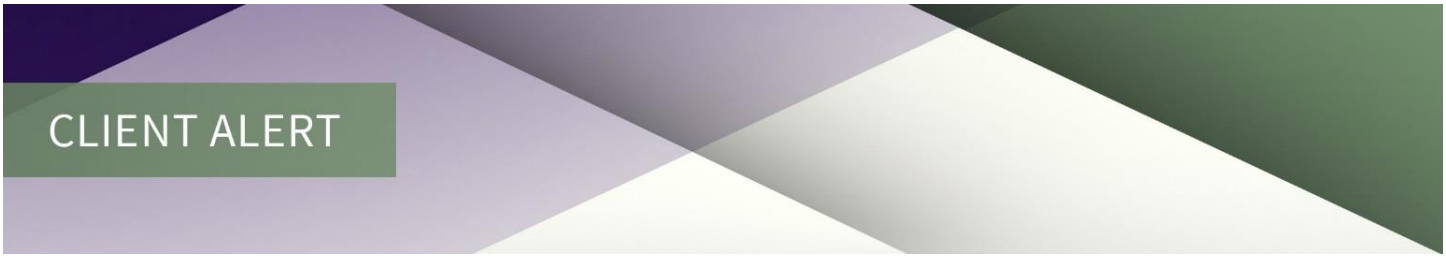


# Federal Reserve Board Proposes to Codify "Control" Standards

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On April 23, 2019, the Board of Governors of the Federal Reserve System (the "Board") published a notice of proposed rulemaking to clarify and revise its "control" rules under the Bank Holding Company Act of 1956, as amended (the "BHC Act"). The proposal aims to clarify and provide greater transparency regarding the criteria used to determine whether one company is considered to have a "controlling influence" over another company for purposes of the BHC Act. In conjunction with the proposed rule, the Board has posed approximately 60 questions on which the Board seeks comments. Comments to the rule are due within 60 days of publication of such rule in the *Federal Register*.

"Control" standards under the BHC Act are important in at least three categories of transactions. Whether an application to the Federal Reserve Board is required for a bank holding company to acquire an interest in a bank may depend on whether the bank holding company will "control" that bank. Bank holding companies are also limited in the types of nonbanking companies they may own, and nonbanking activities in which they may engage, so that whether a bank holding company may acquire an interest in a nonbanking company may also depend on whether the bank holding company would "control" the nonbanking company. In addition, investment funds with multiple investments in a variety of types of companies may jeopardize the permissibility of those holdings if they acquire a controlling interest in a bank. Conversely, an investment by a bank holding company or its affiliate in a fund may result in limitations on the permissible activities of that fund.

The BHC Act contains a three-pronged test for whether one company controls another,[1] including: (1) direct or indirect ownership or control by the first company of 25% or more of any class of voting securities; (2) control in any manner of the election of a majority of directors of a company; or (3) directly or indirectly exercising a "controlling influence" over the management or policies of the second company.[2] How the Board identifies whether the first company exercises a "controlling influence" over the second company has historically been complex and not always clear.

Typically, the Board has based its rebuttable presumptions of control on the quantity and quality of the relationships between one company and its target in determining whether the first company might exercise a controlling influence over the second company. In doing so the Board has reviewed: (i) the size of the first company's voting equity investment in the second company; (ii) the size of the first company's total equity investment in the second company; (iii) the first company's rights to director representation and committee representation on the board of directors of the second company; (iv) the first company's use of proxy solicitations with respect to the second company; (v) management, employee, or director interlocks between the companies; (vi) covenants or other agreements that allow the first company to influence or restrict management or operational decisions of the second company; and (vii) the scope of the business relationships between the companies.

The proposed rule would provide clarity by setting out specific control and noncontrol presumptions to be applied by the Board depending on the first company's tier of ownership of voting shares in the second company. Under the BHC Act, if a company owns 25% or more of any class of a second company's voting securities, the first company is deemed to control the second,[3] and if the first company owns less than 5% of the second company's voting securities there is a presumption of non-control of the second company.[4] As the Board notes, the statutory framework leaves a space between 5% and 25% for purposes of determining if the Board will view the ownership of voting securities as "controlling." Under the proposed rule, depending on the ownership tier in which the first company's holdings of the second company's voting equity fall, the Board would assess other factors, most of which have been used in the past, and evaluate the percentage plus these factors to determine whether or not "control" exists. Presumptions of control would be keyed to three levels of voting ownership: 5%, 10%, and 15%. The supplemental factors that the Board would assess in conjunction with the percentage of voting shares held in the second company are: the first company's "total equity" investment in the second company; the first company's authority to appoint management officials of the second company; director, officer, and employee interlocks between the companies; proxy voting authority; management agreements between the two companies; and other business relationships between the two companies. These are described below.

1 12 U.S.C. § 1841(a)(2).

2 12 U.S.C. § 1841(a)(2); 12 CFR 225.2(e).

3 12 U.S.C. § 1841(a)(2)(A).

4 12 U.S.C. § 1841(a)(3).

*Total Equity Investment.* Historically, the Board's view has been that nonvoting equity interests exceeding 25% of total equity of a company typically raise controlling influence concerns and that a company with voting and nonvoting securities that, when aggregated, represent less than one-third of the total equity of the second company, would not have a controlling influence over the second company if the first controls less than 15% of any class of voting securities of the second company. Under the proposal, the Board would presume control if an investor controls less than 15% of any class of voting shares of the second company but more than one-third of the total equity of the second company, or if an investor controls 15% or more of any class of voting shares of the second company and 25% or more of the second company's total equity.

*Appointment of Management Officials.* The proposal includes a presumption that a first company controls a second company when the first controls at least 5% of a class of voting securities of the second and the senior management officials and directors of the first, together with their immediate family members and the first company, own 25% or more of a class of voting securities of the second company. This presumption would not apply where the first company controls less than 15% of each class of voting securities of the second company and senior management officials and directors of the first company, together with their immediate family members, control 50% or more of each class of voting securities of the second company.

*Management Interlocks*. Historically, the Board has viewed a situation in which an agent of a significant investor of one company serves as a management official of another company as providing a substantial avenue for the first company to have a controlling influence over the second company. The Board has typically found a controlling influence where a company controls 10% or more of a class of voting securities of a second company and has any such management interlock with the second company. The proposed rule would presume control if the first company controls 5% or more of any class of voting securities of the second company and has more than one senior management interlock with the second company, or if a company that controls 15% or more of any class of voting securities of a second company has any senior management interlock with the second company. To trigger these presumptions, the individual would have to serve as a director or employee at the first company and a senior management official at the second company. These changes would slightly liberalize the current practice by limiting the presumptions to senior management officials, rather than management officials generally. In addition to senior management officials, the proposal would presume control where a company that controls 5% or more of any class of voting securities of a second company has a director or employee who is the chief executive officer or its equivalent of the second company.

*Director Interlocks.* The Board has generally considered a single director to be the maximum director representation for a noncontrolling investor with at least 10% of a class of voting securities. However, under a 2008 Policy Statement, the Board has considered a second director representative to be consistent with status as a noncontrolling investor when two director representatives represent a share of the target company's board that is proportional to the investor's voting ownership in the company and when there is another larger shareholder that controls the company. Under the proposed rule, if a company controls 5% or more of any class of voting securities of a second company, control would be presumed

if the first company controls 25% or more of the board of the second company. However, a less than 25% voting shareholder could vote its shares to elect a proportional share of the members of the board of the second company without triggering a control presumption. A control presumption would be triggered if a company that controls 10% or more of any class of voting securities of a second company solicits proxies to appoint a number of directors that equals or exceeds 25% of the total directors on the board of the second company.

The proposal would also presume that a company that controls 5% or more of any class of voting securities of a second company controls the second company if the first company has director representatives that are able to make or block the making of major operational or policy decisions of the second company, such as through supermajority voting requirements, individual veto rights or similar provisions. For a company that controls less than 5% of every class of voting securities of a second company, the proposed rule would not include a presumption of control by the first company based on the level of director representation of the first company.

In addition, the proposed rule would presume control if a company controls 15% or more of any class of voting securities of a second company and any director representative of the first company also serves as the chair of the board of the second company. The proposal would also presume control if a company controls 10% or more of any class of voting securities of a second company and representatives of the first company hold more than 25% of the positions on any board committee of the second company with power to bind the company without the need for additional action by the full board.

*Proxy Voting*. The Board has historically found controlling influence issues where a company controls 10% or more of a class of voting securities of a second company and solicits proxies on some issue from the shareholders of that company. The proposal will give a noncontrolling investor greater latitude to exercise shareholder rights and engage with the second company and other shareholders, as it will not include a presumption that a company that controls 10% or more of a class of voting securities of a second company and that solicits proxies from their shareholders on any issue controls such company.

*Contractual Agreements*. The Board notes that contractual agreements and rights provided therein pose issues with regard to controlling influence when they provide an investor with the ability to direct or block major policy or operational decisions of the second company. Many contractual restrictive covenants are of little concern, but a controlling influence concern arises where a company with a significant voting ownership in another company also has covenants that restrict how the second company operates. The proposal would presume that a first company controls a second company where the first owns 5% or more of any class of voting securities of the second and the first has a contractual right that significantly restricts the discretion of the second company's operational or policy decisions. Conversely, a company with less than 5% of each class of voting securities would be presumed not to control the second company even where it has discretion over the second company's business operations or policies. For this purpose, the proposed rule would use a new defined term, "limiting contractual right," defined as a contractual right that significantly restricts, directly or indirectly,

the discretion of a company over major operational or policy decisions. The proposal would include a nonexclusive list of examples of contractual rights considered to be "limiting contractual rights," and a nonexclusive list of examples of contractual rights not considered to fall within the definition.

*Business Relationships.* The Board has traditionally said that a top customer, supplier, or lender to a company could exercise considerable influence over the company's management and policies. The business relationships the Board views as problematic include circumstances in which there is a combination of significant voting stake in a company and material business relationships.

As a result, under the proposed rule the Board would presume control in the following circumstances: (i) if a company controls 5% or more of any class of voting securities of a second company and has business relationships with the second company that generate in the aggregate 10% or more of the total annual revenues or expenses of the first company or the second company; (ii) if a company controls 10% or more of any class of voting securities of a second company and has business relationships that generate in the aggregate 5% or more of the total annual revenues or expenses of the first company or the second company; or (iii) if a company controls 15% or more of any class of voting securities of a second company and has business relationships that generate in the aggregate 2% or more of the total annual revenues or expenses of the first company or the second company.

*Management Agreements.* The Board has viewed agreements through which one company may direct or exercise significant influence over the operations or management of another company as those that may rise to the level of a controlling influence. The proposed rule would expand the presumption of control through such agreements and arrangements to include other types of agreements or arrangements that give one company the ability to influence the core business or policy decisions of the second company. For this purpose, the Board notes that the proposal would clarify that a management agreement would include an agreement under which a company is a managing member, trustee or general partner of another company, or exercises similar functions.

*Accounting Consolidation.* The Board would presume that if one company consolidates another company under GAAP, the first company controls the second company, as generally GAAP consolidation occurs where the consolidating entity has a controlling financial interest over the consolidated entity. The Board notes that the proposed presumption is not intended to suggest that the absence of consolidation under GAAP indicates that a company does not control another company.

*Divestiture.* Another important piece of the proposal deals with the concept of whether a company is viewed as continuing to exercise control over the second company after the first company's divestiture of the second's securities. The proposal lays out specific standards to clarify when a divesting company is considered to no longer have a controlling influence. Currently, the criteria for obtaining a non–control determination in connection with an investment are clearer than the criteria for divesting control once acquired. Historically, if a company had been determined to control another company,

the controlling company would have to divest a significant portion of the investment, often to less than 5% of total equity, terminate business relationships, remove director appointees from the board, and enter into passivity commitments in order to be viewed as no longer having control of the second company. The proposed rule would create a presumption under which the first company will not be viewed as controlling the divested second company, subject to evaluation of control percentage and other factors such as business relationships and interlocks. Under the proposal 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% 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 would 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.

*Investment Company Exception*. There would be a limited exception under the proposal from all presumptions of control where the target company is an investment company registered with the SEC under the Investment Company Act of 1940 and specific other requirements are met. To qualify for the exception the relationship between the companies would need to be such that the only business relationship between them is that investment advisory, custodian, transfer agent, registrar, administrative, distributor or securities brokerage services are provided by the first company to the second; representatives of the first company make up 25% or less of the board of directors or trustees of the second company; and the first company controls less than 5% of each class of voting securities of the second company and less than 25% of total equity of such company (this criterion could be waived if the first company organized and sponsored the second in the preceding 12 months).

*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.

*Rebuttable Presumption of Noncontrol.* The proposal would introduce a presumption of noncontrol if the first company controls less than 10% of every class of voting securities of the second company and the first company is not presumed to control the second under any of the other proposed presumptions of control. This is an expansion on the former presumption of noncontrol where the first company previously had to control less than 5% of any class of voting securities of the second company.[5]

*"Control" of Securities.* The proposed rule would also include standards for when one company or person "controls" voting and nonvoting securities.

[5] 12 U.S.C. §1841(s)(3); 12 CFR 225.31(e) and 238.21(e).

In its notice of proposed rulemaking, the Board included a chart summarizing its proposed tiered presumptions of control. That chart is attached here.

The highly anticipated proposed rule should come as good news to investors and banking organizations alike, as it is aimed at providing clarity and transparency to an area that has traditionally been opaque and difficult to navigate.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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