FDIC PROPOSES EXPANDING CHANGE IN BANK CONTROL ACT REVIEWS AIMED AT ASSET MANAGERS

Date: 20 August 2024

US Asset Management and Investment Funds Alert

EXECUTIVE SUMMARY

Last month, the Federal Deposit Insurance Corporation (FDIC) Board of Directors (FDIC Board) proposed an amendment to its regulations under the Change in Bank Control Act of 1978 (CBCA). Driven by the growth of passive investment vehicles, and the corresponding increase in bank ownership by large asset managers, the amendment would lead to increased scrutiny of share acquisitions in FDIC-supervised banks by "fund complexes," including indirect acquisitions reviewed by the Board of Governors of the Federal Reserve System (FRB). If adopted, this amendment could significantly increase CBCA filings, impacting the strategies, performance, and operations of fund complexes.

OVERVIEW

On 30 July 2024, the FDIC Board voted (3-2, along ideological lines) to propose an amendment to its regulations and procedures under the CBCA. The proposal, if adopted, would result in the FDIC actively reviewing the acquisition of shares of FDIC-supervised banks by “fund complexes”, including by indirect acquisitions that are also reviewed by the FRB. Such additional scrutiny is aimed at asset managers due to growing concerns by the FDIC about the potential risks posed by passive investment strategies and increasing ownership concentration in banks by large asset managers through the fund complexes they sponsor, manage, or advise. The approved proposal is similar to a prior proposal discussed and withdrawn at the FDIC Board's April meeting.

Passive investment vehicles such as index funds, including index-based exchange-traded funds that acquire shares in FDIC supervised banks as part of their investment strategy, have grown significantly in recent years leading to an increase in the ownership stakes in banks by fund complexes. As a result, the members of the FDIC Board have expressed concerns that fund complexes are acquiring significant amounts of voting securities in FDIC-supervised institutions, which could result in influencing the institution's management and policies or raise the institution's risk profile.

CBCA NOTICE FILING AND PASSIVITY COMMITMENTS

The CBCA requires a notice to be filed with the appropriate federal banking agency when a person or entity seeks to acquire direct or indirect control of an insured depository institution. For purposes of the CBCA, “control” means “the power, directly or indirectly, to direct the management or policies of an insured depository institution or to

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vote 25% or more of any class of voting securities of an insured depository institution."[1] For transactions in which an acquirer will own, hold, or control between 10% and 25% of any class of voting securities of an insured depository institution, the acquirer must file a notice with the appropriate federal banking agency or rebut the presumption of control. To rebut the presumption of control, an acquirer may demonstrate that it will not direct the institution's management or policies, for example, by entering into a written agreement with a banking regulator not to seek board representation or influence policies. These so-called "passivity commitments" are enforceable under Sections 8 and 50 of the Federal Deposit Insurance Act. While the exact provisions of the passivity commitments vary, they generally include restrictions requiring that the investor will not:

- Seek board representation;
- Oppose management's director nominees;
- Have officers or representatives serve as officers or employees of the institution;
- Acquire voting securities that aggregate to a specified percentage of a class or classes;
- Solicit proxies or influence the institution's policies and decisions;
- Dispose or threaten to dispose of securities in order to induce certain actions; or
- Engage in banking or nonbanking transactions with the institution, except in specified instances.

IMPLICATIONS OF THE PROPOSAL

The FDIC views a "fund complex" as a group of registered investment companies, investment funds, other pooled investment vehicles, and institutional accounts that are sponsored, managed, or advised by the same company and its affiliates. The proposal, if adopted, would measure the ownership threshold for the purposes of the required CBCA filing across all registered investment companies, investment funds, other pooled investment vehicles, and institutional accounts in a fund complex.

The FDIC reviews CBCA notices for insured state banks that are not members of the Federal Reserve System and insured state savings associations. As of 31 December 2023, the FDIC supervised 2,936 depository institutions. Upon receiving a CBCA notice, the FDIC has 60 days to disapprove the transaction (such 60-day period may be extended by 30 days at the FDIC's discretion and up to an additional 90 days in certain circumstances). Currently, eight types of transactions are exempt from this notice requirement, including when the FRB reviews a notice under the CBCA. The FDIC is proposing to remove the exemption for notices reviewed by the FRB and to remove references to holding companies from the definition of "covered institution." The result of the removal of this exemption would be to require acquirers of shares of bank holding companies that own an FDIC-supervised bank to file duplicative notices with both the FRB and the FDIC. Moreover, in the context of multibank holding company notices, multiple notices may need to be filed with the FDIC, and the denial of any notices could prohibit or delay the acquisition. In the proposal, the FDIC expressed its view that it is important for it to evaluate a change in control at the bank level, regardless of the fact there is also reviews at the holding company level.

The current exemption for FRB-reviewed CBCA notices does not extend to transactions in which the FRB determines to accept a passivity commitment in lieu of a CBCA notice. In such transactions, the FDIC evaluates

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whether a notice should be filed for indirect acquisition of control of an FDIC-supervised institution. In the proposal, the FDIC notes that in recent years it has typically not determined that a CBCA notice must be filed with the FDIC when the FRB has accepted a passivity commitment in lieu of a CBCA notice. The FDIC has indicated in the proposal that it intends to reconsider its procedures in these instances, which will likely result in the FDIC requiring a CBCA notice to be filed in more transactions.

A likely result of the proposal, if adopted, is that the FDIC will require fund complexes and their asset managers to enter into passivity commitments. The FDIC currently has entered into four passivity commitments with three asset managers investing in FDIC-supervised institutions.[2] This is in contrast to the FRB, which has passivity commitments in place with the majority of large asset managers.

The implications of this proposal would be both significant and wide-ranging. If adopted as proposed, it would result in a dramatic increase in CBCA filings, including by fund complexes. Although fund complexes may already be subject to making filings with the FRB, the FRB currently has passivity commitments in place with a significant number of fund complexes or asset managers, or has accepted passivity commitments in lieu of a CBCA filing, resulting in fewer CBCA filings, and, in such cases, the FDIC has typically not required a CBCA filing. As noted above, however, the FDIC has indicated that it intends to revisit its process for evaluating when a CBCA notice is required in instances where the FRB has such commitments, likely requiring a significant increase in filings. The impact of requiring fund complexes to file CBCA notices could materially impact the investment strategy, performance and operations of the funds within the fund complex, as the potential delay in processing the CBCA filing by the FDIC alongside a notice to the FRB could result in material implications. For example, the proposal, if adopted, could require fund complexes to file such notices when implementing an index reconstitution or rebalance event that may result in the fund complex owning more than 10% of a bank. The processing time for the CBCA notice may significantly impact the ability of one or more funds within the complex to adhere to its investment strategies by delaying the fund's ability to execute transactions implementing the index reconstitution or reallocation. A delay in implementation of the rebalance or reallocation may materially impact the price at which a fund within the fund complex may access the relevant securities, potentially causing material shareholder harm. Further, over time these delays and pricing issues may cause a fund to experience significant tracking errors with respect to its underlying index resulting in harm to existing shareholders and the marketability of the fund.

CONCLUSION

Despite the 3-2 vote by the FDIC Board, FDIC directors of both parties have expressed concerns regarding control of banks by fund complexes. In discussion of subsequently withdrawn proposals by Republican FDIC Director Johnathan McKernan, the FDIC Board has indicated interest in enhancing the FDIC's monitoring of control of banks by fund complexes.[3] Given Acting Comptroller of the Currency Michael Hsu's vote for the proposal, the Office of the Comptroller of the Currency (OCC) may also take similar action with respect to CBCA filings for national banks. In the proposal, the FDIC acknowledged the need for consistency amongst the federal banking agencies in reviewing CBCA notices and stated that it was committed to engaging in dialogue and coordination with the FRB and the OCC to develop an interagency approach to the review of CBCA filings. Comments on the notice of proposed rulemaking will be due 60 days from the date of its publication in the Federal Register. Fund complexes that hold a material amount of one or more bank holding company securities may want to consider providing comments.

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FOOTNOTES

[1] 12 U.S.C. § 1817(j)(8)(B).

[2] Available at https://www.fdic.gov/regulations/applications/resources/change-in-control.html.

[3] The FDIC has confirmed news reports that, subsequent to the approval of the proposal, two large assets managers of index funds received letters from FDIC staff seeking information about the managers' investments in banks and whether the managers are acting as passive shareholders.

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