

The Federal Reserve's Final Control Rule: Six Things To Know

On January 30, 2020, the Board of Governors of the Federal Reserve System ("Board") unanimously approved a [final rule](#) that establishes a comprehensive framework for determining whether a company ("investor") controls another company ("investee") for purposes of the Bank Holding Company Act ("BHCA") and Home Owners' Loan Act ("HOLA"), and clarifies certain control-related concepts. After decades in which questions of control were addressed primarily through policy statements and individual interpretations and determinations, the final rule introduces, for the first time, clear standards codified in regulation.

In general, under the BHCA and HOLA, an investor has control over an investee if (i) the investor directly or indirectly controls 25 percent or more of any class of voting securities of the investee, (ii) the investor controls the election of a majority of the investee's board of directors, or (iii) the investor exercises a "controlling influence" over the management or policies of the investee. While the first two prongs of the definition of "control" are bright-line tests, the "controlling influence" prong has created substantial uncertainty as to whether an investor controls an investee. The Board's final rule brings much-needed clarity and transparency to this key part of the BHCA and HOLA frameworks.

A tabulated summary of the final rule's tiered presumptions, compared against those of the proposed rule, is appended to this Alert. For a preliminary comparison of the text of the final control rule against the text of the proposed rule, [click here](#).

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The final rule is largely unchanged from the April 2019 proposed rule, adopting a tiered framework of control presumptions and some additional presumptions.

The centerpiece of the final rule is a series of rebuttable presumptions of control, tiered based on an investor's level of ownership of voting equity of the investee, that take into account different indicia of control. These indicia of control include the investor's level of ownership of non-voting equity, director representation, proxy solicitations, management interlocks, limiting contractual rights, and business relationships with the investee. Additionally, the final rule adopts other control-related presumptions, such as certain presumptions that apply to divestitures.

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The final rule retains the proposed rule's strict limitations on business relationships between an investor and the investee, but only measures such business relationships from the perspective of the investee.

Because a controlling influence may arise where an investor has material business relationships with the investee, the proposed rule included quantitative limits on the materiality of an investor's business relationships with the investee, which were tiered based on the investor's level of voting equity. Many public commenters argued that the limits placed on business relationships where an investor owns 5 percent or more of the investee's voting equity were more stringent than necessary, but the Board generally rejected these comments in the final rule. The sole change adopted in the final rule is that the quantitative limits on business relationships will apply only from the perspective of the investee, rather than of both parties. Thus, where an investor holds at least 5 but less than 10 percent of an investee's voting equity, business relationships with the investor must account for less than 10 percent of the *investee's* revenues or expenses. This limit drops to 5 percent of revenues or expenses where the investor owns at least 10 but less than 15 percent of the investee's voting equity, and drops to 2 percent where the investor owns at least 15 but less than 25 percent of the voting equity.

3**The final rule retains the presumption that an investor controls the investee where the investor consolidates the investee for purposes of U.S. GAAP.**

Despite opposition from many public commenters, the final rule retains the proposed rule's presumption that an investor that consolidates an investee on its balance sheet for purposes of U.S. GAAP has control over the investee. The preamble to the final rule explains that "[t]he inclusion of the GAAP consolidation presumption should reduce burden and uncertainty by allowing companies to identify presumptive control relationships based on existing accounting standards." Unlike other aspects of the final rule, which generally introduce more flexibility to the control framework, the GAAP consolidation presumption introduces substantial new stringency relative to the Board's prior precedent.

4**Non-controlling investors with 15 percent or more of the voting equity of an investee may now hold up to one-third of its total equity under the BHCA.**

Under prior Board precedent and the proposed rule, an investor that holds 15 percent or more of the voting equity of an investee could own no more than 25 percent of the total equity of the investee while remaining non-controlling. The final rule revises this standard for purposes of the BHCA by allowing investors with up to (but less than) 25 percent of an investee's voting equity to hold up to one-third of the investee's total equity. Notably, however, investors in a savings association or savings and loan holding company would continue to be limited to 25 percent of the total equity at any level of voting equity ownership.

5**The final rule retains the presumption of control for investment funds, but eliminates the exclusion for SEC-registered funds.**

Like the proposed rule, the final rule contains a presumption of control that applies where an investor serves as an investment advisor to the investee, the investee is an investment fund, and the investor directly or indirectly controls either 5 percent or more of the voting stock of the investee, or 25 percent or more of the total equity of the investee, subject to a seeding exception that applies if the investor organized and sponsored the investee within the preceding 12 months. The proposed rule would have also excluded from all control presumptions investment in an investee that is an SEC-registered investment company (provided certain other requirements were met), but the final rule eliminates that provision because, in the words of the preamble, the exclusion for SEC-registered funds had "minimal incremental information value beyond the general investment fund presumption."

6**The final rule expressly confirms that the framework of tiered control presumptions applies equally when determining whether an investment under section 4(c)(6) of the BHCA is "passive."**

Section 4(c)(6) of the BHCA permits bank holding companies to acquire less than 5 percent of any class of voting securities of another company, subject to a further requirement established by Board interpretation that the investment must be "passive." Several commenters on the proposed rule asked the Board to directly confirm that an investment that does not trigger a presumption of control under the new framework would be considered "passive" for purposes of the Board's interpretation of section 4(c)(6). The Board did so in the final rule.

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**Summary of Tiered Presumptions – Preliminary Comparison of Final Rule vs. Proposed Rule
(Presumption triggered if any relationship exceeds the amount on the table)**

	Less than 5% voting	5-9.99% voting	10-14.99% voting	15-24.99% voting
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses of either the second company	Less than 5% of revenues or expenses of either the second company	Less than 2% of revenues or expenses of either the second company
Business Terms	N/A	N/A	Market Terms	Market Terms
Officer/Employee Interlocks	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	<u>BHCs - Less than one-third</u> <u>SLHCs – 25% or less</u>	<u>BHCs - Less than one-third</u> <u>SLHCs – 25% or less</u>	<u>BHCs - Less than one-third</u> <u>SLHCs – 25% or less</u>	<u>BHCs - Less than one-quarter one-third</u> <u>SLHCs – 25% or less</u>