Economic Stabilization Advisory Group | September 1, 2009

# Structuring Private Equity Investments in Failed U.S. Banks under the New FDIC Statement and the Bank Holding Company Act

On August 26, 2009, the Board of Directors of the Federal Deposit Insurance Corporation (the "FDIC") adopted the "Final Statement of Policy on Qualifications for Failed Bank Acquisitions" (the "FDIC Statement") setting out standards and guidelines that the FDIC will apply in accepting bids from investment vehicles and other "private investors" to acquire failed banks and thrifts. The FDIC Statement was issued on the heels of a passionate debate generated by the FDIC's "Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions," issued on July 2, 2009 (the "Proposed Statement"), which was viewed by many in the investment community as a potential impediment to the flow of much needed new capital into the banking sector. The FDIC Statement represents the FDIC's renewed effort to strike a balance between the competing interests of attracting new potential investors in failed banks and creating eligibility standards for non-bank acquirors – including private-equity firms ("PE Firms") – that will help ensure the long term financial strength and prudential management of a bank or thrift emerging from receivership.

This publication summarizes important aspects of the FDIC Statement and highlights possible approaches to structuring private capital investments – including by PE Firms – in failed banks in view of the interplay between the FDIC Statement and applicable Board of Governors of the Federal Reserve System (the "Board") interpretation of "control" of a bank or bank holding company for purposes of the Bank Holding Company Act of 1956 (the "BHCA").

## Significance of New Regulatory Framework

The FDIC Statement sets the new regulatory framework private investors have to comply with in order to qualify as eligible bidders for a failed U.S. bank or thrift. It was prompted by the increased interest that PE Firms have shown in making investments in banks that the FDIC has made available for acquisition and recapitalization prior to being declared insolvent. As more fully explained below, the FDIC Statement imposes certain financial support requirements, prohibits "insider lending," sets a three-year minimum holding period, requires disclosure of the chain of ownership, and restricts how the investment may be structured.

Private investors are at the same time practically urged to limit their involvement to "passive" investment up to certain equity thresholds (generally less than 25% of voting and/or 33% of total equity) in order to avoid becoming a bank holding company and thereby being subject to strict Board supervision, regulation, reporting, capital requirements and limitations on non-banking activities under the BHCA and regulations thereunder.

This publication outlines the four broad categories of investment structures available to a private investor when considering investment in a failed bank or thrift:

- Under two of these scenarios, the "*De Minimis* Investment" and the "Investment Partnership with a Bank," private investors would not be subject to the new strict regulatory regime of the FDIC Statement;
- In the case of a "Private Investor Club Deal," the new FDIC regime would apply; and
- In the case of a "Controlling Investment," the investor would become subject to Board supervision and regulation under the BHCA.

To fully understand the implications of each of these structures, this publication (i) provides a detailed analysis of the new regulatory regime under the FDIC Statement; (ii) describes Board interpretation of "control" under the BHCA; and (iii) outlines alternative structures for a "non-controlling" investment in a failed bank. The Annex hereto further compares the alternative investment structures from the perspective of the FDIC Statement and the BHCA control-related analysis.

## FDIC Statement in Detail

### Scope of the FDIC Statement

The FDIC Statement sets out the terms and conditions that certain "private investors" ("Covered Investors") would be expected to satisfy to obtain bidding eligibility for a proposed acquisition of a failed bank or thrift. Covered Investors are defined to include:

- "Private investors" in a company proposing to directly or indirectly assume deposit liabilities, or deposit liabilities and assets, from a failed insured depository institution in receivership; and
- Applicants for insurance in the case of *de novo* charters issued in connection with the resolution of failed insured depository institutions.

While the FDIC Statement was drafted with PE Firms and similar investment vehicles clearly in mind (which over the past couple of years have employed a variety of creative structures to own banks and thrifts without being subject to the BHCA), the FDIC determined not to define the term "private investors." In this regard, the FDIC simply noted that it is exceedingly "difficult to use precisely defined terms to deal with the relatively new phenomenon of private capital funds joining together to purchase assets and liabilities of failed banks or thrifts."[1]

The FDIC Statement excludes the following types of "private investors" from its coverage (i.e., such investors are <u>not</u> Covered Investors):

- Investors that team up with a holding company of a U.S. depository institution (excluding "shell holding companies") which will have a "strong majority interest" in the resulting bank or thrift and an established record for successful operation of insured banks or thrifts; and
- Investors that individually hold 5% or less of the total voting power of an acquired bank or thrift (or its holding company) – provided there is no evidence of "concerted action" by such investors.

Presumably if "private investors" are deemed to be "acting in concert" with one another, the FDIC can be expected to aggregate the holding of such investors for purposes of determining whether or not they hold, in the aggregate, greater than 5% of the total voting power of the acquired bank (in which case, such investors would be Covered Investors).

[1] In light of the broad definition of "private investor," the FDIC Statement likely applies also to an investment vehicle set up by a non-U.S. sovereign fund or non-US financial or commercial company. However, investments by sovereign funds may require a pre-clearing by the Committee on Foreign Investment in the United States and the investor must not be located in a jurisdiction covered by FDIC Statements' restriction on bank "secrecy jurisdictions" (see below).

Upon application to, and approval by, the FDIC Board of Directors, the specific requirements of the FDIC Statement – discussed in detail below – will no longer apply to Covered Investors provided that the acquired bank or thrift has continuously maintained for seven years a rating of 1 or 2 pursuant to the U.S. supervisory rating of a bank's overall condition ("Camels Rating").

Acquisitions of failed banks or thrifts completed prior to August 26, 2009 (i.e., the FDIC Statement approval date) do not fall within the coverage of the FDIC Statement.

## Investor Requirements

While the FDIC Statement softens certain requirements originally included in the Proposed Statement, it still imposes a number of significant limitations, restrictions and requirements on Covered Investors (and, in certain cases, a depository institution acquired by one or more Covered Investors) in the context of an acquisition of a failed depository institution. These include the following, each of which is discussed in detail below:

- The acquired depository institution must maintain higher capital levels than typically required;
- Covered Investors must provide the FDIC with "cross support" as a means to limit risk to the FDIC under circumstances where one or more Covered Investors own at least 80% of two or more U.S. depository institutions;
- The acquired depository institution may not extend credit to the Covered Investors or their "affiliates";
- Covered Investors may not (subject to very limited exceptions) employ ownership structures utilizing entities domiciled in "bank secrecy jurisdictions";
- Covered Investors must maintain a continued three-year ownership of the acquired bank or thrift;
- Covered Investors may not employ "complex and functionally opaque ownership structures," such as so-called "silo" structures where a single PE Firm seeks to acquire ownership of a depository institution through the creation of multiple investment vehicles so as to avoid technical "control" by the PE Firm under the BHCA.
- Covered Investors must disclose information regarding all entities in the "ownership chain" of the investor.

The FDIC Board of Directors may waive one or more provisions of the FDIC Statement if the exemption is deemed to be in the best interests of the FDIC's Deposit Insurance Fund.

## Capital Requirement

- Under the FDIC Statement, depository institutions acquired by Covered Investors must have a "Tier 1 common equity" to total assets ratio of at least 10% for a period of three years from the time of acquisition (the Proposed Statement required a "Tier 1 leverage ratio" of at least 15%).
- This is a more stringent requirement than the 8% of "Tier 1 leverage ratio" that the FDIC normally requires new banks to initially maintain as a condition to qualify for deposit insurance.
- Not only is the percentage required under the FDIC Statement 2% higher than the standard requirement, but "Tier 1 common equity" is a more stringent measure of capital than the more generally applicable "Tier 1 capital" (which is used for purposes of calculating a bank's "Tier 1 leverage ratio"). "Tier 1 capital" includes, for example, certain perpetual preferred stock and other non-common capital elements. For many banks that have these Tier 1 capital elements as part of their regulatory capital, meeting the FDIC Statement's capital requirement will be a challenge.
- Following the initial three-year period, the acquired insured depository institution must remain at a "well capitalized" level during the remaining period of ownership by the Covered Investors.
- Failure to meet required capital levels will result in the acquired depository institution being treated as "undercapitalized" for purposes of the "Prompt

Corrective Action" framework established by the FDIC Improvement Act of 1991. A bank with "undercapitalized" status must put in place a capital restoration plan and is subject to a number of other operational restrictions.[2]

## Cross Support Requirement

- Covered Investors holding (either individually or jointly) an 80% interest in more than one bank or thrift are expected to provide "cross support" by pledging to the FDIC their proportionate interest in each such institution to pay potential losses to the deposit insurance fund resulting from failure of, or assistance provided to, any other such institutions.
- The FDIC may waive the cross support requirement if enforcing the obligation would not reduce the cost of the bank or thrift failure to the Deposit Insurance Fund.

## Limitation on Affiliate Transactions

- Any extension of credit by the acquired bank to the Covered Investor, an investment fund of a Covered Investor, or an "affiliate" of a Covered Investor is prohibited. For these purposes, "affiliate" includes any portfolio company in which the Covered Investor owns directly or indirectly at least 10% of the equity for at least 30 days.[3]
- Covered Investors will have to provide to the FDIC regular reports disclosing all of their "affiliates."
- Any existing loans from the failed bank to affiliates at the time that the Covered Investor makes the acquisition would not be affected.

## "Secrecy Jurisdiction" Restriction

- The FDIC Statement limits the potential use by Covered Investors of an ownership structure with entities domiciled in "bank secrecy jurisdictions" unless the Covered Investors (i) are subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the Board, and (ii) make commitments to provide information to the applicable U.S. federal banking agency with jurisdiction over the acquired bank, maintain business records in the United States, consent to disclose information covered by confidentiality or privacy laws, and consent to U.S. jurisdiction.
- "Bank secrecy jurisdiction" is broadly defined to include any country that applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws and prevents collection of information on the investor.
- PE Funds established in certain offshore banking centers may well be covered by this provision, and for some of them there will not have been a finding by the Board concerning comprehensive consolidated supervision, in which case the PE Firms would not be able to meet this requirement.

## Three-Year Minimum Holding Requirement

- Covered Investors must maintain their interest in the acquired depository institution for at least three years unless the FDIC approves an earlier sale of the interest.
- The FDIC approval in this regard may not be unreasonably withheld for transfers by the Covered Investor to an affiliate that agrees to abide by the FDIC Statement.
- The holding period does not apply to "mutual funds," defined as open-end investment companies registered under the Investment Company Act of 1940, as amended, that issue redeemable securities allowing investors to redeem on demand.

[2] This aspect of the FDIC Statement is also stricter than generally applicable standards where the "undercapitalized" status is reserved for lower bank capital levels.

[3] This limitation does not apply all of the requirements of Section 23A of the Federal Reserve Act, which imposes strict limits on transactions between a bank and its affiliates, to the acquired depository institution. However, it appears not to allow any loans whatsoever with affiliates, even if fully secured.

## Prohibited Investment Structures

- The FDIC clarifies that it would not approve so-called "silo" ownership structures. "Silo" ownership structures were successfully used, and received required regulatory approval, in past bank acquisitions by PE Firms. This structure typically involves a PE Firm (or its sponsor) creating multiple investment vehicles (e.g., each with a "non-controlling" interest in the resulting depository institution) funded and apparently controlled by the PE Firm (or its sponsor) to acquire ownership of a failed bank or thrift.
- The FDIC is especially concerned that the purpose of this type of structure is to artificially separate the non-financial activities of the PE Firm from its bank activities in order to avoid the status of a bank holding company. The FDIC also believes that this type of structure raises serious concerns about the sufficiency of the financial and managerial support to the acquired institution.

## Disclosure to Regulator

- A Covered Investor must submit to the FDIC information about the investor and all entities in its ownership chains including information on amount of capital, capital diversification, return profile, management team and business model.
- While the FDIC Statement is silent in this respect, the information on "all entities in the ownership chain" could potentially include any limited partners of the Covered Investor if it is organized as a limited partnership.[4] Such disclosure is fairly common for investors in U.S. regulated financial institutions, but will likely raise concerns for investors in private equity funds.
- In reaction to concerns raised by commentators, the FDIC Statement clarifies that confidential business information will be treated confidentially by the FDIC unless disclosure is required by applicable laws such as the Freedom of Information Act.

## Interplay of the BHCA and the FDIC Statement

Under the existing U.S. bank regulatory scheme, private investors (e.g., PE Firm "consortiums") that intend to acquire a failed bank generally need to secure clearance not only from the FDIC (i.e., to participate in the bidding process and, in many cases, acquire deposit insurance for the resulting bank emerging from receivership), <u>but also</u> from the Board to either (or both) (i) acquire "control" of the resulting bank and become a "bank holding company" under the BHCA, and/or (ii) especially in the context of a bank investment by a PE Firm, receive confirmation that the relationships between one or more individual PE Firms and the acquired entity do <u>not</u> involve "control" for purposes of the BHCA.

Indeed, in order to make a successful bid for a failed bank, PE Firms must carefully consider and navigate <u>each</u> of the restrictions (i) imposed by the FDIC Statement – which effectively represent an additional layer of potential FDIC requirements – and (ii) those imposed under the BHCA.

## Consequences of Acquiring Control of a Bank or Bank Holding Company

Any company that acquires "control" of a U.S. bank or bank holding company, as defined by the BHCA and Board interpretation, must itself become a bank holding company, with prior Board approval, and become subject to a host of regulations and restrictions on all aspects of its operations. These restrictions include limitations on the conduct of "non-banking" (or "commercial") activities, consolidated capital regulation, extensive

[4] Bank regulators typically require disclosure of the identity of, and the number and percentage of equity interests held by, each limited partner or shareholder owning 5% (sometimes 10%) or more of any class of equity of the regulated entity.

reporting requirements, and examination and supervision by the Board.[5]

In view of the PE Firm business model – which usually involves active participation in the management of commercial enterprises held as portfolio companies – becoming a bank holding company is generally not a viable option for most PE Firms. Thus, PE Firms generally seek to structure investments in banks or bank holding companies so as to avoid "control" status under the BHCA.

In many cases, this involves teaming up with other PE Firms (so-called "club deals") to assure that no single firm has acquired a "controlling" interest. Historically, this has also sometimes involved the establishment of so-called "silo" structures where a single PE Firm engineered an investment (e.g., through the use of multiple investment vehicles managed by the PE Firm) for the specific purpose of avoiding technical "control" by the PE Firm under the BHCA. As discussed above, however, the FDIC Statement does not permit this type of structure in the context of a failed bank acquisition. Moreover, the "silo" approach appears to be disfavored by Board staff as well. It is thus unlikely that an acquisition employing this approach would survive regulatory scrutiny at least in the near future.

## Concept of Control under the BHCA

The BHCA provides that a company controls a bank, and is therefore a bank holding company, if

- It directly or indirectly owns or controls 25% or more of any class of voting securities of the bank;
- It controls the election of a majority of the bank's directors or trustees; or
- The Board determines that the company otherwise exercises a controlling influence over the bank's management or policies.

A PE Firm's minority investment in a bank or bank holding company often raises questions about whether the PE Firm is able to exercise a "controlling" influence under the third prong of this statutory definition of control.

The Board Policy Statement on equity investments in banks and bank holding companies, issued September 22, 2008 (the "Board Policy Statement"), has broadened opportunities for investors to acquire a minority stake in banks without being determined by the Board to possess the power to exercise a "controlling" influence over the entity. Indeed, by (i) increasing the limits on overall equity holdings (e.g., up to 33% in certain cases), (ii) permitting greater investor representation on the bank's board, and (iii) relaxing certain restrictions on dealings with management, PE Firms now have greater flexibility in structuring "non-controlling" investments than they did under prior Board precedent.

Notwithstanding the adoption of the Board Policy Statement, the Board continues to apply a presumption of "control" for many investments in banking organizations in the 10% to 24.9% range. Frequently, this presumption may be rebutted by entering into s0-called "passivity commitments" with the Board.[6] The Board usually requires such commitments if an investor that intends to acquire more than 10% of the voting shares of a bank

[5] The activity restrictions under the BHCA are principally based on the traditional concern that if industrialists own banks or if banks control commercial enterprises, the resulting conglomerates would have the potential to dominate – and the ability to manipulate – markets to their advantage and to the detriment of the economy as a whole.

The Obama Administration's recent White Paper proposal notes that, "[f]ederal law has long prevented commercial banks from affiliating with commercial companies because of the conflicts of interest, biases in credit allocation, risks to the safety net, concentrations of economic power, and regulatory and supervisory difficulties generated by such affiliations. This policy has served our country well, and the wall between banking and commerce should be retained and strengthened." *See* Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation, page 34.

[6] Standard passivity commitments include promises by the PE Firm not to attempt to (i) exercise a controlling influence over management of the banking organization or (ii) influence the policies or decisions on dividends, investments, loans, pricing of services, personnel, operations of such organization (i.e., office location and opening hours) or any similar decisions or activities.

requests a written non-control determination from the Board.

## Structures for a Non-Controlling Investment in a Failed Bank Following the FDIC Statement

Structuring a non-controlling investment in a bank poses numerous challenges for a PE Firm, including: (i) required consultation with regulators (e.g., the FDIC and the Board); (ii) a regulatory review that can affect the timing of signing and closing; (iii) individual investors that "control" or "presumptively" control the investing vehicle may need to join regulatory filings and commitments; and (iv) the regulator's conclusion on the "control" analysis is oftentimes uncertain.

There are several approaches that PE Firms have historically employed – and may, if deemed commercially viable, continue to employ – to address these challenges and to structure investments in a failed U.S. bank. While each transaction is unique in that it is evaluated by the relevant banking agencies on the basis of the particular facts and circumstances at issue, for the sake of simplicity, we have set out in the Annex hereto the basic outline for four broad categories of investment structures from the perspective of the FDIC Statement and BHCA contr0l-related considerations (including those reflected in the Board Policy Statement).

The Annex shows that, as a general matter, PE Firms may avoid the requirements of the FDIC Statement only if:

- Each PE Firm only makes a "*De Minimis* Investment" of up to 5% of the total voting power of the failed depository institution; or
- PE Firms invest in the failed depository institution along with a bank holding company that owns a "strong majority interest" in the target bank.

Teaming up with a bank holding company in an "Investment Partnership with a Bank" has the advantage of avoiding compliance with the FDIC Statement, while investors under the "Private Investor Club Deal" structure (i.e., the third investment structure covered in the Annex) would be subject to the FDIC's new regime. Financial support requirements (capital maintenance and "cross support"), prohibition of "insider lending," three-year minimum holding period and disclosure requirements are, in other words, the regulatory "extra costs" to a PE Firm of a "club" deal.

Importantly, under the first three scenarios covered in the Annex, the PE Firm's investment must effectively be "passive" in order to assure that it does not "control" the acquired depository institution and become subject to regulation and restriction under the BHCA. An "active" or "controlling" investment in a failed bank (i.e., the fourth investment structure covered in the Annex) can only be made if the investor becomes a bank holding company.

## Moving Forward

It is not at all clear whether PE Firms will be willing to bid for failing banks under the revised rules of the FDIC Statement. While the FDIC appears to have tried to respond to industry criticisms of the Proposed Statement, the liberalizations might be seen as illusory. On the other hand, if additional signs of the easing of the financial crisis continue, PE Firms may see sufficient opportunity for profit by investing in failed banks that it will be worth the risk that the restrictions are more burdensome than they might appear. The FDIC's promise to review the requirements in six months may be the point at which a formal finding is made whether the FDIC Statement helped or hindered the recovery of the banking system.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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## ANNEX

| Nature of PE Firm's<br>Investment in the Failed Bank | Interplay Between the FDIC Statement<br>and "Control"-Related Considerations |
|---|---|
| Investment Structure Category #1<br><br>*"De Minimis* Investment"<br><br>▪ No investment by any individual "private investor" representing more than 5% of the total voting power of the acquired entity, and *provided that* there is no evidence of "concerted action" among investors in the acquired entity. | ▪ FDIC Statement requirements do not apply.<br><br>▪ "Non-Controlling" investment by the individual private investor (in almost all circumstances).<br><br>    ▪ Generally possible for a private investor to acquire up to 33% of the total equity of the acquired institution.<br><br>    ▪ A private investor should not typically be required to make "passivity commitments."<br><br>    ▪ Private investor representation (e.g., one representative) on the board of directors of the acquired institution is generally possible. |
| Investment Structure Category #2<br><br>"Investment Partnership with a Bank"<br><br>▪ One or more individual "private investors" each make an investment representing more than 5% of the total voting power of the acquired entity (but less than 25% of any class of voting securities of the entity) *provided that* another bank holding company with an established record for successful operation of insured banks or thrifts owns a "strong majority interest" in the acquired entity. | ▪ FDIC Statement requirements do not apply.<br><br>▪ "Non-Controlling" investment by the individual private investor generally possible.<br><br>    ▪ Possible in many cases for the private investor to acquire up to 33% of the total equity of the acquired institution so long as the investor does not own, hold or vote more than 14.9% of any class of voting stock of the acquired entity.<br><br>    ▪ In limited cases, the private investor may be required to make or offer to make "passivity" commitments.<br><br>    ▪ Private investor representation (e.g., one representative, and in some cases, two representatives) on the board of directors of the acquired institution should generally be possible. |

| Nature of PE Firm's Investment in the Failed Bank | Interplay Between the FDIC Statement and "Control"-Related Considerations |
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| Investment Structure Category #3<br><br>"Private Investor Club Deal"<br><br>▪ One or more individual "private investors" each make an investment representing more than 5% of the total voting power of the acquired entity (but less than 25% of a class of voting securities of the entity). | ▪ FDIC Statement requirements apply.<br>▪ Financial support requirements - capital maintenance/"cross support."<br>▪ Prohibition on "insider lending."<br>▪ Three-year minimum holding period by private investors.<br>▪ Disclosure requirements relating to private investor ownership.<br>▪ Restrictions on investment structure - no entities domiciled in a bank secrecy law jurisdiction and no "silo" structure.<br><br>▪ "Non-Controlling" investment by the private investor is generally possible.<br>▪ Possible in many cases for the private investor to acquire up to 33% of the total equity of the acquired institution so long as the investor does not own, hold or vote more than 14.9% of any class of voting stock of the acquired entity.<br>▪ In certain cases the private investor (particularly if the investor acquires 10% of more of a class of voting securities of the acquired entity) may be required to make or offer to make "passivity" commitments.<br>▪ Private investor representation (e.g., one representative) on the board of directors of the acquired institution should generally be possible. |

| Nature of PE Firm's Investment in the Failed Bank | Interplay Between the FDIC Statement and "Control"-Related Considerations |
|---|---|
| Investment Structure Category #4<br><br>"Controlling" Investment<br><br>▪ Investment by a "private investor" representing 25% or more of any class of voting securities, or 33% or more of total equity of the acquired entity, or the right to elect a majority of directors of the acquired entity. | ▪ FDIC Statement requirements probably apply.<br>  ▪ Financial support requirements - capital maintenance/"cross support."<br>  ▪ Prohibition on "insider lending."<br>  ▪ Three-year minimum holding period by private investors.<br>  ▪ Disclosure requirements relating to private investor ownership.<br>  ▪ Restrictions on investment structure - no entities domiciled in a bank secrecy law jurisdiction and no "silo" structure.<br><br>▪ FDIC might not impose the FDIC Statement requirements due to the private investor having to become a bank holding company.<br><br>▪ Automatic "controlling" investment by the private investor.<br>  ▪ Private investor becomes a bank holding company.<br>  ▪ Private investor subject to Board supervision, regulation, reporting, capital requirements, and limitation on non-banking activities. |