Federal Reserve Finalizes Revised Control Framework: Initial Reactions

January 31, 2020

Yesterday, the Federal Reserve Board (the "FRB") adopted a new, comprehensive framework for determining "control" under the Bank Holding Company Act ("BHC Act") and Home Owners' Loan Act ("HOLA"). It becomes effective on April 1, 2020. We provide a discussion of critical issues raised by the final rule and its key differences from the April 2019 proposal below.[1] We anticipate publishing a comprehensive summary of the final rule in the near future. A redline comparing the final rule to the currently effective control rules is available here.

The final rule is intended to simplify and clarify the FRB's standards for determining whether a company exercises a controlling influence over the management or policies of another company and, therefore, "controls" the other company under the BHC Act or HOLA. Because of the regulatory approvals and prohibitions associated with acquiring control, the controlling influence standard often effectively caps investments of banking organizations and in them. Like the proposal, the final rule does not affect the requirements of the Change in Bank Control Act and the notice provisions that generally apply under the regulations implementing that statute to acquisitions, directly or indirectly, of 10% of a class of voting securities of a depository institution or depository institution holding company, or other notice requirements (including, for example, Dodd-Frank Act section 163(b)).[2]

Although potentially applicable in a number of areas, the new framework may promote bank/FinTech partnerships that have become more commonplace recently. To this end, the final rule may facilitate (1) banking institutions taking minority stakes in FinTech companies and (2) nonbank investors, including FinTech companies, taking minority stakes in banks, in each case without requiring the FinTech companies to comply with the various requirements of the BHC Act and HOLA.

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1 For additional information about the FRB's April 2019 control proposal, please see our prior analysis here. A redline comparing the final rule to the proposal is available here.

2 However, the final rule confirms that "the control framework in the final rule applies for purposes of section 4(c)(6) and, in particular, the Board's interpretation of section 4(c)(6) located in section 225.137 of Regulation Y."

Given the rulemaking's significance, the proposal generated substantial comment from industry. However, the final rule largely retains the structure and substance of the April 2019 proposal.

The Tiered Framework

The final rule largely retains the proposal's tiered control framework under which the FRB presumes that the acquirer (referred to as the "first company") exercises a controlling influence over the target (the "second company") if the first company owns or controls a specified percentage of the second company's voting securities and other indicia of control are present. The final rule does not modify the proposed four tiers, which are based on a first company's ownership of a class of voting securities of a second company: <5%; 5% to <10%; 10% to <15%; and 15% to <25%.[3] As in the proposal, each higher ownership tier is accompanied by greater restrictions on the following types of control factors: the size of the investor's total equity investment (voting and nonvoting shares); rights to director representation; use of proxy solicitations; officer/employee interlocks; restrictive rights to influence management or operational decisions; and business relationships.[4] Also consistent with the proposal, the final rule does not add a presumption of control for threats to dispose of securities. Although a major subject of comment was how each control presumption should be calibrated, the final rule generally did not change these control factors and their calibration.

As an example of the tiered control framework, an investor in the 5% to <10% tier could avoid a presumption of control and maintain business relationships with a target company if the business relationships comprise less than 10% of the total annual revenue and expenses of the target. However, investors with voting ownership in the higher two tiers are only permitted such business relationships at the 5% and 2% levels, respectively, to benefit from the noncontrol presumption. The attached Appendix A, which the FRB released with the final rule, provides additional detail regarding the tiered control framework.

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[3] A person's percentage of a class of voting securities would be determined according to the method provided in the proposal: the greater of (i) the number of voting securities of the class controlled by the person divided by the number of issued and outstanding voting securities of the class (expressed as a percentage) and (ii) the number of votes that the person could cast divided by the total number of votes that may be cast under the terms of all the voting securities of the class that are issued and outstanding (expressed as a percentage).

[4] Triggering a presumption of control does not mean that the investor "controls" the target company under the BHC Act or HOLA. Rather, the FRB may only make that determination after notice to the investor and an opportunity for a hearing. A presumption of control (or of noncontrol, discussed below) would apply in such a hearing and the presumption may be rebutted. However, control proceedings and rebuttals are exceedingly rare and the presumptions are likely to be treated as bright-line, non-rebuttable rules.

The FRB did change some aspects of the tiered framework as well as other parts of the proposal. Significantly, the FRB eliminated an exception from the control presumptions for SEC-registered investment companies ("RICs"). Further, the FRB slightly modified its calculation of total equity and clarified the rule's application to existing investments. These changes are discussed below; additional provisions of the final rule and their comparison to the April 2019 proposal are presented as Appendix B.

Key Changes Involving the Tiered Framework

As discussed below, the FRB made limited changes to the business relationships, total equity, and director representation aspects of the tiered control framework.

Business Relationships

The business relationships control factor, which many commenters expected to be the binding constraint on noncontrolling investments, was widely decried as too stringent by the industry. As proposed, the factor would have presumed control over a second company where the first company's business relationships with the second company exceeded the applicable percentage of *either* the first *or* second company's revenues or expenses. Although the FRB did not raise the percentages specified in the proposal (and noted above) as many commenters requested, it did eliminate the requirement that the applicable percentage be based on the first company's revenues and expenses. The final rule only takes the revenues and expenses of the second company into account when calculating the business relationships percentage. The revision is intended to respond to commenters' arguments that the proportion of a first company's business relationships devoted to a second company does not affect the first company's ability to influence the management or policies of the second company.

Total Equity

The FRB also made a favorable adjustment to the limit on total equity for noncontrolling investments by bank holding companies ("BHCs"). The final rule permits the first company to own up to one-third of the total equity of the second company, whereas the proposal would have restricted total equity ownership to 25% if the first company owned 15% or more of a class of voting securities of the second company.

The FRB also changed its treatment of total equity ownership with respect to savings and loan holding companies ("SLHCs"). Under HOLA, SLHCs are considered to control a second company if they have contributed more than 25% of the capital of the second company. The FRB stated in the final rule that contributed capital under HOLA

generally has the same meaning as total equity has in the context of control under the BHC Act[5] and therefore that it was eliminating the total equity presumption for SLHCs. This approach appears to result in the final rule imposing different total equity thresholds for BHCs (33%) and SLHCs (25%).

Director Representatives

The FRB also changed the definition of "director representative," though it did not adjust the amount of directors permitted under the proposal. As proposed, the definition would have swept well beyond those nominated by the first company to also include any director who (i) is a current director, employee, or agent of the first company; (ii) was a director, employee, or agent of the first company within the preceding two years; or (iii) is an immediate family member of an individual described in (i) or (ii). Commenters suggested that this expansive definition was unworkable, particularly as applied to large companies, and that the meaning of "agent" was unclear in this context. The FRB revised this definition to cover any individual that represents the interests of a first company through service on the board of a second company. The final rule's list of director representatives consists of "(i) individuals who are officers, employees, or directors of the first company, (ii) individuals who were officers, employees, or directors of the first company within the preceding two years, and (iii) individuals who were nominated or proposed by the first company to be directors of the second company." However, the definition also states that those listed are "examples of persons" that "generally" would be considered director representatives, therefore providing that the list is not necessarily determinative as to whether any individual is or is not a director representative.

Other Key Changes

Elimination of Exception for Registered Investment Companies

The proposal would have applied an additional presumption of control to investment funds. Specifically, it included a presumption that an investment adviser controls an investment fund if the adviser owns 5% or more of any class of voting securities of the fund or 25% or more of the total equity of the fund, unless the adviser organized and sponsored the fund within the preceding year. However, the proposal also included an exception to the control presumptions for investments in RICs where the business relationships are limited to investment advisory and related services provided by the investor, investor representatives comprise 25% or less of the board of the RIC, and either the investor controls less than 5% of each class of voting securities and 25% of the

[5] The final rule also makes notable changes to the calculation of total equity, which we address below.

total equity of the RIC or has organized and sponsored the RIC within the preceding year.

Commenters argued that this framework was inconsistent with FRB precedent, other applicable law, and industry practice. Most notably, they argued that the RIC exception should be revised to allow a reasonable, multiyear seeding period consistent with the Volcker Rule and ownership of up to 24.9% of a class of voting securities as in previous FRB interpretive guidance.

However, the FRB adopted the presumption of control for investment advisers as proposed, and eliminated the RIC exception completely from the final rule. Therefore, banks that organize and sponsor any investment fund will have one year to come into compliance with the applicable ownership limitations or treat them as subsidiaries (though the FRB made clear that the final rule does not affect seeding periods applicable under the Volcker Rule). The FRB acknowledged that this standard conflicts with certain precedents, most notably with respect to the "First Union" precedent permitting ownership of up to 25% of a mutual fund's voting securities. Existing investments based on this precedent may need to be reviewed because, as discussed below, the FRB did not "grandfather" or provide a safe harbor for existing investments that have not been reviewed by the Federal Reserve.

Calculation of Total Equity

Another heavily commented topic was the proposed calculation of total equity. The final rule retains the basic framework for determining the amount of total equity that an investor owns in a stock corporation that prepares GAAP financial statements, which generally involves a three-step process of: (1) determining the percentage of each class of voting and nonvoting common or preferred stock of the other company that the investor owns;[6] (2) multiplying the relevant percentages by the value of the other company's shareholders' equity allocated to the relevant class of stock under GAAP, with retained earnings allocated to common stock; and (3) dividing the investor's dollars of shareholders' equity determined under the second step by the total shareholders' equity of the other company.[7] For this purpose, a company is deemed to control all equity securities controlled by its subsidiaries. Unlike the proposal, however, the final rule does not require companies to include a pro rata share of equity securities controlled by their non-subsidiaries.

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[6] The preamble to the final rule clarifies that different classes of preferred stock with equal seniority (i.e., *pari passu* classes) are treated as a single class for this calculation. However, "[i]f *pari passu* classes of preferred stock have different economic interests in the second company on a per share basis, the number of shares of preferred stock must be adjusted for purposes of this calculation so that each share of preferred stock has the same economic interest in the second company."

[7] Total equity for a company that is not organized as a stock corporation would be determined reasonably consistently with this methodology.

The proposal also would have calculated total equity in a manner that, in some instances, resulted in ownership percentages disproportionate to an investor's economic interest in a company, such as where the company had negative retained earnings or where an investor obtained a liquidation preference. Moreover, the FRB reserved the right to treat nonequity interests as "functionally equivalent to equity," causing substantial uncertainty for investors and running contrary to the FRB's stated rationale for the new control framework. These aspects of the proposal were retained in the final rule. However, the FRB added the converse of the "functional equivalent to equity" test; the final rule permits equity interests to be treated as debt if the interests are "functionally equivalent to debt" and provides a list of relevant debt characteristics. The FRB noted that the "functional equivalent to debt" test "is intended to provide flexibility for unusual structures and is expected to be used rarely" and directed banking institutions to consult with the FRB to determine whether the provision should apply.

Further, the scope of the total equity presumption was reduced to avoid certain unintended acquisitions of control. The proposal would have required the first company to calculate its total equity amount when it acquired and divested equity interests in a second company. This could have resulted in a presumption of control even when the first company divests if the second company's balance sheet shrank since the first company acquired shares. In response to this concern, the final rule requires calculation only when a first company acquires equity interests in a second company.

Treatment of Pre-Existing Investments

Commenters also argued that pre-existing investments should remain subject to the control framework applicable when the investments were made, a topic not addressed by the proposal. In response, the FRB stated that the final rule is "generally consistent with the Board's current practice" and therefore will apply to existing investments. Accordingly, although the FRB does not expect to revisit structures that have already been reviewed by the Federal Reserve System (unless materially altered since the review), there is no "grandfather" or safe harbor for existing investments that have not been reviewed by the Federal Reserve System. Where such existing investments would trigger a presumption of control under the final rule, the FRB states that the "company may contact the Board or its staff to discuss potential actions." The preamble to the final rule also directs companies currently subject to passivity commitments to contact the FRB or the appropriate Federal Reserve Bank to seek relief from them, if desired.

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Please do not hesitate to contact us with any questions.

Appendix A

Summary of Tiered Presumptions

(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 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	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	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less

Appendix B

Additional Issues Raised by Control Final Rule

Proposed Rule	*Final Rule*
4(c)(6) Investments. Did not explicitly state whether the presumptions of control and noncontrol would apply to investments of BHCs under section 4(c)(6) of the BHC Act.	Confirmed in the final rule that "the control framework in the final rule applies for purposes of section 4(c)(6) and, in particular, the Board's interpretation of section 4(c)(6) located in section 225.137 of Regulation Y."
Convertible Securities. Included a general rule that an investor owning convertible securities, options, warrants or similar instruments is deemed to own the maximum percentage of voting securities that the investor could receive upon exchange or conversion (assuming no other parties elected to exercise their options or otherwise converted or exchanged their shares for voting shares) and limited exceptions to the general rule, such as an exception for instruments that are subject to the conversion and transfer restrictions of the FRB's 2008 Policy Statement on Equity Investments in Banks and Bank Holding Companies, published as 12 CFR 225.144.	Adopted as proposed, but with an additional exception to the generally applicable "look-through" approach for preferred securities that have no voting rights unless the issuer fails to pay dividends for six or more quarters. These are only considered "voting securities" if a sufficient number of dividends are missed and the voting rights are active. The definitions of "voting securities" and "nonvoting securities" also were adopted as proposed.
GAAP Consolidation. Included a presumption that an investor controls the other company if the investor consolidates the other company on its financial statements in accordance with U.S. generally accepted accounting principles.	Adopted as proposed. However, the FRB clarified an issue applicable to foreign banking organizations, some of which are required to hold all "ownership interests" in U.S. subsidiaries through a U.S. intermediate holding company. The preamble to the final rule states that "ownership interest" does not include contractual relationships, including contractual relationships that result in consolidation of a company under the variable interest entity standard. Accordingly, it continues, where a U.S. branch of a foreign bank has a contract with an asset-backed commercial paper conduit that must be consolidated under this standard, the contract is not an ownership interest and therefore may remain between the branch and the conduit.

Proposed Rule	*Final Rule*
Fiduciary Exception. Provided that the presumptions of control did not apply to the extent that a first company controls voting or nonvoting securities of a second company in a fiduciary capacity without sole discretionary authority to exercise the voting rights.	Restated to be more consistent with the BHC Act. That is, the "without sole discretionary authority to exercise the voting rights" condition to the fiduciary exception applies only to investments in depository institutions and depository institution holding companies. Investments in other entities may benefit from the fiduciary exception without respect to this condition. Parallel treatment would apply for purposes of Regulation LL. The FRB declined commenters' requests to provide additional clarity around the scope of the fiduciary exception. However, it noted that the final rule is intended to align with the FRB's "traditional understanding" of the scope of the fiduciary exception, the "primary example" of which is that of a bank's "trust department."
Limiting Contractual Rights. Defined "limiting contractual rights" that could trigger a presumption of control and included lists of rights that would, and would not, be limiting contractual rights. These provisions were intended to allow noncontrolling investors to benefit from certain defensive rights (e.g., a requirement that the other company maintains its corporate existence or restrictions on the ability of the other company to issue more senior securities) but were also generally intended to prohibit such investors from making business decisions for the other company in the ordinary course (e.g., restrictions on activities in which the other company may engage, restrictions on the compensation of senior management officials of the other company).	Provides that the lists, which are unchanged from the proposal, are not necessarily determinative. Specifically, the final rule states that the listed provisions are merely examples of what generally would or would not be considered a limiting contractual right; whether or not a particular contractual right is a limiting contractual right depends on whether the contractual right meets the functional regulatory definition. The FRB also clarified that "a contractual provision that provides a reasonable and non-punitive mechanism for an investing company to reduce its investment to comply with the activities restrictions of the BHC Act or HOLA," information rights, and rights to preserve tax status or tax benefits generally would not be limiting contractual rights.

Proposed Rule	*Final Rule*
Control Over Securities. The proposal provided rules for determining whether a person "controls" a security, including that a person controls a security if the person owns the security or has the power to sell, transfer, pledge, or otherwise dispose of the security (with certain exceptions). In addition, a person controls a security if the person had the power to vote the security, other than due to holding a short-term, revocable proxy. The proposal also provided that a company that owns, controls, or holds with power to vote 5 percent or more of any class of voting securities of a second company controls any securities issued by the second company that are owned, controlled, or held with power to vote by the senior management officials, directors, or controlling shareholders of the first company, or by the immediate family members of such individuals.	Adopted substantially as proposed. The FRB clarified that securities held by an underwriter for a very limited period of time for purposes of conducting a bona fide underwriting generally do not raise control concerns. The final rule also integrated the standards for control over voting securities through associated individuals with the proposed "5-25" presumption, which also would have attributed to a company securities owned by associated individuals, because of their significant overlap. In doing so, the FRB retained the exception to the proposed 5-25 presumption applicable when a company controls less than 15 percent of each class of voting securities of another company and a majority of each class of voting securities of the other company are controlled by the first company's senior management officials, directors, and controlling shareholders, as well as immediate family members of such individuals.
Agreements Restricting Securities. Included a general rule that an investor controls a security if it is a party to an agreement or an understanding under which the rights of the owner of the security are restricted in any manner and exceptions to the general rule, including exceptions for rights of first refusal and similar rights that are on market terms and do not pose significant restrictions on the transfer of securities and for restrictions that are incident to a bona fide loan transaction.	Adopted as proposed.
Noncontrol presumption. Included a presumption that an investor does not control another company if the investor owns less than 10% of the other company and does not trigger any of the applicable presumptions of control.	Adopted as proposed.

Proposed Rule	*Final Rule*
Divestiture Presumption. The FRB generally has applied a significantly more restrictive control standard to an investor attempting to divest control of another company as compared to an investor that had not previously controlled the other company. The proposal lessens, but does not eliminate, this more restrictive control standard. The change would allow an investor to divest control (1) immediately after it reduces its ownership below 15% of all classes of voting securities of the other company (and thereafter stays below 15% for two years) or (2) after two years of owning between 15% and 24.99% of its voting securities. The other proposed presumptions of control would continue to apply.	Adopted as proposed.

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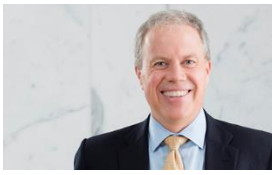
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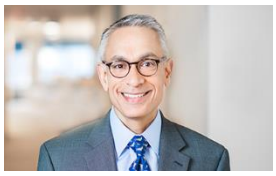
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