Federal Reserve Proposal Would Clarify the Regulatory Control Framework

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Financial Services

On April 23, 2019, the Board of Governors of the Federal Reserve System (the "Board") issued a proposal that would clarify the types and degrees of relationships that constitute "control" over a banking organization for purposes of the Bank Holding Company Act (the "BHCA") and the Home Owners' Loan Act (the "HOLA").[1] The proposal is the Board's first major pronouncement on the topic of "control" since a 2008 policy statement on equity investments in banks and bank holding companies. The concept of "control" has far-reaching implications for banking organizations and companies in which they invest, but the proposal will be of particular interest to companies seeking to invest in banking organizations without becoming regulated depository institution holding companies (and banking organizations seeking to attract such investment).

Key takeaways from the proposal include the following:

- The proposal largely represents a codification of the Board's historic interpretations, many of which were not previously available in the form of written guidance.
- The proposal is structured as a series of tiered presumptions setting forth the facts and circumstances that give rise to a "controlling influence" by an investor with a given amount of voting equity. Together with the proposal, the Board released a table summarizing the various tiers of presumptions.
- The control presumptions are noteworthy in that they would provide more leeway than was previously assumed to be the case to investors who hold smaller voting interests to serve on a banking organization's board and board committees, have business relationships with the banking organization (including on non-market terms), and have a management interlock with the banking organization. In particular:
    - ***Board representation***. In prior guidance, the Board generally permitted non-controlling investors to have only one representative on a banking organization's board of directors, or two representatives (on a board of nine or more directors) if such director representation was proportional to the investor's interest and another

[1] The proposal would not apply to control issues under the Change in Bank Control Act, which the Board administers on an interagency basis. Generally, the Change in Bank Control Act gives the primary federal regulator of an insured depository institution or its holding company 60 days to disapprove a proposed transaction that would result in a change in control of the institution or company.

investor had control under the BHCA. Under the proposal, however, non-controlling investors that control less than 5 percent of the banking organization's voting equity could control up to (but less than) 50 percent of the banking organization's directors, and non-controlling investors that control 5 to 24.99 percent of the banking organization's voting equity may control up to (but less than) 25 percent of the banking organization's directors, provided (in the case of an investor who controls 15 to 24.99 percent of the banking organization's voting equity) that no director representative is the chair of the board.

- ***Board committees***. In prior guidance, the Board stated that non-controlling investors could not occupy more than 25 percent of the seats on *any* of the banking organization's board committees. Under the proposal, however, the 25 percent restriction would apply only to investors that own 10 percent or more of the banking organization's voting equity, and only to those board committees that can bind the banking organization. There would be no restrictions on committee representation for committees that do not have the power to bind the banking organization.
- ***Business relationships***. In prior guidance, the Board stated that business relationships (*e.g.*, supplier, customer, or lender relationships) between a non-controlling investor and a banking organization were permitted only if they were quantitatively limited and qualitatively non-material. The Board took a case-by-case approach to reviewing such business relationships, and was particularly skeptical of business relationships between a banking organization and a non-controlling investor that were not on market terms. Under the proposal, however, business relationships between a non-controlling investor and the banking organization would be permitted if they do not exceed a specified percentage of the annual revenues or expenses of either the investor or the banking organization (with the specified percentage keyed to the investor's level of voting equity). For instance, investors with control of less than 10 percent of the banking organization's voting equity could have business relationships with the banking organization representing up to 10 percent of either entity's annual revenues or expenses. Additionally, business relationships between a non-controlling investor and a banking organization would not need to be on market terms for investors with control of less than 10 percent of the banking organization's voting equity.
- ***Management interlocks***. In prior guidance, the Board has identified management interlocks as an indicator of control, but has not quantified the number of permissible management interlocks for a non-controlling investor. Under the proposal, however, one management interlock would be permitted for an investor that controls up to (but less than) 15 percent of the banking organization's voting equity, provided that the employee is not the CEO of the banking organization.

- Additionally, the proposal includes a divestiture presumption that would make it easier to terminate a control relationship by divesting from a banking organization. The divestiture presumption would represent a shift from the Board's historical practice, under which a controlling influence could linger even after a substantial divestment. The divestiture presumption would be limited to divestments of control positions; the proposal does not discuss divestitures that would enable a non-controlling investor to be released from its passivity commitments.
- The Board has not proposed to change the amount of non-voting equity that an investor can hold without having a controlling influence. Total equity limits for a non-controlling

investor would remain one-third, for an investor with less than 15 percent of any class of voting securities; or 25 percent, for an investor with 15 percent or more but less than 25 percent of any class of voting securities. However, the proposal would, for the first time, establish clear rules for calculating an investor's total equity percentage. Additionally, the proposal would clarify the scope of defensive rights that securities can provide shareholders while remaining "non-voting securities."

Background

The concept of "control" permeates federal banking regulation. Most significantly, the BHCA and HOLA impose substantial restrictions on any company that directly or indirectly controls a bank, savings association, bank holding company, or savings and loan holding company (collectively, "banking organizations"). A company that controls a banking organization is subject to Board supervision, regulation, and enforcement, which includes periodic examinations, reporting obligations, capital and liquidity requirements, and restrictions on the activities and transactions in which the company is permitted to engage. Avoiding "control" is therefore an absolute requirement for many investors evaluating potential investments in banking organizations.

The BHCA's definition of "control" is also relevant in a variety of other regulatory contexts, such as:

- Determining the extent to which a company can accept an investment from a banking organization without becoming subject to banking regulation such as the Volcker Rule.
- Setting parameters for permissible investment by a bank holding company in a nonbank company under section 4(c)(6) of the BHCA.
- Determining whether a foreign banking organization's investment in a U.S. company must be made through its U.S. intermediate holding company.
- Identifying entities that are affiliated with an insured depository institution for purposes of Regulation W's limitations on transactions with affiliates.

The BHCA uses a three-pronged test to define "control." As implemented by the Board, a company (which we refer to as the "first company" or the "investor") has control over another company (which we refer to as the "second company" or the "issuer") if:

1. the first company directly or indirectly or acting through one or more other persons owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the second company;
2. the first company controls in any manner the election of a majority of the directors of the second company; or
3. the Board determines that the first company directly or indirectly has the power to exercise a "controlling influence" over the management or policies of the second company.[2]

[2] Additionally, a statutory presumption of non-control applies if the first company controls less than 5 percent of any class of voting securities of the second company.

The HOLA defines "control" similarly to the BHCA.[3] Although the first two prongs of the "control" definition are bright-line tests, the "controlling influence" test involves a facts-and-circumstances determination by the Board. As a result, an investor seeking to avoid the requirements and restrictions of the BHCA and HOLA has faced uncertainty as to whether its investment in a banking organization will be considered non-controlling by the Board.

Over the years, the Board has developed views of the facts and circumstances that give rise to a "controlling influence." Although the Board has memorialized some of its practices in regulation and guidance, including policy statements it released in 1982 and 2008, it has also construed the "controlling influence" standard in a patchwork of written and unwritten interpretations. This approach has allowed Board staff to depart from past practices as it deems warranted, and to develop unwritten standards that have, at times, been applied selectively.

The proposal largely codifies and harmonizes the Board's historic practices, with certain adjustments. According to the Board, the proposal is intended to increase transparency and promote greater certainty among investors in banking organizations, which in turn should improve banking organizations' ability to raise capital.

Tiered presumptions of control

The most significant aspect of the proposal is the establishment of a series of tiered rebuttable presumptions of control within Regulation Y and Regulation LL, which implement the BHCA and HOLA, respectively. Although the Board would reserve the authority to find that a controlling influence exists even where none of the presumptions of control are triggered, the preamble to the proposed rules states that the Board "generally would not expect to find that a company controls another company unless the first company triggers a presumption of control with respect to the second company."

The rebuttable presumptions of control are structured based on specified levels of ownership of voting equity, and take into account the scope of different types of relationships between the companies[4] that the Board views as potentially giving rise to a "controlling influence." Such relationships that may be indicia of control include:

- ***Voting and non-voting equity investment.*** Although a large investment in voting stock is perhaps the most direct mechanism by which a company can exert control over a second company, a large non-voting equity investment can also give rise to a controlling influence. For example, the first company can exert a controlling influence over the second company by threatening to dispose of its investment; in that case, the Board assumes that the second company would seek to avoid the negative market signal of such a sale by acceding to the first company's views.

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[3] Under HOLA, a company also has control over another company if the first company contributed more than 25 percent of the capital of the second company.

[4] Generally, a relationship between one company and a subsidiary of the other company would be viewed the same way as a direct relationship between the companies.

- ***Director representation.*** Director representation could also give rise to a controlling influence not only through board voting, but also through access to non-public information.
- ***Proxy solicitations.*** The Board believes that a company can exert a controlling influence over a second company by soliciting proxies that are contrary to the recommendation of the second company's board. In the proposal, however, the Board recognizes the need to balance controlling influence concerns with normal shareholder activities. Accordingly, the proposal would ease limitations on certain proxy solicitations.
- ***Management interlocks.*** A management interlock exists when a director or management official of a company is also a director or management official of a second company. Management interlocks can enable the first company to exert a controlling influence over the second company through access to non-public information, and through influence over the second company's policies and decisions.
- ***Limiting contractual rights.*** A limiting contractual right is defined as a contractual right that would allow a company to significantly restrict the discretion of a second company over operational and policy decisions. The proposal contains a non-exclusive list of contractual rights that would be deemed to be limiting contractual rights (*e.g.*, the investor has the contractual right to prohibit the issuer from entering into new business lines, or the investor has the contractual right to hire or fire one or more senior management officials of the issuer), as well as a non-exclusive list of contractual rights that would be deemed not to be limiting contractual rights (*e.g.*, the investor has the contractual right to prevent the issuer from issuing securities senior to the securities owned by the investor). Both lists are included in the Appendix to this Client Alert.
- ***Business relationships.*** A controlling influence may arise where a company has a material business relationship with a second company, such as when one company is the major supplier, customer, or lender to the other company. The proposal takes a quantitative approach to evaluating the materiality of a business relationship.

The tiered presumptions are described in more detail below. The presumptions are cumulative, meaning that a company seeking to avoid control and that holds (for example) 16 percent of any class of voting securities would need to avoid triggering the control presumptions corresponding to all three ownership levels outlined below (*i.e.*, 5 percent, 10 percent, and 15 percent ownership).

<u>Ownership or control of 5 percent or more of voting securities</u>. A company that controls 5 percent or more of the outstanding securities of any class of voting securities of a second company would be presumed to control the second company if any of the following six factors is present:

- ***Director representation.*** The investor's director representatives control 25 percent or more of the directors on the issuer's board, or have the ability to make or block the making of major operational or policy decisions of the issuer.
- ***Management interlocks.*** Two or more employees or directors of the investor serve as senior management officials of the issuer.
- ***Management interlocks.*** An employee or director of the investor serves as CEO of the issuer.

- ***Business relationships.*** The investor enters into transactions or has business relationships with the issuer representing 10 percent or more of the total annual revenues or expenses of either the issuer or the investor on a consolidated basis.[5] It is not clear whether this control presumption (and the analogous control presumptions in the other ownership levels) would be a forward-looking or backward-looking test.
- ***Limiting contractual rights.*** The investor has one or more limiting contractual rights with respect to the issuer (except certain agreements in connection with an upcoming merger with or controlling investment in the issuer).
- ***Investment by senior management and directors.*** The investor's senior management and directors (and their immediate family members) control 25 percent or more of any class of voting securities of the issuer. An exception applies where the investor controls less than 15 percent of each class of the issuer's voting securities, and the investor's senior management and directors (and their immediate family members) control 50 percent or more of each class of the issuer's voting securities.

<u>Ownership or control of 10 percent or more of voting securities</u>. A company that controls 10 percent or more of the outstanding securities of any class of voting securities of a second company would be presumed to control that second company *if any of the preceding indicia of control is present*, or if any of the following additional factors is present:

- ***Proxy solicitations.*** The investor proposes a number of director representatives to the issuer's board in opposition to those proposed by the issuer's management that (taken together with the number of the investor's director representatives already on the issuer's board) represents 25 percent or more of the issuer's board. The preamble to the proposal specifically notes that the Board is not proposing a general ban on proxy solicitations, which it historically has imposed in its standard passivity commitments for non-controlling investors.
- ***Director representation.*** The investor's director representatives comprise more than 25 percent of any committee of the issuer's board that can bind the issuer.[6]
- ***Business relationships.*** The investor enters into transactions or has business relationships with the issuer that are not on market terms or that represent 5 percent or more of the total annual revenues or expenses of either the issuer or the investor on a consolidated basis.

<u>Ownership or control of 15 percent or more of voting securities</u>. A company that controls 15 percent or more of the outstanding securities of any class of voting securities of a second company would be presumed to control that second company *if any of the preceding indicia of control is present*, or any of the following additional factors is present:

- ***Total equity investment.*** The investor controls 25 percent or more of the total equity of the issuer.

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5 At this ownership level, business relationships between the investor and the issuer would not need to be on market terms.

6 The preamble to the proposal states that such committees typically include the audit committee, compensation committee, and executive committee.

- ***Director representation.*** The investor's director representative serves as the chair of the issuer's board of directors.
- ***Management interlocks.*** One or more employees or directors of the investor serve as a senior management official of the issuer.
- ***Business relationships.*** The investor enters into transactions or has business relationships with the issuer representing 2 percent or more of the total annual revenues or expenses of either the issuer or the investor on a consolidated basis.

Additional control (and non-control) presumptions

In addition to the tiered presumptions of control based on the investor's voting equity in the issuer, the proposal would add or clarify other control presumptions that are not related to the investor's level of voting equity. A company would be presumed to control a second company in any of the following circumstances, generally at <u>any</u> level of investment in voting securities:

- ***Total equity investment.*** The first company controls one-third or more of the second company's outstanding total equity.
- ***Management agreement.*** A management agreement is in place that gives the first company significant influence or discretion over the general management, overall operations, or core business or policy decisions of the second company. Examples of such agreements include where the first company is the managing member, trustee, or general partner of the second company.
- ***U.S. GAAP consolidation.*** The first company consolidates the second company on its financial statements prepared under U.S. generally accepted accounting principles.
- ***Investment advisory relationship.*** The second company is an investment fund, the first company serves as an investment advisor to the second company, and the first company directly or indirectly controls 5 percent or more of any class of voting securities, or 25 percent or more of the total equity, of the second company. This control presumption would not apply if the first company organized and sponsored the second company within the preceding 12 months. As with all scenarios, however, the first company could still have control of the second company in the first 12 months based on the statute's bright-line tests or by triggering other control presumptions (*e.g.*, if the first company controls 25 percent or more of any class of voting securities of the second company).

The proposal would provide an exception to all of its control presumptions where the second company is an SEC-registered investment company, and the business relationships between the companies are limited to investment advisory, custodian, transfer agent, registrar, administrative, distributor, and securities brokerage services provided by the first company to the second company. To qualify for this exception, the first company (1) could not have director representatives exceeding 25 percent of the second company's board, and (2) could not control 5 percent or more of any class of voting securities, or 25 percent or more of the total equity, of the second company unless the first company organized and sponsored the second company within the preceding 12 months.

The BHCA and existing regulations create a presumption of *non*-control where the investor controls less than 5 percent of any class of the issuer's voting securities. The proposal would expand this presumption of non-control to include situations where the investor controls less than 10 percent of every class of the issuer's voting securities, provided that no other presumption of control is triggered.[7]

Divestiture of control

The proposal would revise the Board's past practices regarding divestiture cases, in which a company that controls a banking organization seeks to terminate the control relationship by reducing its investment. The Board has historically taken a strict view of divestiture cases, reasoning that where a company controlled a banking organization for a substantial period, the company could potentially continue to exert a controlling influence over the banking organization even after a substantial divestiture. As a result, an investor seeking to *terminate* control has historically been required to divest to a much lower percentage of voting equity and total equity than would be sufficient to *create* control in the first place.

The proposal would recognize that whatever lingering influence exists following a substantial divestiture tends to decrease over time. As such, the proposal would establish a divestiture presumption whereby an investor that controlled the issuer at any point in the preceding two years would be presumed to control the issuer if the investor owns 15 percent or more of any class of the issuer's voting securities.[8] Thus, a controlling investor could effectively terminate a control relationship by either:

- divesting to below 15 percent of the issuer's voting equity immediately; or
- divesting to below 25 percent of the issuer's voting equity and waiting two years.

In each case, the investor would need to avoid triggering other control presumptions.

The divestiture presumption would not apply – in other words, the investor would not need to divest to below 15 percent of the voting equity to terminate control – if, following the divestiture, a majority of each class of voting securities of the issuer is controlled by a single individual or company that is unaffiliated with the investor. The preamble to the proposal also states that the divestiture presumption would not apply where an investor sells a subsidiary to a third company and receives stock of the third company in consideration for the sale.

Calculation of total equity

The proposal includes a standard for calculating a company's total equity percentage in a second company where that second company is a stock corporation that prepares its financial statements according to U.S. GAAP. The calculation would involve the following three steps:

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[7] The proposal would also incorporate this presumption of non-control into Regulation LL, despite the fact that HOLA does not contain a presumption of non-control for situations where the investor controls less than 5 percent of any class of the issuer's securities.

[8] For this presumption of control to apply, the investor would have had to control the issuer through ownership of 25 percent or more of any class of voting securities, or control over a majority of the issuer's board of directors, rather than through the power to exercise a controlling influence.

1. Determine the percentage of each class of voting and non-voting common stock of the issuer that is held by the investor, and the percentage of preferred stock of the issuer that is held by the investor.

2. Multiply each percentage from Step 1 by the value of the issuer's shareholders' equity that is allocated to the corresponding class of stock under U.S. GAAP. All shareholders' equity that is not allocated to preferred stock, such as retained earnings, is allocated to common stock.

3. Sum the products from Step 2 (so that the results for all classes of stock are added together), and divide this amount by the issuer's total shareholders' equity. The result would be the investor's total equity percentage in the issuer.

The proposal would include various adjustments for more complex structures, such as those involving subsidiaries, and rules for when debt and other instruments will be treated as functionally equivalent to equity.

Control proceedings

The proposal would update existing regulations regarding the procedures under which the Board may determine that a company exercises a "controlling influence" over a banking organization. Under the regulations and proposal, the Board has the discretion to issue a preliminary determination of control if it appears, based on a presumption of control or other facts and circumstances, that a company has a controlling influence over a banking organization. The company thereafter has 30 days to respond with (i) a plan to terminate the control relationship, (ii) a response contesting the preliminary determination, or (iii) an application for the Board to approve the control relationship. If the company protests the preliminary determination, a hearing is ordered where material facts are in dispute. At such hearing, the Board's substantive and procedural rules, including the control presumptions and Federal Rules of Evidence, would apply. The Board may issue a final order stating its determination following such hearing.

Miscellaneous

Another noteworthy feature of the proposal relates to non-voting equity. Historically, shares that incorporated all but the most limited defensive shareholder rights were viewed as voting securities by the Board. The proposal would enumerate a non-exclusive list of additional types of shareholder rights that the Board views as permissible for non-voting securities. The list incorporates shareholder rights commonly incorporated in the non-voting equity of investment funds structured as limited partnerships or limited liability companies (*e.g.*, the right to vote to remove a general partner or managing member for cause, or to continue or dissolve the company following the removal of a general partner or managing member).

It is worth noting what the proposal does *not* address. The proposal would not alter the "look-through" treatment of options, warrants, and convertible instruments for purposes of calculating the investor's voting and non-voting equity investment in the issuer, whereby the Board assumes that such options, warrants, and conversion features are exercised except in narrow circumstances. As mentioned previously, the proposal also would not revise the Board's existing interpretations of the Change in Bank Control Act, including the "acting in concert" standard.[9]

The proposal does not purport to change the Board staff's informal process of reviewing non-controlling investments. It also does not discuss whether the Board will continue to require certain non-controlling investors to enter into standard passivity commitments, as it historically has done. If such commitments continue to be required, the proposal does not discuss the circumstances in which they will be required or their contents. Some aspects of the proposal conflict with the Board's current standard passivity commitments. For example, the standard passivity commitments forbid a non-controlling investor from soliciting proxies on any issue, or threatening to sell stock to induce the issuer to take or forego any action. The preamble to the proposal specifically notes that the Board is not proposing a general ban on either type of action.

Finally, the preamble to the proposal indicates that the Board considered (but ultimately did not propose) an approach that distinguishes between closely-held and widely-held banking organizations. The Board requested public comments on this decision.

Conclusion

By increasing transparency around the Board's "controlling influence" analysis, the proposal will give investors and banking organizations some additional certainty when making non-controlling investments. However, the proposal generally would not provide more leeway for investors to make larger non-controlling equity investments than is currently permitted under the Board's control framework.

The proposal will be open for public comment for 60 days following its publication in the Federal Register.

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9 The standard applies to persons "acting in concert" with one or more other persons to acquire control of an insured depository institution or holding company.

Appendix: Regulatory Definition of "Limiting Contractual Rights"

As explained above, one of the indicia of control that appears throughout the proposal's tiered presumptions is whether a company has limiting contractual rights with respect to the second company. A limiting contractual right would be defined as a contractual right that would allow the first company to significantly restrict the discretion of a second company over operational and policy decisions. The proposal contains a non-exclusive list of contractual rights that would be deemed to be limiting contractual rights, as well as a non-exclusive list of contractual rights that would be deemed not to be limiting contractual rights. Both lists are reproduced below.

Contractual rights that are deemed to be limiting contractual rights. Limiting contractual rights include contractual rights of the investor that allow the investor to restrict or exert significant influence over the following decisions of the issuer:

- Activities in which the issuer may engage (e.g., prohibitions on new lines of business).
- How the issuer directs the proceeds of the investor's investment.
- Hiring, firing, and compensation of one or more senior management officials of the issuer (including the issuer's policies or budget concerning employee compensation and benefits).
- The issuer's ability to engage in fundamental transactions (e.g., merger, consolidation, acquisition) with respect to its subsidiaries or assets.
- The issuer's ability to make investments or expenditures.
- The issuer's achieving or maintaining financial targets or limits (e.g., debt-to-equity ratio).
- The issuer's payment of dividends or redemption of senior instruments.
- The issuer's ability to issue junior equity or debt (and amend the terms thereof).
- The issuer's ability to engage in a public offering or de-list from a securities exchange.
- The issuer's ability to amend its organizational documents (e.g., articles of incorporation, bylaws), other than pursuant to defensive shareholder rights of the investor.
- The issuer's ability to select or remove any independent accountant, auditor, investment advisor, etc.
- The issuer's ability to significantly alter accounting methods, or its regulatory, tax, or liability status.

Contractual rights that are deemed not to be limiting contractual rights. Limiting contractual rights do not include contractual rights of the investor that would not allow the investor to restrict the discretion of the issuer over operational and policy decisions of the issuer, including:

- Rights of the investor to restrict the issuer's ability to issue securities that are senior to those of the investor.
- Requirements that the investor receive financial reports of the type ordinarily available to common stockholders.
- Requirements that the issuer maintain its corporate existence.
- Requirements that the issuer consult with the investor on a reasonable periodic basis.

- Requirements that the issuer notify the investor of material events affecting the issuer.
- Requirements that the issuer comply with applicable statutory and regulatory requirements.
- Market-standard requirements that the investor receive similar contractual rights as those held by other the investors in the issuer.
- Requirements that the investor be able to purchase additional equity of the issuer in order to maintain the investor's percentage ownership in the issuer.
- Requirements that the issuer ensure that any shareholder that intends to sell its shares of the issuer provide the other shareholders of the issuer (or the issuer itself) with the opportunity to purchase the shares before the shares can be sold to a third party.
- Requirements that the issuer take reasonable steps to preserve its tax status or tax benefits (e.g., S-corporation status).