BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 15-15

December 3, 2015

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK AND TO ALL HOLDING COMPANIES SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Supervisory Concerns Related to Shareholder Protection Arrangements

Applicability: This guidance applies to bank holding companies and savings and loan holding companies, including those with $10 billion or less in consolidated assets.

The Federal Reserve is issuing this guidance to explain supervisory concerns related to arrangements structured by bank and savings and loan holding companies (collectively, "holding companies") to protect the financial investments made by shareholders (collectively, "shareholder protection arrangements"). In particular, such arrangements raise concerns because they could have negative implications on a holding company's capital or financial position, or limit the holding company's ability to raise capital in the future.[1] A holding company, regardless of its asset size, should be aware that the Federal Reserve may object to a shareholder protection arrangement based on the facts and circumstances and the features of the particular arrangement. Therefore, a holding company that is engaged in capital raising efforts or is considering the implementation or modification of a shareholder protection arrangement should review this guidance to help ensure that supervisory concerns are addressed.

Background

The Federal Reserve 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 some instances, supervisory staff has found 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. These arrangements impede the ability of a holding

[1] As discussed further below, these arrangements may come in many different forms, including all or portions of agreements between shareholders (or other relevant parties), company plans, organizing documents, and other contractual provisions that provide shareholder protections.

company to serve as a source of strength to its insured depository subsidiaries[2] and were considered unsafe and unsound.

Shareholder Protection Arrangements

Examples of shareholder protection arrangements that have raised supervisory issues include, but are not limited to, provisions whereby:

- The holding company 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;[3]
- The holding company 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;
- Existing shareholders of the holding company are able to acquire additional shares at significant discounts to market value in a new offering if any shareholder crosses a specific ownership threshold;[4]
- Investors with less-than-majority control are granted the contractual right to restrict or prevent the holding company from issuing additional shares; or
- 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

[2] Pursuant to section 616(d) of the Dodd-Frank Wall Street Reform and Consumer Protection 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. *See* 12 U.S.C. 1831o-1; 12 CFR 225.4(a); and 12 CFR 238.8(a).

[3] Provisions of this type and the next example are often referred to as "down-round" provisions. Down-round provisions can take many forms, but all are designed to protect existing shareholders in the event a holding company's stock price declines in a subsequent effort to raise capital or sell the holding company.

[4] Provisions of this type are often referred to as "poison pills" and were originally developed as defenses against contested acquisitions. There are multiple common forms, but these provisions generally operate by increasing the ownership interest of shareholders other than a buyer of a significant block of shares, thereby diluting the buyer and preventing the takeover bid.

Poison pill structures have also been applied in the context of tax benefit preservation plans (TBPPs), which, in general terms, are designed to preserve net operating losses within the requirements of section 382 of the Internal Revenue Code. Under section 382, the use of deferred tax assets can be restricted by an "ownership change." Thus, TBPPs and poison pills use similar mechanisms to restrict changes in ownership, despite different underlying purposes. TBPPs may also take forms different from traditional poison pills.

As an example, a TBPP or poison pill may provide all shareholders, other than the shareholder crossing the relevant threshold, the right to acquire shares of the holding company at a substantial discount, reducing the incentive of shareholders to acquire more shares at or above the threshold. These rights may or may not terminate within a set amount of time.

that would significantly inhibit secondary market transactions in the shares of the holding company.[5]

Arrangements of these types (in whatever form) have the potential to impose additional financial obligations on a holding company or restrict in some way the primary or secondary market for the holding company's shares. Often, these arrangements serve to protect the value of the initial investment made by a particular subset of shareholders rather than the viability of the issuing holding company, or, in other ways, provide current shareholders with an advantage over future, similarly situated, investors.[6]

Supervisory Oversight

If supervisory or applications staff determine that a particular shareholder protection arrangement impairs the ability of a holding company to raise or maintain capital, particularly during a period of stress on the firm, or that provisions of the arrangement are in violation of applicable supervisory enforcement actions, Federal Reserve staff should consult with appropriate Board supervisory staff to determine the appropriate action. This can occur when:

- *Federal Reserve staff become aware of a proposed shareholder protection arrangement (for example, as part of an effort to raise capital or a proposal to expand)*: Federal Reserve staff should incorporate a review of such arrangements during consideration of the specific proposal, whether or not there is a formal application or other approval requirement.
- *Federal Reserve staff become aware of an existing shareholder protection arrangement during the course of a supervisory activity (for example, in discussions with the holding company's management)*: Federal Reserve staff should incorporate a review of such arrangements in the examination scope or supervisory plan for the holding company and, on limited occasions, in connection with an application filing.[7]

The Federal Reserve may direct a holding company's board of directors to modify or remove a shareholder protection arrangement that gives rise to safety-and-soundness 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 by-laws, and other considerations.[8] The Reserve Bank's communications with the holding company

[5] These arrangements could include complete prohibitions on share transfers, as well as certain forms of buy-sell agreements, rights of first refusal, or similar arrangements that sufficiently restrict the transfer of shares as to effectively prohibit most, if not all, transfers.

[6] In general, the right to participate in subsequent offerings to prevent dilution of ownership, when fully paid for, has not raised the concerns described in this letter.

[7] This guidance is focused on supervisory actions going forward and is not intended to require active confirmation by a holding company or Federal Reserve staff on a routine basis that a shareholder protection issue does not exist. To facilitate the identification of shareholder protection arrangements that raise supervisory concern, the management and other representatives of holding companies are encouraged to bring all such existing or proposed arrangements to the attention of relevant supervisory and applications staff when appropriate.

[8] Holding companies subject to the Board's Regulation Q (12 CFR part 217) are subject to additional regulatory requirements that should be considered in connection with shareholder protection arrangements. In particular, common equity tier 1 capital instruments and additional tier 1 capital instruments are required to satisfy eligibility criteria that effectively disqualify instruments with certain features used in some shareholder protection

should comply with applicable supervisory guidance, including SR letter 13-13/ CA letter 13-10, "Supervisory Considerations for the Communication of Supervisory Findings." If a holding company has questions regarding the removal or modification of a shareholder protection arrangement, the holding company should consult with the appropriate Federal Reserve Bank or the persons listed at the end of this letter.

Reserve Banks are asked to distribute this letter to all holding companies supervised by the Federal Reserve. General questions regarding this letter should be directed to the following staff in the Division of Banking Supervision and Regulation: Richard C. Watkins, Deputy Associate Director, at (202) 452-3421; and Jonathan K. Rono, Senior Supervisory Financial Analyst, at (202) 721-4568. Questions regarding application related matters should be directed to: Susan Motyka, Manager of Domestic Banking Acquisitions & Activities, at (202) 452-5280; and Melissa W. Clark, Senior Supervisory Financial Analyst, at (202) 452-2277. In addition, questions may be sent via the Board's public website.[9]

Michael S. Gibson
Director

Cross Reference to:

- SR letter 13-13/ CA letter 13-10, "Supervisory Considerations for the Communication of Supervisory Findings"

arrangements, such as features that limit or discourage future capital issuances, compensate existing investors if new instruments are issued at a lower price, create incentives to redeem, or interfere with the full discretion of the issuer to cancel dividend payments except under limited circumstances. *See* 12 CFR 217.20. Further, the Board may require a holding company to exclude capital instruments from regulatory capital if such instruments have characteristics or terms that diminish the instrument's ability to absorb losses, or otherwise present safety-and-soundness concerns. *See* 12 CFR 217.1(d)(2).

[9] See http://www.federalreserve.gov/apps/contactus/feedback.aspx.