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Federal Reserve Board Clarifies Determination of "Control"

The Federal Reserve Board ("FRB") has announced that it intends to restate and revise the rules it applies when determining "control" for general Bank Holding Company Act purposes, which can impact investments in or by banks and bank holding companies.[1] The FRB has proposed[2] to do this by (1) slightly modifying the rebuttable presumptions it will apply in formal control determinations,[3] (2) adding some definitions and examples and (3) adjusting the relative weight it will give in any such determination to (a) ownership (including ownership by affiliates of the putative controlling party and ownership by the putative controlling party in various capacities, such as fiduciary), (b) board membership and management overlap, and (c) business relationships.

Variations in the way in which control can be established (or avoided) have clearly tracked developments in the financial system over the decades, especially as interstate banking became common and the range of permissible affiliations with other financial companies broadened. The FRB's proposals clearly make use of its experience in dealing with these changes. They also reflect what the FRB considers to be the basic purpose of defining control: (i) making sure bank holding companies have the financial strength and managerial ability necessary to protect and operate their banks and (ii) maintaining the traditional separation of banking and commerce.

The proposed revisions to the general rules relating to control determinations are structured in large part around rebuttable presumptions, which are expected to be easier to apply than other types of regulatory constraint. There are several rebuttable presumptions[4] of control:

- Entry into a contract that provides for the exercise by one company of "significant influence or discretion over the general management, overall operations, or core business or policy decisions" of another company;[5]
- Control of at least one-third of the other company's total equity;

- Control of 5,[6] 10[7] or 15[8] percent or more of any class of the other company's voting securities, in each case together with other factors, which become more stringent as equity ownership increases;
- Consolidating the other company under GAAP;
- Serving as an investment adviser of the other company if the other company is an investment fund,[9] together with another factor;[10] or
- Retaining 15 percent or more of any class of voting securities of the other company after having, during the previous two years, either held 25 percent or more of any class of voting securities of the other company or controlled the election of a majority of the directors, trustees or general partners of the other company.[11]

These presumptions do not apply if the other company is a registered investment company and certain other conditions are satisfied, or if the putative controlling company holds the securities of the other company in a fiduciary capacity without sole discretionary authority to vote them.

There are also two rebuttable presumptions of noncontrol:

- The putative controlling company holds less than 10 percent of each class of the other company's voting securities and does not fall within any of the control presumptions described above; or
- The putative controlling company holds less than 5 percent of any class of voting securities of the other company, unless there has been a preliminary or final determination that it exercises a controlling influence over the management or policies of the other company.

The application of these presumptions as to control or noncontrol depends on a definitional framework that specifies what constitutes a class of voting securities, which interests count as equity, what constitutes control[12] over securities and how the various indicative percentages are to be calculated. An extensive definition of "limiting contractual right" sets forth a non-exclusive list of contractual rights that may constitute the exercise of control by one company over another, independently of voting rights or participation in governance. These rights include, among others, those that make it possible to restrict or exert substantial influence over:

- The lines of business in which the other company may engage;
- The use of funds provided by the putative controlling company;
- Hiring;
- The other company's ability to make investments, merge, make acquisitions or dissolve;
- The permissible range of financial ratios or targets;
- The issuance of junior equity or debt;
- The amendment of the terms applicable to any securities;
- Engaging in public offerings;
- Amending corporate documents;
- Removing or selecting auditors, investment advisers or investment bankers; and
- Making significant changes in tax or accounting policies.

Requirements that do not constitute impermissible limitations include those pursuant to which the other company must:

- Continue to provide typical financials;
- Periodically consult with and provide notices to the putative controlling company;
- Allow the putative controlling company to object to the issuance of senior securities or maintain its ownership percentage and contractual parity with other investors;
- Provide a right of first refusal with respect to proposed sales by other investors in the other company; and
- Maintain its tax or organizational status.

The existence of limiting contractual rights is especially important if the putative controlling company holds only 5 percent of any class of the other company's voting securities. The preamble to the notice of proposed rulemaking expressly states that limiting contractual rights are irrelevant if the putative controlling company holds less than 5 percent of any class of voting security. However, the extent to which such limiting contractual rights might also play a role in control determinations at the 10 and 15 percent level of holdings is not discussed. Because the rebuttable presumptions based on percentage ownership are expressed in terms of "X percent or more," the relevant additional rights are likely to be somewhat cumulative. The boundary between limiting contractual rights and contracts that provide "significant influence or discretion over the general management, overall operations, or core business or policy decisions"[13] may also prove unclear from time to time.

The proposed changes reflect the FRB's extensive experience with the kinds of changes and attempted adaptations to changes that have characterized the financial world in recent decades. Those who regularly invest in banks or who structure bank investments will need to evaluate the implications of these changes for their businesses. Moreover, given the increased interconnectivity between traditional banks and FinTech and RegTech firms, it is possible that these relationships could be found to limit contractual rights or significantly "influence the general management, overall operations, or core business or policy decisions." Similarly, it is conceivable that some types of FinTech or RegTech products or services could engender the kinds of influence that could be deemed problematic.

[1] Although the general definition of control is crucial in understanding constraints on investments in or by banks and bank holding companies, there are other limitations on affiliation that apply in special cases and are set forth in, among other places, Regulation W, Regulation K and the Volcker Rule. The proposed rulemaking also would revise a parallel definition of control under the Home Owners Loan Act, under Regulation LL, which deals with savings and loan holding companies.
[2] Initially published at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190423a.htm. Comments are due 60 days after the proposal is published in the *Federal Register*.
[3] There is presumably an additional rebuttable presumption that applying the proposed rules to plan transactions (outside of formal control proceedings) will generally be indicative of what is likely to happen in a control proceeding.
[4] Some of the definitions have aspects that might be thought of as covert presumptions, but the Board does not treat them as such.
[5] Regulation Y, §225.32(b)
[6] Providing 25% or more of the directors of the other company; holding enough board seats to block major operational or policy decisions of the other company; having two or more employees or directors that are also senior management officials of the other company; having an employee or director that is also the CEO of the other company; maintaining business relationships with the other company that generate at least 10 percent of the total consolidated revenues of either company; having certain contractual abilities to limit the business of the other company; or having senior management officials and directors who, together with their immediate families, hold 25 percent of any class of the other company's voting securities (50 percent if the putative controlling company itself holds less than 15 percent of each class of the other company's voting securities).
[7] Proposing one or more board nominees in opposition to the nominees of the other company if the number of the nominees plus the number of serving directors would equal more than 25 percent of the total board members; placing more than 25 percent of the members of any committee of the other company that can bind the other company; or entering into business relationships with the other company that are not on market terms or that generate in the aggregate 5 percent or more of the consolidated revenues or expenses of either company.
[8] Controlling 25 percent of the total equity of the second company; having a director that also serves as the chair of the other company's board; having one or more employees or directors serve as a senior management official of the other company; or entering into business relationships with the other company that generate in the aggregate 2 percent of the revenues or expenses of either company.
[9] This is defined more broadly than registered investment company and includes not only registered investment companies but also funds exempt from registration, commodity funds and real estate investment trusts, as well as their non-US equivalents.
[10] Controlling 5 percent or more of any class of the other company's voting securities; or controlling 25 percent or more of the other company's total equity. These additional factors are treated as non-existent during the first year of the other company's existence, to allow for seeding.
[11] This does not apply if 50 percent or more of each class of the voting securities of the other company are held either by someone who is neither a senior management official nor a director of the divesting company or by a company that is not affiliated with the divesting company.
[12] Among the issues dealt with are those that arise in connection with convertible securities, contingent rights, restrictions on transferability, options and warrants and in connection with the aggregation of holdings scattered among the companies and their officers, directors and other affiliates.
[13] As noted above significant influence or discretion over the general management, overall operations, or core business or policy decisions satisfies a rebuttable presumption of control.