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# Effect of Rule 19c-4 of the SEC on Anti-Takeover Measures by Converted Institutions

*Summary:* Rule 19c-4 of the SEC has a potentially significant impact on the ability of institutions that have converted from mutual to stock form to adopt certain anti-takeover measures, including certain types of anti-takeover charter provisions.

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On July 7, 1988, the Securities and Exchange Commission ("Commission or SEC") announced the adoption of Rule 19c-4 ("Rule") under the Securities Exchange Act of 1934 ("34 Act" or "Act") which has the effect of amending the rules of national securities exchanges ("exchanges") and national securities associations ("associations") (collectively "self-regulatory organizations") regarding listing and authorization requirements concerning shareholder voting rights. As discussed below, the Rule has a potentially significant impact on the ability of institutions that have converted from mutual to stock form to adopt certain anti-takeover measures, including certain types of anti-takeover charter provisions.

### Summary of the Rule

As explained in the adopting Release (Release No. 34-25891, "Release"), Rule 19c-4 amends exchange and association rules to prohibit the common stock or other

equity securities of a domestic issuer from being or remaining listed on an exchange or from being or remaining authorized for quotation and/or transaction reporting through an automated inter-dealer quotation system operated by an association (such as the National Association of Securities Dealers Automated Quotation ["NASDAQ"] System), if such issuer "issues any class of security or takes other corporate action with the effect of nullifying, restricting, or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer registered pursuant to Section 12 of the Act."

The Rule outlines certain activities that are presumed to "nullify, restrict or disparately reduce" the per share voting rights of shareholders. These are: corporate action to impose any restriction on the voting power of shares of the common stock of the issuer held by the beneficial or record holder based on the number of shares or the length of time such shares have been held by such holder; the issuance of shares in an issuer exchange offer in which the securities offered have voting rights greater or less than the per share voting rights of any outstanding class of the issuer's common stock; and any issuance of securities pursuant to a stock dividend, or any other type of distribution of stock, in which the securities have voting

rights greater than the per share voting rights of any outstanding class of the common stock of the issuer.

The Rule also provides specific exemptions to the presumptions described above which, taken alone, would be deemed not to have the effect upon shareholders' rights prohibited by the Rule. Under the exemptions, the issuance of disparate voting rights securities pursuant to an initial registered public offering ("IPO") would be presumed not to be a disenfranchising action prohibited by the Rule because, as explained in the Release, "(t)he purchase of limited voting rights stock in an IPO does not disenfranchise shareholders who purchase shares with the full knowledge, through adequate disclosure, of the limits on their individual and collective voting power. In such a situation, there is no existing class of public shareholders that is deprived of actual or potential voting control by the issuance of a class of disparate voting rights stock."

For similar reasons, the issuance of any class of securities through a registered public offering with voting rights "not greater" than the per share voting rights of any outstanding class of common stock of the issuer also is presumed not to have the prohibited effect, since "... shareholders purchasing a new issue of lower voting stock are fully aware of the limits on their voting

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power, both individually and collectively, at the time of purchase.”

In addition, the prohibited effect would be presumed not to result if securities are issued in a “bona fide” merger or acquisition, when such securities have voting rights no greater than those of any outstanding class of common stock, and if corporate action is taken pursuant to state anti-takeover statutes requiring a state’s domestic corporation to condition the voting rights of a beneficial or record holder of a specified threshold percentage of the corporation’s voting stock on the approval of the corporation’s independent shareholders.

Although the Rule itself does not specifically exempt mandatory restrictions on voting rights applicable under federal law, the Release explains that action taken pursuant to both specific state or federal requirements would not constitute prohibited action since the disenfranchising effect is the result of state or federal action, not “corporate action” prohibited by the Rule.

Finally, the Rule permits the self-regulatory organizations to adopt additional rules, policies, practices or interpretations to specify what types of securities issuances and other corporate actions are covered by, or excluded from, the prohibition of the Rule.

## The Mutual to Stock Conversion Regulations

FSLIC-insured or federally-chartered institutions converting from mutual to stock form are required by the Federal Home Loan Bank Board’s (“Board”) conversion regulations to register the securities issued in connection with the conversion under Section 12 of the ‘34 Act, and to undertake not to deregister such securities for a period of

three years thereafter. 12 C.F.R. § 563b.3(c)(19)(i). Therefore, the securities of such institutions would be subject, for at least three years, to the application of Rule 19c-4.

The conversion regulations further require that a converting institution include in its plan of conversion an undertaking to use its best efforts to encourage and assist a market maker to establish and maintain a market for the securities issued by the institution in the conversion and to use best efforts to list the shares of stock issued in connection with the conversion on a national or regional securities exchange or on the NASDAQ quotation system. 12 C.F.R. §§ 563b.3(c)(19)(ii) and (iii).<sup>1</sup> It is important to recall that in the case of holding company conversions these provisions are applicable to the stock of the holding company.

Therefore, if a converted institution or holding company thereof takes corporate action that is deemed by its appropriate self-regulatory organization to result in an effect prohibited by the Rule within three years of conversion, the institution or holding company must be concerned not only with the detrimental effect of being delisted from an exchange or losing its eligibility to be quoted on NASDAQ, but also with violation of its plan of conversion.

In this regard, it is clear from the discussion in the Release that the prohibition on offers to acquire and acquisition of more than ten percent of any class of stock of the converting institution without prior Board approval, as set forth at 12 C.F.R. § 563b.3(i)(3) of the conversion regulations, is “federal” rather than “corporate” action and, therefore, would raise no presumption of prohibited effect under the Rule. However, the adoption by a converted institution or its holding company of the

optional charter provision under 12 C.F.R. § 552.4(b)(8) that permits the institution to extend the limitations on beneficial ownership for up to five years<sup>2</sup> may, depending on the circumstances, run afoul of the Rule’s prohibitions.

If, for example, at the time of conversion, the optional charter provision was adopted, and the effects of the provision were fully described in the offering materials, the offering would qualify for the IPO exemption provided by the Rule.<sup>3</sup>

If, however, the converting institution or holding company did not adopt the optional charter provision at the time of conversion, but following conversion it decided to amend its charter to do so, it appears that such action may trigger the consequences of the Rule.<sup>4</sup> As noted earlier, if such stock is delisted or dropped from quotation on NASDAQ within three years of conversion, it also would cause the institution to be in violation of its plan of conversion.

## Other Anti-Takeover Measures Affected by the Rule

While the foregoing focuses on the interplay between Rule 19c-4 and the adoption of the optional charter provision permitted by the Board’s conversion regulations, any “corporate action” that produces a disenfranchising effect would have the same ramifications for a recently converted institution as those previously discussed. This would appear to include, for example, the issuance of certain types of “poison pill” securities pursuant to a stock dividend (or other type of distribution) in which the securities issued have greater per share voting rights than the per share voting rights of any outstanding class of the institution’s common stock (so-called “voting pills”).

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Accordingly, the potential interaction between Rule 19c-4 and the conversion regulations will be considered by staff in reviewing applications of federally chartered associations to amend their charters to include various types of anti-takeover provisions, as well as in reviewing any proxy materials in which such proposed amendments are described.

If the effect of a proposed amendment appears to be prohibited by the Rule and the association has recently converted from mutual to stock form, the staff will request that counsel amend the opinion required to be submitted in connection with anti-takeover charter amendments pursuant to 12 C.F.R. § 552.4(c) to address the applicability of the Rule and its effect on the requirements of the association's plan of conversion. If the revised opinion does not satisfy the staff's concerns, this may be a basis for denial of the proposed amendment. Alternatively (provided that the proposal raises no concerns other than those generated by the Rule), approval may be conditioned upon the association's receiving a favorable ruling from the appropriate self-regulatory organization to the effect that the Rule does not apply to the proposed action or that an exception to the Rule is available.

The proxy materials to be used in connection with the proposed amendment should include disclosure relating to the above.

## State-Chartered Institutions

While the Board generally does not have authority to object to charter provisions adopted by state-chartered institutions that comply with state law, the staff will do so in the case of an institution that has recently converted to stock form

and then attempts to adopt a charter provision that is within the scope Rule 19c-4. Again, in these instances, the Board's jurisdiction may be asserted since adoption of such provision would violate the terms of the institution's conversion. Thus, proxy materials of recently converted, state-chartered institutions that relate to the adoption of this type of charter provision will elicit the same comments and concerns from the staff and should include the same disclosure as would be required for a federally chartered association.

Furthermore, with regard to both federally and state chartered insured institutions, the staff will be alert for other filings, such as Forms 8-K or 8-A, which indicate that an institution plans to distribute a new class of securities, as a dividend or otherwise, which would provide for greater voting rights than the institution's outstanding common stock.

Similarly, if the staff becomes aware of such actions being taken by holding companies of recently converted institutions, counsel for the holding company, if known, will be contacted and advised of the issue presented by the holding company's action.

## Holding Company Reorganizations

As a final note, it appears that a transaction relating to the reorganization of a recently converted institution into a holding company structure also may raise issues under Rule 19c-4 since the same conditions are imposed on the holding company that, but for the reorganization, would otherwise be applicable to the converted institution.

Because it is unclear as to how this type of transaction will be categor-

ized for purposes of the Rule<sup>5</sup>, the staff will review all applications and proxy materials relating to such a reorganization with the concerns raised by Rule 19c-4 in mind. Unless or until a position is taken by the self-regulatory organizations on this issue that would obviate the need to do so,<sup>6</sup> counsel representing the holding company/converted institution in the transaction will be asked to confirm in writing that nothing in the holding company's current charter or bylaws would be prohibited by the Rule, or that an exception provided by the Rule is available. Counsel also will be asked to confirm that management is aware of the application and consequences of the Rule to enable them to avoid any future corporate action that could lead to a violation of the conditions of the approval of the holding company application.

In cases where such representations cannot be definitively made, approval of the application may be conditioned upon receipt of a favorable ruling from the appropriate self-regulatory organization as to the application of the Rule.

As with the materials relating to anti-takeover charter provisions described above, the proxy statement furnished to shareholders in connection with the reorganization should contain disclosure on this issue.

If questions arise concerning the foregoing, please contact Kathy Ulrich, Staff Attorney, (202) 906-7049.

<sup>1</sup> The regulation does not limit the time period during which the institution must use its best efforts to cause such securities to be quoted on NASDAQ or listed on an exchange.

<sup>2</sup> See 12 C.F.R. 563.3(i)(7).

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3 Since the offering of stock by an institution in a conversion is exempt from registration pursuant to Section 3(a)(5) of the Securities Act of 1933 ("33 Act") it does not fit squarely into the requirement of the rule's IPO exemption that the stock be offered in a registered public offering. We have been advised, however, by representatives of the New York and American Stock Exchanges and the National Association of Securities Dealers for NASDAQ that they would treat the offering of stock in a conversion as an IPO for purposes of Rule 19c-4 because the sale of stock is subject to disclosure standards similar to those required in a '33 Act public offering. Representatives of the SEC's Division of Market Regulation also have indicated that they would not consider this position inconsistent with the Rule. In holding company conversions this issue is not present because the holding company stock is sold in a "registered" public offering.

4 See footnote 135 of the Release. The footnote clearly indicates that the extension of the limitation on beneficial ownership of the institution's stock beyond the mandatory three-year period required by 563b.3(i)(3) would be considered corporate action prohibited by the Rule. It is not clear however, whether the adoption of the optional provision subsequent to conversion, with a time period on the ownership limitation of only three years from the date of conversion would be permitted, because, although the time frames of such a provision would mirror

those of the mandatory requirement, the optional provision further provides the institution with the ability to sterilize any stock owned in excess of 10% even if the acquisition of such stock were approved by the Board. Therefore, to ensure compliance with its plan of conversion, an institution seeking to adopt such a three-year provision after the initial offering of conversion stock (and within the three-year period after conversion that the stock is required to be listed on an exchange or quoted on NASDAQ under conversion regulations) should request an interpretive position from the SRO on which the institution's stock is listed or quoted before enacting the charter amendment.

5 As previously discussed, the Rule specifically prohibits the "issuance of securities through an exchange offer by the issuer for an outstanding class of common stock of the issuer in which the securities issued have voting rights greater or less than the per share voting rights of the outstanding stock of the issuer." What is meant by an "issuer" exchange offer, however, is not spelled out in the Rule or in the preamble to the adopting release. Therefore, while the reorganization is an "exchange offer," it is not clear whether the holding company and the insured institution would be treated as one and the same so that any corporate action taken to disenfranchise any existing shareholders would fall within this specific prohibition of the Rule.

Correlatively, neither is it clear that the holding company would be treated as a new

issuer for purposes of the Rule, thereby allowing the stock registered in the exchange offer to qualify for the IPO exception.

To further complicate matters, the transaction also may qualify for the exception available for the issuance of lower voting rights stock in connection with a "bona fide merger of acquisition". Apart from noting, however, that "...a merger or (business) combination between a company with a disparate voting rights plan and a company with a one share one vote capitalization must be scrutinized to ensure that it is being effected for a bona fide purpose", the Release fails to provide guidance as to the availability of this exception.

In light of the foregoing, in connection with a recent application on Form H-(e)1 by an institution to reorganize into a holding company structure, the new holding company has requested an interpretive position from NASDAQ as to whether its charter provision containing a capped voting plan that exceeds the scope of 12 C.F.R. 563b.3(i)(3) would be deemed to disenfranchise the holders of the institutions's outstanding common stock. As of yet, no ruling has been provided by NASDAQ.

6 We have been informed that NASDAQ, the American Stock Exchange and the New York Stock Exchange will take "consensus" positions on questions such as these that are presented to them.



— Julie L. Williams, Deputy General Counsel