

# Federal Reserve Proposes to Clarify and Revise Control Framework

April 24, 2019

Yesterday, the Federal Reserve Board (the “FRB”) proposed a new, comprehensive framework for determining “control” under the Bank Holding Company Act (“BHC Act”) and Home Owners’ Loan Act (“HOLA”). We provide a high-level overview of the proposal below. Comments on the proposal will be due 60 days after its publication in the Federal Register.

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The proposal 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. The proposal would codify certain aspects of the FRB’s controlling influence precedent and, at the same time, would make some significant changes, including with respect to de-control (*i.e.*, the so-called “tear-down” rules).

Although potentially applicable in a number of areas, the proposed new framework may promote bank/FinTech partnerships that have become more commonplace recently. To this end, the proposal 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. Importantly, the proposal 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 bank or thrift, or other notice requirements (including, for example, Dodd-Frank Act section 163(b)).

**Tiered Control Framework.** Under the proposal, a company would be presumed to exercise a controlling influence over the management and policies of another company if the company investing owns or controls a specified percentage of the other company’s voting securities and other indicia of control are present. Specifically, the proposal establishes the following four-tier framework based on an investing company’s ownership of a class of voting securities of another company: <5%; 5% to <10%; 10% to <15%; and 15% to <25%. In general, each higher ownership tier is accompanied by

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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.

For example, 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 both the investor and the target. However, investors with voting ownership in the higher two tiers would only be permitted such business relationships at the 5% and 2% levels, respectively, to benefit from the noncontrol presumption. The attached [Appendix](#), which the FRB released with the proposal, provides additional detail regarding the tiered control framework.

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.

**Revisions to the "Tear-Down" Precedent.** One of the most significant changes included in the proposal would make it easier for an investor that has controlled another company to divest such control. 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. In many cases an investor that controlled another company has been required to reduce its investment in the other company below 5% of voting securities (and eliminate or reduce other relationships) in order to divest control successfully.

The proposal lessens, but does not eliminate, the FRB's more restrictive control standard for previously controlling investors. Specifically, the FRB would presume that an investor continues to control another company only if the investor owns 15% or more of any class of voting securities and only for two years after the investor divests below 25%. This proposed change is intended to 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 discussed above would continue to apply regardless of whether an investor benefits from the more permissive tear-down standards.

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**Presumption of Noncontrol and Other Matters.** The proposal includes a number of other clarifications to the FRB's control precedent, including:

- 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;
- a presumption that an investor controls the other company if it owns 33% or more of the other company's total equity or the investor consolidates the other company on its financial statements in accordance with U.S. generally accepted accounting principles ("GAAP");
- 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, including 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, 12 CFR 225.144;
- 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;
- standards 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; (2) multiplying the relevant percentages by the value of the other company's shareholders' equity allocated to the relevant class of stock under GAAP; and (3) dividing the investor's dollars of shareholders' equity determined under the second step by the total shareholders' equity of the other company. Total equity for a company that is not organized as a stock corporation would be determined reasonably consistently with the above methodology;
- 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

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total equity of the fund, unless the adviser organized and sponsored the fund within the preceding year;

- an exception to the control presumptions for investments in registered investment companies (“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 total equity of the RIC or has organized and sponsored the RIC within the preceding year; and
- definitions and examples of the types of an investor’s contractual rights that could trigger a presumption of control. These changes are intended to allow noncontrolling investors to benefit from certain defensive rights (*e.g.*, a requirement that the other company maintains its corporate existence, restrictions on the ability of the other company to issue more senior securities, and the ability to vote on a replacement general partner or managing member) but is 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).

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Please do not hesitate to contact us with any questions.

## Appendix

### 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	Less than 5% of revenues or expenses	Less than 2% of revenues or expenses
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	Less than one third	Less than one third	Less than one third	Less than one quarter

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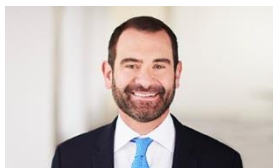
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