for a bank that is in substantial risk of failure.

FRB APPLICATION PROCESS

Timing and Filing Location

Applications to establish a bank holding company are submitted to the appropriate Federal Reserve Bank for the district in which the target bank is located. If the target bank is in New York, then the application is submitted to the Federal Reserve Bank of New York. Applications are normally reviewed by the FRB and acted upon within 60 days after receipt unless the FRB notifies the applicant that the period is being extended due to novel issues, supervisory concerns, or other factors. Once approved, the acquisition may not be consummated for 30 calendar days after the action by the FRB unless the Department of Justice authorizes a waiting period of 15 calendar days, which is normally authorized.

Publication Requirement

The applicant is required to publish, in a newspaper of general circulation in the community in which the head office of the target bank is located, a notice that must state that the public has 30 calendar days to submit comments on the proposal.

Information to be Provided with the Application

The application form requires the applicant to disclose a broad variety of information; below is a summary of the significant items to be provided:

1. **Transaction information:** The applicant must provide information relating to the number of shares to be acquired, description of any unusual contract terms, description of the due diligence performed on the target bank, and information on the parties to the transaction.
2. **Operations, structure and ownership of the applicant:** The applicant must discuss the activities it intends to engage in, and the organizational and operational history of the applicant. The applicant must also provide an organizational chart showing the applicant and any affiliates, information on major shareholders, quarterly and annual reports, and a description of the applicant’s compliance program.
3. **Financial and managerial information:** The applicant must provide parent-only and consolidated financial statements, capital ratios and information, and current information related to the quality of the applicant’s assets.
4. **Home country supervision:** The applicant must identify the home country supervisor and discuss the major laws governing the applicant’s operations and activities. The applicant must also describe the supervisory process of the home country regulator.
5. **Anti-money laundering and other related measures:** The applicant must describe any home country laws that are designed to deter or prohibit money laundering, terrorist financing, or other illicit activities. The applicant must also discuss the home country supervisor’s requirements imposed on banks for the detection and prevention of money laundering, terrorist financing, and other illicit activities. Additionally, the applicant must describe the actions it has taken to ensure that the applicant and its offices and subsidiaries are not used for purposes of money laundering, terrorist financing, or other illicit activities.
6. **Competition:** The FRB’s focus on competition review is negligible if the applicant only intends to acquire one bank through the current application.
7. **Convenience and needs:** The FRB’s focus on convenience and needs is also less important in a proposal in which the applicant is only proposing to acquire one bank.
8. **Other matters:** The applicant must list each jurisdiction in which it has material operations, and provide with respect to each listed jurisdiction a description of any secrecy laws or other impediments that would restrict the ability of the applicant or its parent from providing any required information to the FRB as to the applicant’s operations or activities. The applicant must also describe any non-banking activities that will be conducted in the United States.

APPLICATIONS TO THE CHARTERING AUTHORITIES

As discussed above, in addition to submitting an application to the FRB, the investor will also be required to submit an application to the primary chartering authority of the target bank. If the target bank is a national bank, which is regulated by the OCC, then no filing is required because the OCC will rely on the filing made to the FRB.¹⁷ If the target bank is chartered by the state of New York, then the following filing requirements apply.

Acquisition of a New York State chartered bank is regulated by the NYSBD, and is treated by the NYSBD as a change in control of the target bank. The NYSBD requires an application filing fee of \$12,500, and review takes on average three months, but may take longer if novel issues arise. The application to be submitted to the NYSBD must include the following information:

1. the name and address of the target bank
2. identification of any bank securities already owned by the applicant
3. identification and discussion of the shares to be acquired by the applicant
4. discussion of the source and amount of funds or other consideration to be paid for the shares
5. description of the contractual arrangements and understandings between the parties to the transaction
6. information on the target bank: The applicant must provide information as to the purpose of the transaction, the intent of the applicant to direct the policies of the target, any management services that the applicant will provide, and any contracts that the applicant has or intends to have with the target bank.
7. description of all sources of financing which would be available to the applicant for future use in connection with the banking institution and the manner and terms on which it would be available to the applicant
8. any additional information that the NYSBD may deem necessary.¹⁸

CFIUS REVIEW

The acquisition of U.S. domestic companies by foreign persons is subject to review by the Committee on Foreign Investments in the United States (CFIUS or the committee). The modern

CFIUS, and the scope of its review, is the product of more than 30 years of legislative fine-tuning, most recently the Foreign Investment and National Security Act of 2007.¹⁹ The goal of CFIUS review is to determine whether an acquisition of or investment in a domestic entity by a foreign entity poses a threat to the “national security” of the United States. If the committee finds credible evidence that such a threat exists, and the President of the United States concurs, then the President may block or unwind an investment or transaction. Currently, after the CFIUS receives voluntary notice of a planned acquisition, it may begin a 30-day review to determine whether the transaction could pose a threat to national security.²⁰ At the end of this period, the committee may conclude that no such threat exists and end the review, or it may commence a 45-day investigation. Upon the conclusion of the investigation, the committee is required to submit a report to the President containing its recommendation.²¹ Within fifteen days, the Office of the President may suspend, prohibit, or order certain modifications to the transaction through a mitigation agreement, or it may permit the acquisition by not taking any action. Regardless of the outcome, it must submit a report to Congress explaining its decision.²² This structure resembles the two-stage merger review process under the Hart-Scott-Rodino Act of 1976,²³ but understandably involves much less transparency given the sensitive nature of national security information. For this reason, and also because the executive’s findings are not subject to judicial review, the confidence in the Hart-Scott-Rodino regime cannot be automatically transposed onto the CFIUS framework.²⁴

The main benefit for companies of a voluntary CFIUS filing is that any notified transaction with potential national security implications enjoys a regulatory safe harbor, immunizing it against subsequent reviews or actions by the President, except in cases in which the parties have engaged in misrepresentations during the CFIUS process.²⁵ In contrast, a transaction *without* a voluntary filing with CFIUS that subsequently raises national security concerns can be reviewed and unwound by the President at any time, even long after closing. Another benefit of filing involves the opportunity for informal guidance whereby the regulator and the company discuss the adequacy of the filing and the expected shape of the CFIUS process. In fact, this opportunity for informal pre-filing guidance is explicitly encouraged in Treasury Department regulations.²⁶

One of the major problems with the CFIUS legislation and regulations, is that they fail to define with precision or exclusivity

what constitutes “national security.” The legislation does, however, contain a non-exhaustive list of factors that may be considered when determining whether a national security threat exists. These factors include domestic production needed for projected national defense requirements, the capability and capacity of domestic industries to meet national defense requirements, the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the United States to meet national security requirements, the potential effects of an acquisition on sales of military goods, equipment, or technology to countries supporting terrorism or raising proliferation concerns, and the potential effects on U.S. technological leadership in areas affecting national security.²⁷

Whether the scope of “national security” includes investments in or acquisitions of financial services entities remains uncertain, and we have not found any instances of such a proposed transaction being blocked. We note, however, that with the increased presence of sovereign wealth funds in financial institution investments, and the critical importance of the domestic banking system to the recent financial crisis, it is conceivable that under certain circumstances national security issues may be implicated in an investment in a domestic financial institution. However, in cases in which the investors are not associated with a foreign government, the target of the investment is not a major financial institution, and the relevant foreign country does not pose national security concerns, the risk of adverse CFIUS action is lessened.

In the current economic environment, financial institutions are eager to attract new investment capital, and U.S. regulators have shown that they are looking for ways to accommodate. The dilemma for some investors will be to consider and determine what level of control and scope of activity they seek for their investment. Through careful planning with experienced advisors and close cooperation with the regulators, investors in financial institutions should be able to realize the goals of their investments without unwanted regulatory burdens.

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ENDNOTES

- 1 This article assumes that the target bank would not be a failing bank. In the event that the target is a failing bank, additional review by the Federal Deposit Insurance Corporation will be required.
- 2 For purposes of this article, we have assumed that the target bank will be a commercial bank and not a savings association. However, if the target is a state or federally chartered savings association, the application will be made to the Office of Thrift Supervision, as well as the state regulator. The procedures will likely be similar to those discussed herein.
- 3 The current federal deposit insurance limit is \$250,000. The application of federal deposit insurance rules to accounts with multiple holders, or the availability of insurance to a depositor with multiple account relationships at a single bank, depends upon a variety of factors that are beyond the scope of this article.
- 4 12 U.S.C. § 1842(a)(1); 12 C.F.R. § 225.11(a).
- 5 12 U.S.C. § 2901 *et seq.*
- 6 UFJ Holdings, Inc. (In Formation), 87 Fed. Res. Bull. 270, 272 (2001).
- 7 12 U.S.C. § 1842(c)(1). In reviewing market concentration, the FRB looks to Department of Justice merger guidelines.
- 8 12 U.S.C. § 1842(c)(3)(B). As provided in Regulation Y, the board determines whether a foreign bank is subject to consolidated home country supervision under the standards set forth in Regulation K. 12 C.F.R. 225.13(a)(4). Regulation K provides that a foreign bank may be considered subject

to consolidated supervision if the board determines that the bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank, including the relationships of the bank to its affiliates, to assess the foreign bank's overall financial condition and compliance with law and regulation. 12 C.F.R. 211.24(c)(1)(ii). In a 2008 order involving State Bank of India, Mumbai, India, the FRB recognized India as having an acceptable supervisory regime for the more limited review required in establishing a branch or representative office in the United States, however the FRB's review of India's regulatory scheme will be more extensive for a bank acquisition. *See* Order Approving Establishment of a Branch, State Bank of India, Mumbai, India (Jan. 25, 2008).

- 9 12 U.S.C. § 1842(c)(3)(A).
- 10 12 U.S.C. § 1842(c)(2).
- 11 12 C.F.R. § 225.13(b)(1).
- 12 12 U.S.C. § 1842(c)(5).
- 13 *See, e.g.*, The PNC Financial Services Group, Inc. (FRB Order, April 26, 2005).
- 14 *See, e.g.*, Banco Bilbao Vizcaya Argentina, S.A., n. 8 (FRB Order, March 30, 2005).
- 15 *See, e.g.*, Deutsche Bank AG, 85 Fed. Res. Bull. 509, 511 n. 16 (1999).
- 16 12 C.F.R. § 225.4(a)(1).
- 17 Comptroller's Licensing Manual, Change in Bank Control, pg. 1-2 (Jan. 2007) (noting a filing exemption for transactions subject to approval under Section 3 of the BHCA, 12 U.S.C. § 1842).
- 18 NYSBD Supervisory Procedure CB 117.
- 19 Pub. L. No. 110-49, 121 Stat. 246 (2007) (to be codified at 50 U.S.C. § 2061). *See also*, the Investment Survey Act of 1976, 22 U.S.C. §§ 3101-3108; Exon-Florio Amendment to the Defense Production Act of 1950; Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (May 9, 1975), as amended by Exec. Order No. 12,188, 45 Fed. Reg. 989 (Jan. 4, 1980); Exec. Order No. 12,661, 54 Fed. Reg. 779 (Jan. 9, 1989); Exec. Order No. 12,860, 58 Fed. Reg. 47,201 (Sept. 8, 1993); and Exec. Order No. 13,286, 68 Fed. Reg. 10,619 (Mar. 5,

2003). For an overview of the early years of CFIUS activity, *see* James K. Jackson, Cong. Research Service, Report No. RL33388, The Committee on Foreign Investment in the United States 2-4 (2007).

- 20 50 U.S.C. § 2170(a).
- 21 31 C.F.R. § 800.504(b).
- 22 50 U.S.C. § 2170(g).
- 23 15 U.S.C. § 18(a).
- 24 George Stephanov Georgiev, The Reformed CFIUS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security, *Yale Journal on Regulation*, Vol. 25:125 (2008).
- 25 31 C.F.R. § 800.601(d).
- 26 31 C.F.R. 800.401(f).
- 27 50 U.S.C. § 2170(f).