Sullivan & Cromwell LLP

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Federal Reserve Proposes Comprehensive Regulation for Determining "Control"

Federal Reserve Proposes Revision of Its Control Rules

SUMMARY

On April 23, 2019, the Board of Governors of the Federal Reserve System (the "Federal Reserve") approved a much-anticipated notice of proposed rulemaking (the "NPR") to revise its "control" rules under the Bank Holding Company Act of 1956, as amended (the "BHC Act").[1] Historically, the formal codification of the control rules has been limited, with much of the jurisprudence on control arising from the Federal Reserve's case-by-case interpretations, some of which have not been published. The NPR is intended to "provide substantial additional transparency on the types of relationships that the Board would view as supporting a determination that one company controls another company" by codifying, and in some cases modifying, the Federal Reserve's presumptions in a formal regulation.[2]

Under long-standing practice, the question of whether control exists for purposes of the BHC Act is a factual determination that depends on the circumstances of each case. Over time, however, the Federal Reserve "has identified a number of factors and thresholds that [it] believes generally would be indicative of [control]."[3] The NPR proposes to amend the Federal Reserve's Regulation Y[4] to implement a tiered framework based on share ownership of any class of voting securities (below five percent, five percent to 9.99 percent, 10 percent to 14.99 percent and 15 percent to 24.99 percent) that would "significantly expand" the number of presumptions for use in control determinations—including a number of rebuttable presumptions of control and a new, rebuttable presumption of noncontrol—depending on the percentage of a class of voting securities held by the investor.[5] As the investor's ownership percentage in a class of a company's voting securities increases into a higher tier, its other relationships with the company generally must decrease for the investor to avoid being deemed to control the company under the expanded presumptions of control.[6] These expanded presumptions are intended to be generally consistent with

historic practice, and in many cases do not significantly revise the Federal Reserve's existing control framework, but there are important "targeted adjustments" that liberalize certain aspects of the Federal Reserve's historic guidance.[7]

Generally, the NPR only modestly liberalizes, as a practical matter, the current rules with respect to investments by bank holding companies in other companies. More liberal treatment is, however, provided to investors in banks (including private equity investors and possibly activist hedge funds) through such modifications as the level of permissible directors and their role, clarification on proxy contests and the apparent removal of so-called passivity commitments (which are not mentioned in the NPR). Another key change is the liberalization of the so-called "tear down" rule, enabling an investor to exit its investment over time.

The Federal Reserve is seeking comment from the public and has asked nearly 60 questions covering almost every aspect of the NPR. Comments on the proposal are due 60 days after the NPR's date of publication in the Federal Register.

BACKGROUND

The issue of "control" is a central concept under the BHC Act. Among other things, control determines: whether an investor in a bank 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[8] 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.

Congress added the so-called "controlling influence test" to the BHC Act in 1970[9] to recognize that "actual control of any bank, even at less than 25 percent, is sufficient to require the controlling company to register as a bank holding company."[10] Over the ensuing decades, the Federal Reserve has interpreted the controlling influence test in a variety of regulations, policy statements and guidelines, interpretations, and formal determinations, as well as in other informal advice, which has resulted in a complex, and not always consistent or transparent, framework for determining whether control exists.

Between 1970 and 1982, the Federal Reserve's interpretations of the controlling influence test was largely consistent with the legislative history and focused on whether a company actually controlled a bank.[11]

During the 1980s, the Federal Reserve issued a series of interpretative letters, formal statements and revisions to Regulation Y that expanded the concept of controlling influence beyond the Federal Reserve's earlier interpretations.[12] This expansion of the controlling influence test began in response to so-called interstate "stakeout" investments in banks and bank holding companies.[13] At that time, several bank holding companies had begun to explore investments in non-voting securities of banking organizations in other states in anticipation of potential state approval of some form of interstate banking (which was effectively precluded at that time). In other cases, bank holding companies made minority investments in financial services companies, such as insurance agencies, in anticipation of legislative or regulatory amendments to expand the BHC Act's "closely related to banking" test for permissible activities under Section 4. These investments generally included convertible preferred securities or merger agreements that would be activated only in the event of a change in law that would permit the transaction.

The Federal Reserve's interpretations and policy statements then imposed a number of restrictions, including:

- a restriction on any equity investment to 25 percent of the investee's total equity (with equity being deemed to include subordinated debt);
- a limitation on common shares equivalents to 25 percent of the pro forma common shares, combined with a requirement of wide disposition;
- severe restrictions on business relationships between the investor and the investee;
- restrictions on covenants designed to assure the soundness of the investment;
- a prohibition on requirements of extensive consultation on financial matters;
- prohibitions or limitations on interlocking directors, interlocking management officials and consultation on major decisions;
- prohibitions on director representation for a company that acquired between 10 and 24.9 percent of a bank's voting stock; and
- prohibitions on financial covenants such as maximum leverage ratios.

The Federal Reserve subsequently issued policy statements and changes to Regulation Y that liberalized to a degree some of the Federal Reserve's earlier restrictions. For example, under the Federal Reserve's Policy Statement on Equity Investments in Banks and Bank Holding Companies (2008) (the "2008 Policy Statement"), the Federal Reserve clarified that a minority investor's ability to appoint a single representative to a bank's board of directors (noting that a typical board has 9 or 10 members) generally would not result in control.[14] Notwithstanding the 2008 Policy Statement and other guidance, the Federal Reserve's current rules on control extend beyond the earliest interpretations that focused on actual control. Another feature of the current regulatory regime on the question of control has been a sharp dichotomy in the standards for initially acquiring control ("build-up") and divesting control ("tear down"). For many years, the Federal Reserve has taken the position that the restrictions on a tear down to avoid or end control must be more stringent than on a build-up investment. As just one example, the Federal Reserve has required that a tear down investment be reduced to below five percent (or, in some cases, even to zero) of total equity to avoid a continuing control determination.

Recognizing the *ad hoc* manner in which the Federal Reserve has developed its framework around "control," and the complexity of, and lack of transparency surrounding, the control rules, the Federal Reserve has determined to "provide substantial additional transparency" by codifying its existing presumptions of control (with "targeted adjustments") in the Federal Reserve's regulations.[15]

DISCUSSION

As indicated, the Federal Reserve is proposing to put in place a tiered framework, based on the percentage of a class of voting securities held by a company. Under that framework, a company would be presumed to control a second company[16] if relationships exceeded the applicable threshold for that tier, as set forth in the below chart:[17]

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 key committee(1)	25% or less of a key committee(1)
Business Relationships	No threshold	Less than 10% of revenues or expenses(2)	Less than 5% of revenues or expenses(2)	Less than 2% of revenues or expenses(2)
Business Terms	No threshold	No threshold	Market terms	Market terms
Officer/Employee Interlocks	No threshold	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
Total Equity	Less than 33.33%	Less than 33.33%	Less than 33.33%	Less than 25%

(1) These are committees that have the power to bind a company without the approval of the full board of directors. Consistent with historic practice, examples provided by the Federal Reserve include the audit committee, compensation committee and executive committee.

(2) This threshold is exceeded and the presumption of control is triggered if the revenues or expenses attributable to the business relationship exceed the threshold revenues or expenses of *either* of the first company *or* the second company.

Although many of these presumptions do not alter the Federal Reserve's current framework for determining whether control exists, certain of the NPR's "targeted adjustments" represent a departure from the Federal Reserve's existing guidance, as discussed below. Although the codification of these presumptions may increase the "transparency" of the Federal Reserve's existing control framework, they only "clarify whether certain common fact patterns are likely to give rise to a controlling influence" and are intended to assist the Federal Reserve in determining whether control exists.[18] "Notwithstanding the presumptions of control or noncontrol, the [Federal Reserve] may or may not find there to be a controlling influence based on the facts and circumstances presented by a particular case."[19] At the same time, however, the NPR suggests that an investor that does not trigger a presumption of control under the tiered framework could only be held to be in control in unusual circumstances.

A. MAJOR CHANGES RESULTING FROM THE FRAMEWORK

Key changes resulting from this framework include the following:

- **Below five percent**: a formal presumption of non-control.
- **Five percent to 9.99 percent**: an increase in the percentage of business relationships; a management interlock (other than the chief executive officer).
- **10 percent to 14.99 percent**: board representation up to 24.9 percent; director service as board chair; expanded committee representation; increase in the percentage of business relationships; a management interlock (other than the chief executive officer).
- **15 percent to 24.99 percent**: board representation up to 24.9 percent; expanded committee representation.

As noted, a key change not mentioned in the NPR is the apparent elimination of the requirement for passivity commitments at higher investment levels.

B. "TEAR DOWN" RULE

In the NPR, the Federal Reserve proposes to revise the so-called "tear down" rule related to divestiture of control. As noted, under the Federal Reserve's current guidance, the Federal Reserve has made it far easier to achieve a finding of non-control of a company than to divest control once it is acquired. Under this so-called "tear down" rule, the Federal Reserve has generally required a company to divest a significant portion of its investment (frequently to less than five percent, or in some cases as low as zero percent of total equity); remove its director appointees from the board; terminate business relationships; and/or enter into a series of passivity commitments before the Federal Reserve will accept that the first company no longer controls a second company for purposes of the BHC Act.

The NPR creates a presumption that the first company generally would not be presumed to control a divested second company if certain conditions are met. Under the NPR, the first company would not be deemed to control a second company that was a subsidiary of the first 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, the first company generally would not be presumed to control the second if:

- the first company sells a subsidiary to a third company and a majority of each class of voting securities of the second company that is being sold is controlled by a single unaffiliated individual or company; or
- the first company sells a subsidiary to a third company and receives stock of the third company as some or all of the consideration for the sale (so long as the selling company does not control the acquiring company).

This change would significantly facilitate divestitures, which are often structured so as to have the divesting company take back equity of the purchaser. This change also may be of particular benefit to so-called fintech and other financial services companies that have been precluded from seeking a banking charter because of the presence of a large shareholder.

C. CALCULATION OF OWNERSHIP

As set forth in the 2008 Policy Statement, a company may control another company if its total equity investment, including both voting and nonvoting securities, exceeds certain thresholds. Under current practice, the Federal Reserve calculates a company's ownership percentage in a class of voting securities and in a bank's total equity using its own method, commonly referred to as "Fed math." Options, warrants or other securities that are freely convertible into a class or series of stock are deemed to be converted and/or exercised as of the day the first company acquires the convertible interest, regardless of whether it is in the money or whether the first company actually intends to exercise the option or warrant. For example, options or warrants for common stock are treated as common stock and calculated as voting securities on an as-exercised basis. Moreover, the Federal Reserve generally calculates the first company's percentage of the class of applicable securities (and of total equity) as if *no other investor* exercised its options or warrants. This can lead to untoward results for a company that holds a relatively small percentage of a class of voting securities of a second company on a fully-diluted basis, but that would hold a greater percentage under this method of calculation.

Importantly, the NPR would exclude from the "Fed math" calculation options, warrants or convertible instruments that an investor holds to avoid having the investor's position diluted in the event the company were to increase the number of its outstanding voting securities. That is, "Fed math" would not apply to convertible instruments as long as such instruments do not give the investor the right to acquire a higher percentage of the class of voting securities held immediately prior to conversion.

The NPR also provides the standard for calculating a company's "total equity" percentage in a second company that is a stock corporation that prepares financial statements under U.S. generally accepted accounting principles ("GAAP"). Although by its terms the standard for calculating total equity would apply only to stock corporations that prepare financials under GAAP, the Federal Reserve recognized that there may be other circumstances where it is possible to apply the standard to entities that are not stock corporations or that do not prepare GAAP financial statements, and would apply the same standard to those entities to "the maximum extent possible consistent with the principles underlying the general standard."[20] The Federal Reserve's calculation of total equity has been challenging in a number of situations, but particularly in investments in start-ups and early stage fintech companies that have experienced a history of operating losses. Moreover, the Federal Reserve has not previously provided public guidance on the calculation of total equity and, therefore, the proposed approach may differ from methodologies bank holding companies or other investors have used to calculate their total equity positions.

The NPR provides adjustments for more complex structures such as when a first company holds equity investments in a second company and the second company's parent. The calculation of total equity of the second company owned by the first company would include both the direct total equity of the second company controlled by the first company, and the indirect total equity of the second company controlled by the first company, "weighted by the total equity percentage of the second company's parent company in the second company."[21]

The NPR also provides that certain debt instruments may be included in some circumstances in the calculation of total equity if they include certain equity-like features, including applicable tax law treatment of the debt instrument as equity, extremely long-dated maturity or the qualification of the instrument as equity under GAAP or other applicable accounting standards, or if the issuance of the debt is not on market terms.[22] Moreover, other interests that are functionally equivalent to equity, such as one that entitles a company to share profits of a second company, could be treated as equity for purposes of the calculation.

The calculation of total equity for purposes of applying the applicable presumptions of control would be required any time the first company acquires control or ceases to control equity instruments (or other instruments that are treated as equity) of the second company.

D. SOLICITATION OF PROXIES

Historically, the Federal Reserve has taken the position that the solicitation of proxies by a company in opposition to a recommendation of a second company's board, including to elect directors to the second company's board, may cause the first company to be deemed to control the second company.

The NPR would, however, liberalize this position by enabling a company controlling 10 percent or more of any class of voting securities of a second company to solicit proxies to appoint a number of directors that represents less than a quarter of the second company's board without being presumed to control the second company. Significantly, the NPR proposes that proxy solicitation is not a presumptive control factor for an investor holding up to 9.99 percent of a class of voting securities. It is rare for an activist to cross the 10 percent line because doing so imposes requirements for disclosure and approval under the Change in Bank Control Act and analogous state laws.

E. INVESTMENT ADVICE

Historically, many institutions have limited their own investments in investment funds to which the institution serves as an investment adviser to less than five percent of total equity to avoid being deemed to control the investment fund. The NPR provides that when a first company serves as investment adviser to a second company that is an investment fund, the first company would be presumed to control the second company only if the first company controls 25 percent or more of the total equity capital or more than five percent of any class of voting securities of the second company. This presumption of control would not apply, and the first company investment adviser would be permitted to hold additional equity of the second company, during a limited seeding period.

F. ACCOUNTING CONSOLIDATION

The Federal Reserve has previously expressed in informal guidance a view that the consolidation of a company on another company's financial statements under GAAP does not necessarily result in control. However, under the NPR, a company would be presumed to control a second company if the second company is consolidated on the first company's financial statements under GAAP. This presumption is not intended to suggest that a company would not control a second company in the absence of consolidation.[23]

G. APPOINTMENT OF DIRECTORS

Although one of the BHC Act's tests for control is whether a company controls the election of a majority of directors of a second company, the Federal Reserve historically has taken a far more conservative position under the controlling influence test, in some cases precluding any director interlock. In the 2008 Policy Statement, the Federal Reserve took the position that a minority investor's right to appoint a single director would not result in a controlling influence.[24] However the Federal Reserve also noted that boards of banking organizations typically have 9 or 10 directors, and that director representation may be proportionate to the investor's total interest.

In addition, the appointed director would not be permitted to serve as chairman of the board or any committee or to serve on any committee in which the director would represent 25 percent or more of the committee's members (*i.e.*, the committee must consist of at least five members).[25] In some cases, the Federal Reserve has gone even further and required that the director not serve on a "key" committee, such as the executive committee or audit committee.

The NPR's proposed presumptions would permit a company to appoint any number of directors that constitute less than 25 percent of the total members of the second company's board before a presumption of control would be triggered. The NPR liberalizes this presumption even further for a company holding less than five percent of any class of voting securities, which would not be presumed to control a second company unless it were to appoint 50 percent or more of the total members of the board. Companies may also avoid a presumption of control even if a director appointee serves as chairman of the board, if the investment is under 15 percent of a class of voting securities, or sits on board committees, including, in some cases, "key" committees, as summarized in the above table.

H. BUSINESS RELATIONSHIPS

Historically, the Federal Reserve took the position that material business transactions or relationships between the investor and the banking organization or the banking organization and the investee could result in control under the controlling influence test, and then defined the term "material" as more than *de minimis*. In the 2008 Policy Statement, the Federal Reserve noted that "not all business relationships . . . provide the investor a controlling influence over the management or policies of the banking organization . . . particularly where an investor's voting securities percentage in the banking organization was closer to 10 percent than 25 percent."[26] In practice, the Federal Reserve makes determinations of whether a business relationship is permissible for a noncontrolling investment on a case-by-case basis, but is far more likely to find that a business relationship results in a controlling influence where an investor holds 10 percent or more of a class of voting securities. In addition, business relationships that are exclusive, not on market terms or that cannot be terminated without penalty almost always result in a determination that such relationships create a controlling influence.

Under the NPR's tiered approach, a presumption of control would be created depending on the first company's amount of voting equity, as summarized in the above table. Notably, a company that holds less than 10 percent of any class of voting securities of a second company would not trigger a presumption of control by entering into business relationships with the second company that are not on market terms. The NPR does not discuss presumptions related to business relationships that are exclusive or that cannot be terminated without penalty.

The NPR also provides that the thresholds that would trigger presumptions of control are based on revenues *or expenses* and apply to both the investor and investee. Historically, for control purposes, bank holding companies have generally analyzed their investments based on the percentage of total revenues the business relationship generates for each of the bank holding company and the second company. Under the NPR, bank holding companies would also definitively be required to analyze the expenses that the business relationship creates for both parties.

I. OFFICER INTERLOCKS

Historically, the Federal Reserve has taken the position that management interlocks, particularly those related to senior management positions, combined with an equity investment, cause a company to control a second company under the controlling influence test.

The NPR proposes to eliminate the existing presumption of control of shared management interlocks coupled with an investment in five percent or more of any class of voting securities where there is not a larger shareholder.[27] Instead, the NPR would permit a company to maintain certain senior management interlocks before a presumption of control is triggered, as summarized in the above table. Importantly, a company that holds less than five percent of any class of voting securities of a second company could maintain any number of officer interlocks with the second company without triggering a presumption of control under the NPR.

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ENDNOTES

1 Federal Reserve, Draft Notice of Proposed Rulemaking, *Control and Divestiture Proceedings* (April 23, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/control-proposal-fr-notice-20190423.pdf. The NPR would also amend 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 the Federal Reserve "believes that the statutory construct for controlling influence under HOLA is sufficiently similar to the BHC Act that it is appropriate to apply the same presumptions and related provisions to determinations of controlling influence under each statute." NPR at 79.

Importantly, the NPR would only change the Federal Reserve's rules for control under the BHC Act and HOLA. The proposal would not, for example, 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.

2 NPR at 1.

3 *Id.* at 6.

4 12 C.F.R. Part 225.

5 NPR at 1.

6 *Id.* at 6.

7 *Id.* at 1.

8 12 U.S.C. § 1841(a)(2).

9 Pub. Law 91-607 (Dec. 31, 1970).

10 115 Cong. Rec. H10561 (daily ed. Nov. 5, 1969) (statement of Rep. Ashley).

11 *See, e.g.*, *Patagonia Corp.*, 63 Fed. Res. Bull. 288, 292 (1977) ("The original amendment [to the BHC Act to add the controlling influence test] was offered by Congressman Ashley, and from statements by him and Congressman Patman it was clear that they intended to reach situations of actual control."). Since *Patagonia*, however, the Federal Reserve has largely ignored the "actual control" standard articulated by the legislative sponsor. There is, for example, no reference to this standard in the NPR.

12 *See, e.g.*, Federal Reserve, Policy Statement On Nonvoting Equity Investments by Bank Holding Companies, 47 Fed. Reg. 30965 (July 16, 1982) (the "1982 Policy Statement").

13 *See, e.g.*, 1982 Policy Statement ("In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding . . . located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the [BHC Act] . . ., the [Federal Reserve] believes it is appropriate to provide guidance regarding the consistency of such arrangements with the [BHC Act].").

14 *See* 12 C.F.R. § 225.31; 2008 Policy Statement, *available at* https://www.federalreserve.gov/bcreg20080922b1.pdf.

15 NPR at 1.

16 For purposes of consistency with the NPR, the "Discussion" section of this memorandum uses the terms "first company" and "second company," as defined in the NPR. "First company" means "the company whose control over the second company is the subject of a determination of control by the [Federal Reserve]." "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]." NPR at 53.

ENDNOTES (CONTINUED)

17 The summary chart is substantially reproduced from Vice Chair for Supervision Quarles' Memorandum to the Board of Governors, Notice of Proposed Rulemaking to Revise the Board's Rules for Determining Whether a Company Has Control Over Another Company (April 16, 2019) Appendix, *available at* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-proposal-board-memo-20190423.pdf.

18 NPR at 6, 14.

19 *Id.* at 14

20 *Id*. at 68.

21 *Id.* The NPR provides an example of this calculation: assuming that "(i) the first company has direct control over 10 percent of the total equity of the second company; (ii) the first company has 10 percent of the total equity of a third company that controls the second company; and (iii) the third company has 50 percent of the total equity of the second company," then "the total equity of the first company in the second company would be 15 percent—the 10 percent direct total equity interest plus a five percent indirect total equity interest (*i.e.*, 10 percent of the 50 percent total equity interest that the third company has in the second company)."

22 *Id.* at 69.

23 *Id.* at 43.

24 *Id.* at 6.

25 *Id.* at 8.

26 *Id*. at 13.

27 12 C.F.R. § 225.31(d)(2)(iii).

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