

Financial Services

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FEBRUARY 4, 2020

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Federal Reserve Reinterprets Control

The Federal Reserve Board (Board) has adopted a rule¹ that is intended to provide more detailed, accessible and slightly more generous criteria and procedures for use in determining whether control exists within the meaning of the Bank Holding Company Act and the Home Owners' Loan Act. A determination that control exists usually results in the attribution of holding company status and all of the attendant regulatory consequences to the investing company or in the commencement of negotiations regarding changes in the proposed investment that will preclude such an attribution.

The matrix form of the diagram that was released along with the Rule shows the conceptual structure of the Rule quite clearly. For each of four levels of equity ownership² the permissible levels of nine other types of relationship are set forth.³ Generally speaking, the higher the percentage of ownership, the lower the permissible level of the other kinds of involvement. For example, while a business relationship that generates less than 10% of the revenues or expenses of the putatively controlled company will not lead to a finding of control if the putative controlling company holds 5%-9.99% of a class of voting securities issued by the putatively controlled company, it will lead to such a finding at higher levels of ownership. At the 10%-14.99% level of ownership, on the other hand, to be non-controlling a business relationship must generate less than 5% of the revenues or expenses of the putatively controlled company, and at the 15%- 24.99% level, less than 2% may be generated. There are several semi-exceptions to this generalization. Any one of the following three circumstances will lead to a finding of control at any level of voting ownership, even at less than 5% of a class of voting securities: the existence of a management agreement, holding one-half or more of the directorships, and holding one-third or more of the total equity. In addition, the Board subjects the entire analytical framework of the Rule to a *ceteris paribus* clause to allow for divergent results if important components of the framework change or are abused, so that the ordinarily expected effects of a specific factor no longer seem to arise. Many of the parameters are also expressed as rebuttable presumptions. The ability to find that all things are



no longer equal or that a presumption has been rebutted means that some flexibility and trade-offs may be expected.

Determining where in the matrix of relationships a specific deal or structure will fall will depend on how the holdings of voting securities and total equity are calculated⁴, the positioning of directors and senior executives and the evaluation of a number of concepts. Among the conceptual evaluations that can be crucial are the following:

- Are the terms of a business relationship market terms, and what counts as the relevant market?
- Is an agreement between the two parties a management agreement, i.e., does it allow the putatively controlling company to direct or exercise “significant influence or discretion over the general management, overall operations, or core business or policy decisions of” the putatively controlled company?⁵
- Or is any agreement between the two companies one that contains provisions which significantly limit the discretion of the management of the putatively controlled company? The definition of the applicable term, “limiting contractual right,”⁶ lists 12 examples of such provisions and 10 examples of provisions which are not considered inappropriately limiting. Since these are only examples and deals often contain unique provisions, it will be necessary from time to time to elucidate the intended effect of the examples taken as a whole.

The Rule becomes effective on April 1, 2020. Because the Board considers the Rule to be largely reflective of existing practice, the Rule does not grandfather existing structures. Instead, the supplementary material in the release states that structures previously reviewed by the Board are likely to stand, and parties to structures that already exist but have not been reviewed may wish to contact the Board if they have questions. In addition, because the Board is, in connection with the Rule, abandoning its practice of obtaining passivity commitments for certain kinds of relationships, the supplementary material states that parties to existing passivity commitments may contact the Board for relief.



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¹ January 30, 2020, Control and Divestiture Proceedings (Rule), to be codified at 12 CFR Part 225 for bank holding companies and 12 CFR Part 238 for savings and loan holding companies. Available at the Board's website.

² Measured by percentage of any class of voting securities (supplemented by consideration of the aggregate amount of other forms of equity). The levels are: less than 5%, less than 10%, less than 15% and less than 25%.

³ Number of directors (less than a quarter when holding between 5% and 24.99% of a class of voting securities), board chairman (permissible below 15% of a class of voting securities), director service on board committees (at 10% or above, no more than one-quarter of the members of a board committee can be from the putatively controlling company), business relationships, terms of the business relationships (must be market terms at the 10%-24.99% level), officer/employee interlocks (permitted below 5%; one interlock but no CEO from 5% to 14.99%, and none at 15% or above), contractual powers (either management agreements or agreements that limit the powers of the management of the putatively controlled company), involvement in proxy contests to replace more than the permissible number of directors at 10% and above, and total equity. The matrix omits the provision which presumes control when the investor consolidates the putatively controlled company for accounting purposes.

⁴ The Rule prescribes a method for making those calculations as well as rules for treating options, warrants, convertible securities and classes that vote together.

⁵ 12 CFR 225.32(b) and 238.22(b).

⁶ 12 CFR 225.31(e)(5) and 12 CFR 238.21(e)(5).