SULLIVAN & CROMWELL LLP

January 31, 2020

Federal Reserve Final Rule for Determining "Control"

Federal Reserve Adopts Final Rule Revising the "Controlling Influence" Prong of Its Control Rules

SUMMARY

On January 30, 2020, the Board of Governors of the Federal Reserve System (the "Federal Reserve") adopted a final rule (the "Final Rule") revising the "controlling influence" prong of its "control" rules under the Bank Holding Company Act of 1956, as amended (the "BHC Act").[1]

The Final Rule largely adopts the proposed rule, issued by the Federal Reserve in April 2019 (the "Proposed Rule"),[2] reaffirms the Federal Reserve's conceptual framework for analyzing "controlling influence," and rejects a number of banking industry recommendations for liberalization. Our Memorandum to Clients, published on April 24, 2019, discusses key aspects of the Proposed Rule.

The Final Rule will be effective on April 1, 2020.

BACKGROUND

The issue of "control" is a central concept under the BHC Act. Among other things, control determines: whether an investor in a banking organization is subject to the requirements and restrictions of the BHC Act (by becoming a "bank holding company"); whether a bank holding company's investment in a company is permissible under the BHC Act and/or subjects the investee company to the requirements and restrictions of the BHC Act; and whether an investor in any depository organization is subject to the Volcker Rule. As a result, a determination of whether or not an investment constitutes "control" is often determinative of whether an investment can be made (or, at least, must be restructured to avoid control).

Section 2(a)(2) of the BHC Act[3] applies a three-part test to determine whether a company "controls" a bank or other company for purposes of the statute: (i) the company, directly or indirectly, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank; (ii) the company controls in any manner the election of a majority of the directors or trustees of the bank; or (iii) the Federal Reserve determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a "controlling influence" over the management or policies of the bank. It is the third of these three tests that has created almost all the issues regarding whether control exists in any given investment.[4]

Recognizing the *ad hoc* manner in which the Federal Reserve developed its regulatory framework around "control," and the complexity of, and lack of transparency surrounding, the control analysis, the Federal Reserve issued the Proposed Rule, aiming to "provide substantial additional transparency" by codifying its existing presumptions of control (with "targeted adjustments") in the Federal Reserve's regulations.[5]

The Final Rule adopts the same framework, and most of the specific provisions of, the Proposed Rule. The Federal Reserve has expressed its view that the Final Rule is "generally consistent with current practice," that "no major impact on the banking industry is expected," and that the Final Rule "significantly improves the transparency and predictability around questions of controlling influence."[6]

DISCUSSION

A. TIERED FRAMEWORK FOR PRESUMPTIONS OF CONTROL

The Final Rule adopts the Proposed Rule's framework of tiered presumptions of control that are based on the percentage of a class of voting securities held by a company and incorporates nine "relationships." Under this tiered framework, a company will be presumed to control a second company if any of those relationships exceeds the applicable threshold for the relevant tier, as set forth in the chart below:[7]

Summary of Tiered Presumptions

(Presumption of control is triggered if any relationship exceeds a threshold set forth for the applicable tier of ownership of a class of voting securities)

	Ownership of Class of Voting Securities			
	Less than 5%	5% - 9.99%	10% - 14.99%	15% - 24.99%
Directors	Less than 50%	Less than 25%	Less than 25%	Less than 25%
Director Service as Board Chair	No threshold	No threshold	No threshold	No director representative is chair of the board
Director Service on Board Committees	No threshold	No threshold	25% or less of a committee with power to bind the company	25% or less of a committee with power to bind the company
Business Relationships	No threshold	Less than 10% of revenues or expenses of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
Business Terms	No threshold	No threshold	Market terms	Market terms
Officer/Employee Interlocks	No threshold	No more than one interlock, never CEO	No more than one 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 for Directors	No threshold	No threshold	No soliciting proxies to replace 25% or more of directors	No soliciting proxies to replace 25% or more of directors
Total Equity[(1)]	Less than 33.33%	Less than 33.33%	Less than 33.33%	Less than 33.3%

(1) "Total Equity" in the above table presents the Final Rule's presumptions of control under the BHC Act and the Federal Reserve's Regulation Y. Presumptions of control with respect to savings and loan holding companies ("SLHC") under HOLA would instead create a presumption of control if a company's interest in an SLHC were 25 percent or more of the SLHC's total equity.

This tiered framework is basically identical to that in the Proposed Rule, with two adjustments:

- **First,** the presumption of control based on the level of business relationships between a first company and a second company[8] take into account the significance of the relationships only from the perspective of the second company. The Proposed Rule would have examined business relationships from the perspectives of both companies and would have created a presumption of control if revenues or expenses attributable to the relationship exceeded proposed thresholds with respect to either company.
- **Second,** the Final Rule adopted a uniform limit of 33.3 percent of total equity. Under the Proposed Rule, a company that controls between 15 percent and 24.99 percent of a class of the second company's voting stock would have been presumed to control the second company if the first company held more than 25 percent of the second company's total equity.

B. OTHER IMPORTANT ASPECTS OF THE FINAL RULE

The Final Rule also includes a number of important provisions, including additional presumptions of control and definitions for determining various elements of the Final Rule's presumptions of control, nearly all of which were adopted as proposed.

1. Calculation of Total Equity

Industry commenters expressed substantial concern that the methodology for calculating total equity would lead to a first company being deemed to control a second company, as a result of a relatively small investment, particularly with respect to start-ups and other entities that have little or no retained earnings under U.S. generally accepted accounting principles ("GAAP"). Commenters also noted that the proposed methodology could have the effect of discouraging investment into new companies or small businesses. Nonetheless, the Final Rule adopts the Proposed Rule's total equity calculation methodology, which is based on the amount of the second company's GAAP shareholders' equity allocated to the stock held by the first company.[9]

In addition, a first company is required to include in the calculation of total equity any debt instruments or other interests that are "functionally equivalent to equity." The Final Rule includes a list of non-exclusive examples of when debt may be considered functionally equivalent to equity, including treatment of the debt as equity under accounting, regulatory or tax standards; subordination of the debt; or long maturity. The Final Rule notes, however, that the Federal Reserve "expects to reclassify debt as equity under the [Final Rule] only under unusual circumstances to prevent evasion of the rule," and that the Final Rule should not be understood to indicate that debt with one or more of the listed features "automatically would be treated as equity."[10]

The Final Rule did add a provision to exclude equity instruments from the calculation of total equity if they are functionally equivalent to debt. The Final Rule notes, however, that "[t]his provision is intended to provide flexibility for unusual structures and is expected to be used rarely," and that companies should consult with the Federal Reserve to determine whether an equity instrument can be excluded from total equity.[11]

The Final Rule departs from the Proposed Rule in two other respects. First, the Final Rule eliminates a proposed provision that would have included a *pro rata* share of the second company's equity held by a non-subsidiary of the first company. Under the Final Rule, a first company must include in the total equity calculation only equity securities held by it and its subsidiaries. Second, under the Final Rule, a first company is required to calculate total equity only at the time of investment and when it acquires control over additional equity in the second company, and is not required to recalculate total equity when it sells or otherwise disposes of equity of the second company, as the Proposed Rule would have required.

2. Use of Passivity Commitments

Like the Proposed Rule, the text of the Final Rule is silent on the use of passivity commitments. In the preamble to the Final Rule, however, the Federal Reserve noted that it "does not intend to obtain the standard-form passivity commitments going forward."[12] The Federal Reserve also noted that, "absent unusual circumstances," it "expects to be receptive to . . . requests for relief" from existing passivity commitments.[13]

3. Investment Advice and Investment Funds

Notwithstanding industry recommendations to align the treatment of investment funds with other regulatory frameworks, such as the Volcker Rule, by, for example, allowing for a longer seeding period or by permitting an investment adviser to control up to 25 percent of any class of an investment fund's voting securities after the fund's seeding period, the Final Rule adopts the presumption of control for investment advisers as proposed. Under the Final Rule, a company that serves as an investment adviser to an investment fund will be presumed to control the investment fund if the company controls five percent or more of any class of the investment fund's voting securities or 25 percent or more of the fund's total equity, with a limited exception for a one-year seeding period.[14]

4. Accounting Consolidation

Despite industry concern that a presumption of control tied to accounting consolidation under GAAP would result in first companies being deemed to control second companies over which the first company did not exercise a controlling influence, such as certain variable interest entities and asset-backed commercial paper conduits, the Final Rule adopts the Proposed Rule's presumption that a company controls all companies that the first company consolidates for purposes of GAAP.[15]

The Final Rule by its terms creates a presumption of control only with respect to companies consolidated under GAAP, and does not apply the same presumption to consolidation under different accounting standards, *e.g.*, the International Financial Reporting Standards. The Federal Reserve noted, however, that it is "likely to have control concerns where a company consolidates another company on its financial statements under another accounting standard, particularly if the other accounting standard has consolidation standards that are similar to the consolidation standards under GAAP."[16]

The Proposed Rule sought comment on whether the Federal Reserve should presume that a first company controls companies that it accounts for under the equity method of accounting. Industry commenters strongly objected, noting that the threshold for presuming control under the equity method of accounting based on ownership of voting securities (20 percent) is substantially less than the BHC Act's control threshold (25 percent). The Final Rule does not adopt a presumption of control related to the equity method of accounting.

5. "Tear Down" Rule

The Final Rule adopts the presumption of control related to divestiture (the so-called "tear down" rule) as proposed, which represents one of the few material liberalizations to the Federal Reserve's historical practices. Under the Final Rule, a first company would be presumed to control a second company following a divestiture, if (i) at any time during the prior two years, the first company controlled the second company by (a) owning 25 percent or more of a class of the second company's voting securities or (b) controlling the election of a majority of the second company's directors, and (ii) the first company controls 15 percent or more of any class of the second company's voting securities. In practice, under the Final Rule, a first company generally would not be presumed to control a second company if:

- the first company (a) divests to below 15 percent of any class of voting securities of the second company and (b) no other presumptions of control apply (such as business relationships) (however, if the first company's ownership were to increase to 15 percent or more of any class of voting securities of the second company at any time during the two years following divestiture, then the first company would be presumed to control the second); or
- the first company (a) divests to between 15 and 25 percent of a class of voting securities of the second company, (b) two years pass and (c) no other presumptions of control apply (such as business relationships).

In addition, a first company will not be presumed to control a second company under the divestiture presumption if 50 percent or more of each class of the second company's voting securities is controlled by a person that is not a senior management official or director of the first company, or by a company that is not an affiliate of the first company.

6. Fiduciary Exception

Consistent with the Proposed Rule and the Federal Reserve's historical practice, under the Final Rule, presumptions of control do not apply to the extent that a company holds securities of a second company in a fiduciary capacity. In response to industry comment, the Federal Reserve revised the Proposed Rule to align with Sections 3 and 4 of the BHC Act. The Proposed Rule would have imposed the additional requirement that *all* securities held in a fiduciary capacity must also be held without sole discretionary authority to exercise the voting rights of the securities. The Final Rule, however, clarifies that this requirement only applies to securities of depository institutions or depository institution holding companies.[17]

7. Options, Warrants and Convertible Securities

The Final Rule adopts the Proposed Rule's "look-through" approach with respect to convertible instruments. Under the Final Rule, a person is deemed to control the maximum number of securities underlying a convertible instrument that the person could control as a result of the conversion or exchange of the instrument. There are limited exceptions to this approach for securities that are convertible upon specific types of transfers, such as a public offering, or that a person has agreed to acquire pursuant to a securities

purchase agreement. The Final Rule, however, did not include industry recommendations to limit the scope of the "look-through" approach to options and warrants that are in the money or that can be freely converted or exercised by the holder within a prescribed time period, *e.g.*, 60 days.

In response to industry comment, however, and consistent with historical practice, the Final Rule includes a provision to clarify that preferred securities that would be nonvoting but for a right to elect directors that becomes effective only after six or more quarters of unpaid dividends will not be treated as voting securities until the holder is actually entitled to exercise such voting rights.[18]

8. Application of the Proposed Rule to Existing Investments

The Final Rule rejects industry recommendations to apply the rule's framework only to prospective investments and to grandfather all existing investments (or, at a minimum, provide for a phase-in period). The Federal Reserve noted that because the Final Rule "is generally consistent with the [Federal Reserve's] current practice," it does not grandfather existing investments or provide for a transition period.[19] The Federal Reserve also notes that, if a first company previously considered a relationship not to constitute control, and the relationship was not reviewed by the Federal Reserve, but would be presumed to be a controlling relationship under the Final Rule, the first company "may contact the [Federal Reserve] to discuss potential actions."[20]

9. Application of the Control Framework to Other Statutes and Regulations

Finally, the Federal Reserve clarified that the Final Rule only changes the Federal Reserve's rules for control under the BHC Act and HOLA. The Final Rule does not apply to other statutes or regulations that include their own concepts of control such as the Change in Bank Control Act, Regulation O or Regulation W. For example, the Final Rule does not affect the requirement to obtain approval from the applicable regulators under the Change in Bank Control Act prior to acquiring control of a bank or bank holding company or the related presumption that a person seeking to acquire 10 percent or more of any class of voting securities of a bank or bank holding company would, in certain cases, control the bank or bank holding company for purposes of the Change in Bank Control Act.

* * *

ENDNOTES

1 Federal Reserve, Draft Final Rule, *Control and Divestiture Proceedings* (January 30, 2020), *available at* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-rule-fr-notice-20200130.pdf. The Final rule also amends the Federal Reserve's Regulation LL, 12 C.F.R. Part 238, in a substantially similar manner to revise determinations of control under the Home Owners' Loan Act ("HOLA") with respect to savings and loan holding companies. HOLA contains substantially similar tests for control as the BHC Act, and, with the exception of a lower threshold for "total equity," the Final Rule generally applies the same presumptions of control and related provisions to savings and loan companies under Regulation LL as it does to bank holding companies under Regulation Y.

2 84 Fed. Reg. 21634 (May 14, 2019).

3 12 U.S.C. § 1841(a)(2).

4 For a detailed discussion on the history of the Federal Reserve's control framework, please refer to our April 24, 2019 Memorandum to Clients on the Proposed Rule.

5 84 Fed. Reg. at 21634.

6 Final Rule at 12.

7 The summary chart is substantially reproduced from Vice Chair for Supervision Quarles' Memorandum to the Board of Governors, Final Rule to Revise the Board's Framework for Determining Whether a Company Has Control Over Another Company Under the Bank Holding Company Act and the Home Owners' Loan Act (January 23, 2020) Appendix, *available at* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-rule-memo-20200130.pdf.

8 For purposes of consistency with the Final Rule, the "Discussion" section of this memorandum uses the terms "first company" and "second company," as defined in the Final Rule. "First company" means "the company whose control over the second company is the subject of a determination of control by the [Federal Reserve]." Final Rule at 99. "Second company" means "the company the control of which by the first company is the subject of a determination of control by the [Federal Reserve]." Final Rule at 102.

9 The total equity calculation includes a correction to clarify that classes of preferred with equal seniority are treated as a single class for purposes of the total equity calculation. If *pari passu* classes of preferred stock have different economic interests, then the Final Rule states that "the number of shares of preferred stock must be adjusted for purposes of [the total equity calculation] so that each share of preferred stock has the same economic interest in the second company. Final Rule at 109.

10 Final Rule at 72.

11 *Id.* at 73.

12 *Id.* at 86.

13 *Id*.

14 *Id.* at 106.

15 *Id.* at 106.

16 *Id.* at 46.

17 *Id.* at 107.

18 *Id.* at 94.

19 *Id.* at 86.

20 *Id.* at 87.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York

Thomas C. Baxter Jr.	+1-212-558-4324	baxtert@sullcrom.com
Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Elizabeth T. Davy	+1-212-558-7257	davye@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Michael T. Escue	+1-212-558-3721	escuem@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Wendy M. Goldberg	+1-212-558-7915	goldbergw@sullcrom.com
Charles C. Gray	+1-212-558-4410	grayc@sullcrom.com
Shari D. Leventhal	+1-212-558-4354	leventhals@sullcrom.com
Marion Leydier	+1-212-558-7925	leydierm@sullcrom.com
Erik D. Lindauer	+1-212-558-3548	lindauere@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Camille L. Orme	+1-212-558-3373	ormec@sullcrom.com
Stephen M. Salley	+1-212-558-4998	salleys@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com
Donald J. Toumey	+1-212-558-4077	toumeyd@sullcrom.com
Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com
Benjamin H. Weiner	+1-212-558-7861	weinerb@sullcrom.com
Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com

Washington, D.C.			
	Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
	William F. Kroener III	+1-202-956-7095	kroenerw@sullcrom.com
	Stephen H. Meyer	+1-202-956-7605	meyerst@sullcrom.com
	Jennifer L. Sutton	+1-202-956-7060	suttonj@sullcrom.com
	Andrea R. Tokheim	+1-202-956-7015	tokheima@sullcrom.com
	Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
Los Angeles			
	Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
	William F. Kroener III	+1-310-712-6696	kroenerw@sullcrom.com
Paris			
	William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Tokyo			
	Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com