CLIENT ALERT

Federal Reserve Board Finalizes Control Standards Rule

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The Board of Governors of the Federal Reserve System (the "Board") recently adopted a final rule (the "Final Rule")[1] codifying certain presumptions relevant to the determination of whether a company exercises "controlling influence" over another company for the purposes of the Bank Holding Company Act of 1956, as amended (the "BHC Act").[2] The Final Rule is largely consistent with the notice of proposed rulemaking issued by the Board on May 8, 2019 (the "Proposed Rule").[3] The Board believes that the Final Rule will provide bank holding companies ("BHCs"), savings and loan holding companies ("SLHCs"), depository institutions and investors with significant additional transparency as to the facts and circumstances that the Board views as most relevant when making determinations of control.

The Final Rule will become effective April 1, 2020.

1 Federal Reserve Board, Control and Divestiture Proceedings (January 30, 2020), available here.

2 The Final Rule also provides similar control standards for the purposes of the Home Owners' Loan Act, as amended ("HOLA"), which regulates savings and loan holding companies. The Final Rule does not address questions of control for the purposes of the Change in Bank Control Act, Regulation O or Regulation W.

3 For more information on the Proposed Rule, please see our related client memorandum entitled "Federal Reserve Board Proposes to Codify 'Control' Standards" (May 8, 2019), available here.

Background

The concept of "control" is central to the BHC Act and the regulations promulgated thereunder. A company deemed to directly or indirectly control a bank or a BHC (collectively, "Banking Organizations") is subject to regulation as a BHC under the BHC Act, including supervisory oversight and examinations by the Board, regular financial reporting, capital and liquidity requirements, source of strength obligations, limitations on nonbanking activities and restrictions on affiliate transactions. Conversely, a company may also be subject to regulation as a BHC if it is deemed to be under the control of a Banking Organization. As a result, the question of control is often determinative with respect to the permissibility and viability of transactions involving Banking Organizations.

The BHC Act provides a three-pronged test to determine whether a company controls another company for the purposes of the statute. A company has control over another company if the first company: (i) directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the second company, (ii) controls in any manner the election of a majority of the directors or trustees of the second company or (iii) directly or indirectly exercises a "controlling influence" over the management or policies of the second company. While the first two prongs have long been understood to be relatively bright-line standards, the final prong has been the subject of considerable speculation among practitioners as a result of the complex process by which the Board determined whether or not a controlling influence exists.

The Board has historically interpreted "controlling influence" to mean something less than complete domination or control over all aspects of management and policies, based on the specific facts and circumstances in each case. While the BHC Act provides a statutory presumption against control when the first company holds less than 5 percent of any class of voting securities of the second company, even the "mere potential for manipulation" may be sufficient for a finding of control.[4] The Board has developed over the years an ad hoc regulatory framework to fill the gaps in the statutory language and articulate certain factors and thresholds that the Board views as indicative of controlling influence or a lack thereof. This final prong and the Board's presumptions of control are the principal subject of the Final Rule.

Tiered Presumption Framework

The Final Rule substantially adopts the tiered presumption framework of the Proposed Rule.[5] The framework sets out specific presumptions of control and noncontrol to be applied based on the first company's tier of ownership of voting

[4] *Interamericas Investments, Ltd. v. Bd. of Governors of the Fed. Reserve Sys.*, 111 F.3d 376, 383 (5th Cir. 1997).

[5] The Board declined to adopt two notable aspects of the framework in the Proposed Rule. First, the Proposed Rule examined the relationship between the first company and the second company from the perspective of both companies. The Final Rule only examines such relationship from the perspective of the second company. Second, the Proposed Rule presumed control where the first company held between 15 and 24.99 percent of a company's voting shares as well as more than 25 percent of such company's equity. The Final Rule uniformly presumes that an investor controls the company if the investor holds more than 33.33 percent of equity.

shares of the second company. The supplemental factors that the Board will assess in conjunction with the percentage of voting shares held in the second company are: the first company's representation on the board of directors of the second company; the scope and terms of the business relationship between the two companies; officer and employee interlocks between the companies; the contractual rights the first company has with respect to management of the second company; proxy voting authority; and the size of the first company's total equity investment in the second company. Generally speaking, the Final Rule provides greater flexibility for a company in a lower tier of ownership of voting shares to conduct business with the second company without being presumed to exercise a controlling influence over the second company.

The chart below provides a summary prepared by the Board of the presumptions of control based on the percentage of the tier of ownership of voting shares held by the first company. The first company will be presumed to not control the second company if the terms of its relationship with the second company do not exceed those listed under the applicable tier of ownership of voting shares.

Percentage of Voting Shares of the Second Company Held by the First Company

	< 5%	**5% - 9.99%**	**10% - 14.99%**	**15% - 24.99%**
Director Representation	< 50%	< 25%	< 25%	< 25%
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	≤ 25% of a committee with power to bind the company	≤ 25% of a committee with power to bind the company
Business Relationships	N/A	< 10% of revenues or expenses of the second company	< 5% of revenues or expenses of the second company	< 2% of revenues or expenses of 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 Solicitations	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[6]	< 33.33%	< 33.33%	< 33.33%	< 33.33%

[6] For the purposes of HOLA, the threshold for SLHCs is 25 percent.

Director Representation: Consistent with the second prong of the BHC Act control test, the Board considers a company's level of representation on the board of directors of a second company to be an important factor for controlling influence. The Final Rule adopts the language of the Proposed Rule with respect to the presumptions of control for director representatives serving as chair of the board or serving on certain committees and does not distinguish between public and private companies or between companies with varying proportions of independent directors. An advisory committee may fall within the scope of this standard if the committee has the ability to take action that binds the company or its subsidiaries. A rebuttable presumption of control may also arise where the first company, through a combination of its voting share ownership and representation on the second company's board of directors, has the ability to make or block the making of major operational or policy decisions of the second company.

Business Relationships: The Board will examine the business relationship between the first company and the second to determine whether the economics of their relationship provides a means through which the first company could exercise a controlling influence over the second company. In determining whether such controlling influence exists, the Board will consider whether the first company's business relationship with the second company generates significant amounts of total consolidated annual revenues and expenses of the second company, as each term is generally understood in the context of U.S. generally accepted accounting principles ("GAAP").[7]

Proxy Solicitations: The Board has historically found controlling influence issues where a company controls 10 percent or more of a class of voting securities of a second company and solicits proxies on an issue from the shareholders of that company. The Final Rule presumes control if the first company controls 10 percent or more of any class of the second company's voting shares and also solicits proxies to appoint the directors of the second company in opposition to the nominees of the second company where the first company's nominees (if elected) would comprise more than 25 percent of the board of directors.

Senior Management Interlocks: In light of the significant power wielded by officers of a company to implement policies set by the board of directors (or equivalent body), make policy recommendations to the board of directors, make ancillary policy decisions and operate the company on a day-to-day basis, the Board has historically considered an agent of a significant investor serving as a management official of another company to exercise a controlling influence over the second company. This presumption focuses on "senior management," defined to include any person with authority to participate (other than as a director) in major policy-making functions of a company, without regard for such person's title.

Contractual Powers: A company that controls a material amount of voting securities of a second company may have contractual arrangements with the second company (*e.g.*, investment agreements, debt agreements and service

[7] For purposes of the Final Rule, revenue is understood to mean gross income, not income net of expenses.

agreements). The Final Rule incorporates the concept of control by "limiting contractual right" whereby a company may be deemed to have a controlling influence over a second company as a result of the first company's contractual right to restrict the discretion of the company, including its management, to make major operational and policy decisions. The Final Rule provides a non-exhaustive list of contractual rights that are[8] and are not[9] considered to be limiting contractual rights.

Size of Equity Investment: In addition to the percentage of voting shares held by an investor, the Board believes that the overall size of an equity investment, including both voting and nonvoting equity, is a strong indicator of the degree of influence an investor has over the company, as a company is more likely to accommodate the demands of large shareholders in order to preserve its capital base. The Final Rule presumes control of a second company if the first company holds 33.33% or more of the second company's total equity, regardless of what percentage of voting shares is controlled by the first company.

Additional Presumptions of Control

In addition to the tiered presumption framework described above, the Final Rule includes several additional presumptions of control. Several of these presumptions clarified presumptions already in Regulation Y and Regulation LL, while others relate to standards that the Board historically has used to make control decisions.

Management Agreements: The Board has long believed that management agreements under which a company can direct or exercise significant influence over the management or operations of another company raise significant controlling

[8] Examples of limiting contractual rights include the right to restrict or exert influence over: (i) what activities the company may engage in, (ii) how the company directs the proceeds of the investor's investment, (iii) the hiring, firing and compensation of senior management, (iv) the company's ability to merge or consolidate or its ability to acquire and dispose of subsidiaries or assets, (v) the company's ability to make investments or expenditures, (vi) the company's achieving or maintaining a financial target or limit, (vii) the company's ability to make payments of dividends on any class of securities, (viii) the company's ability to authorize or issue additional junior equity or debt securities, (ix) the company's ability to engage in a public offering or to list or de-list itself on an exchange, (x) the company's ability to amend its bylaws or articles of incorporation, (xi) the removal or selection of independent service providers and (xii) the ability of the company to alter its accounting methodologies or regulatory, tax or liability status.

[9] Examples of contractual rights that are not limiting contractual rights include: (i) a right that allows the investor to restrict or exert control over the company's ability to issue securities senior to those held by the investor, (ii) a requirement that the investor receive financial reports or other information ordinarily available to common shareholders, (iii) a requirement that the company maintain its corporate existence, (iv) a requirement that the company consult with the investor on a periodic basis, (v) a requirement that the company consult with the investor on a reasonable periodic basis, (vi) a requirement that the company provide notice of material events affecting the company, (vii) a requirement that the company comply with applicable statutory and regulatory requirements, (viii) market-standard "most favored nation" provisions, (ix) market-standard "drag-along" or "tag-along" rights, (x) a right of first refusal or (xi) a requirement that the company take reasonable steps to ensure the preservation of tax status and tax benefits.

influence concerns. The Final Rule slightly expands the existing regulatory presumption by specifying additional types of agreements that would allow a company to direct or exercise significant influence over the core business or policy decisions of another company, including agreements where a company is a managing member, trustee, or general partner of another company or exercises similar powers and functions.

Investment Advice and Investment Funds: The Final Rule includes a presumption of control when a company serves as investment adviser to an investment fund and controls 5 percent or more of any class of voting securities of the fund or 25 percent or more of the total equity of the fund.[10] However, the presumption does not apply to investment advisers of investment funds organized and sponsored within the preceding 12 months to reflect the initial seeding period of the fund. The one-year seeding period is only available to the company that organizes and sponsors an investment fund and not to other early investors in an investment fund.

Divestiture: The Board historically has taken the position that a company that controls another company may continue to exert a controlling influence over the second company even after a substantial divestiture. Under the Final Rule, a company which, during the previous two years, controlled a second company will be presumed to remain in control if the first company owns 15 percent or more of any class of voting securities of the second company. Other control factors, such as business relationships and interlocks, would continue to apply in evaluating whether a divesting company exercises a controlling influence over a partially divested company. The divestiture presumption will generally not apply if a company sells a subsidiary to a third company and receives stock of the third company as consideration for the sale, or if a majority of each class of voting securities of the company that is being divested is controlled by a single unaffiliated entity.

Fiduciary Exception: The presumptions of control would not apply where the first company controls voting or nonvoting securities of a second company in a fiduciary capacity without authority to exercise the voting rights.

"5-25" Presumption: The Proposed Rule included a presumption that a company controls a second company if (i) the first company controls at least 5 percent of any class of voting securities of the second company and (ii) the senior management and directors of the first company, together with the first company, own 25 percent or more of any class of voting securities of the second company. This "5-25" presumption was not adopted in the Final Rule. Instead, the Final Rule provides that a company that controls 5 percent or more of any class of voting securities of another company also controls any securities issued by the second company that are controlled by the senior management, directors or controlling shareholders of the first company. However, the Board is revising this provision to incorporate the exception to

[10] For purposes of this presumption, an "investment adviser" includes any person registered as an investment adviser under the Investment Advisers Act of 1940, any person registered as a commodity trading adviser under the Commodity Exchange Act, or a foreign equivalent of such a registered adviser. The term "investment fund" includes a wide range of investment vehicles, including investment companies registered under, and those exempt from registration under, the Investment Company Act of 1940, and foreign equivalents of registered investment companies and exempt investment companies.

the proposed 5-25 presumption when the company controls less than 15 percent of each class of voting securities of the other company and a majority of each class of voting securities of the other company is controlled by the first company's senior management, directors, and controlling shareholders.

Rebuttable Presumption of Non-control: Under the Final Rule, a company is presumed not to control a second company if the first company (i) controls less than 10 percent of every class of voting securities of the second company and (ii) is not presumed to control the second company under any of the presumptions of control. This presumption modestly expands the statutory and pre-existing regulatory rebuttable presumption of non-control applicable to a company that controls less than 5 percent of any class of voting securities of a second company.

Control-Related Definitions

The Final Rule provides additional clarity by defining a number of terms relevant to control determinations that were not codified previously.

Voting Securities and Nonvoting Securities: Largely consistent with the Proposed Rule, the Final Rule changes the term "nonvoting shares" to "nonvoting securities" and adds equity instruments issued by companies other than stock corporations (*e.g.*, limited liability companies and partnerships) to the definition of nonvoting securities. In addition, the Final Rule also specifies certain defensive voting rights that would not cause a security to be considered a voting security, including the right to vote to remove a general partner or managing member for cause; the right to vote to replace a general partner or managing member that has been removed for cause or has become incapacitated; and the right to vote to dissolve the company or to continue operations following such removal.

Total Equity: The Final Rule includes a methodology, generally based on GAAP, for calculating total equity for the purposes of determining a first company's total equity percentage of a second company, which must be calculated at the time of investment. Notably, the methodology would allow certain debt and other interests that are functionally equivalent to equity to be treated as equity for the purposes of such calculations (and vice versa).

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