



## Proposed Changes for the Federal Reserve's Control Analysis

Posted by Mark Nuccio and Gideon Blatt, Ropes & Gray LLP, on Wednesday, May 1, 2019

**Editor's note:** Mark Nuccio is partner and Gideon Blatt is an associate at Ropes & Gray LLP. This post is based on their Ropes & Gray memorandum.

On April 23, 2019, the Federal Reserve Board (the "Board") released for public comment proposed changes to its longstanding positions on the exercise of controlling influence under the Bank Holding Company Act of 1956, as amended (the "BHC Act")<sup>1</sup> (the "Proposal").<sup>2</sup> The Proposal holds promise for simplification of structures and promoting investment activity in the financial services, asset management and fintech sectors.

The Proposal revises the current approach for determining control and introduces a "Tiered Presumptions" framework that would consider the scope of various relationships at certain thresholds of voting rights (5%, 10% and 15%) to trigger a regulatory presumption of control. Specifically, the Proposal relates to indicia of control that may trigger a presumption of a controlling influence.<sup>3</sup>

While the Proposal is couched in terms of control of a banking organization, it will have farther-reaching effects because the Board uses the same controlling influence standards when analyzing non-banking controlling influence questions. Comments must be received by 60 days after the date of publication in the Federal Register.<sup>4</sup>

### 1. Control under the BHC Act

Under the BHC Act, control is defined by a three-pronged test: a company controls another company if it (i) directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of voting securities; (ii) controls in any manner the election of a majority of the directors; or (iii) directly or indirectly exercises a controlling influence over the management or policies.

<sup>1</sup> U.S.C. § 1841 *et seq.* The Proposal also applies to the Home Owners' Loan Act of 1933 ("HOLA"), 12 U.S.C. § 1461 *et seq.*

<sup>2</sup> Notice of proposed rulemaking with request for comment, Federal Reserve Board (April 23, 2019), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/control-proposal-fr-notice-20190423.pdf>. The Proposal relates solely to the issue of whether an investment, alone or in combination with other relationships, raises controlling influence concerns. Proposal at 15.

<sup>3</sup> See 12 CFR Part 225; 12 CFR 225.31 and 238.21. The Proposal would be the first modification of the regulatory presumptions of control since 1984.

<sup>4</sup> U.S.C. § 1841(a)(2); 12 CFR 225.2(e).

The first two prongs are bright-line rules favored by investors, who often seek to structure their investments to avoid the responsibilities and restrictions accompanying the statutory definition of control.<sup>5</sup> The third prong—whether a company directly or indirectly exercises a controlling influence over the management or policies of the bank or company (a “controlling influence”)—is a factual determination by the Board.<sup>6</sup>

While investors who own less than 5% of any class of voting securities may rely on a statutory safe harbor to conclude non-control, and investors who own 25% or more of any class of voting securities are presumed to control unless the Board determines otherwise, uncertainty arises when an investor owns between 5% and 25% of any class of voting securities.<sup>7</sup> The BHC Act provides that control due to controlling influence only arises once the Board determines, based on the facts presented and after notice and opportunity for a hearing, that a company controls another company.<sup>8</sup> The lack of a bright-line rule on what constitutes a controlling influence, and the *a posteriori* nature of a Board determination, has accentuated uncertainty in business planning and contract negotiations and drafting.

## 2. Proposed Revisions of Existing Presumptions of Control: “Tiered Presumptions” for Finding Controlling Influence

The proposed presumptions are arranged in tiers based on the level of voting ownership of any class—5%; 10%; and 15%.<sup>9</sup> A voting interest exceeding the particular threshold combined with the presence of another specified relationship would trigger a presumption of control.

The Proposal is structured on a sliding scale: generally, as an investor’s ownership percentage of voting shares in a company increases, the additional relationships and other factors through which the investor could exercise control must decrease in order to avoid triggering the application of a presumption of control. The proposed tiered framework is designed to incorporate the major factors and thresholds that the Board has historically viewed as presenting controlling influence concerns. In addition to the ownership percentage of a class of voting shares, the relationships and factors include:

- the size of the total equity investment;

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<sup>5</sup> Under the BHC Act, a company that controls a bank or bank holding company is subject to the Board’s regulations and supervisory oversight, including regular examinations, financial reporting obligations, capital and liquidity requirements, source of strength obligations, activities restrictions and restrictions on certain affiliate transactions. See, e.g., 12 U.S.C. §§ 371c, 371c-1, 1831o-1, 1841(a), 1843 and 1844(c); 12 CFR parts 217, 223 and 225.

<sup>6</sup> CFR 225.143.

<sup>7</sup> See 12 U.S.C. § 1841(a)(3); 12 CFR 225.31(e).

<sup>8</sup> Historically, in assessing the controlling influence prong, the Board has considered a number of factors relating to the size of the investment and certain other relationships. The Board’s 2008 policy statement reiterated the facts and circumstances approach to determining a controlling influence and expanded on various factors that would provide one company the ability to exercise a controlling influence on another company, triggering a presumption of control. See Policy Statement on equity investments in banks and bank holding companies (September 22, 2008), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20080922c.htm> (the “2008 Policy Statement”). The Proposal notes that, notwithstanding the presumptions of control or non-control, the Board may or may not find there to be a controlling influence based on the facts and circumstances presented by a particular case. Proposal at 14.

<sup>9</sup> The 5%/10%/15% thresholds are plucked from other bank regulatory schemes. Five percent is the level of voting ownership at which the statutory presumption of non-control ceases to apply. 12 U.S.C. § 1841(a)(2)(C). Ten percent is a level of voting ownership used by the Board in other circumstances to identify major investors in banking organizations. 12 U.S.C. § 1841(a)(3). Investors at 15% are significant investors closer to statutory control (at 25%) than presumed noncontrol (at less than 5%), and the Board has used 15% as a threshold in certain control precedents. See Proposal at 26-27; see also, e.g., 2008 Policy Statement at 10.

- rights to director and committee representation on the board of directors;
- the use of proxy solicitations;
- management, employee or director interlocks;
- covenants or other agreements that allow for influence or restrict management or operational decisions; and
- the scope of the business relationships.<sup>10</sup>

The Summary of Tiered Presumptions chart accompanying the Proposal's release includes a shorthand grid showing combinations of voting percentage and relationships that, if exceeded, would trigger a presumption of control under the Proposal:

	<b>Less than 5% voting</b>	<b>5-9.99% voting</b>	<b>10-14.99% voting</b>	<b>15-24.99% voting</b>
<b>Directors</b>	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
<b>Director Service as Board Chair</b>	N/A	N/A	N/A	No director representative is chair of the board
<b>Director Service on Board Committees</b>	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
<b>Business Relationships</b>	N/A	Less than 10% of revenues or expenses	Less than 5% of revenues or expenses	Less than 2% of revenues or expenses
<b>Business Terms</b>	N/A	N/A	Market Terms	Market Terms
<b>Officer/Employee Interlocks</b>	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
<b>Contractual</b>	Powers No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
<b>Proxy Contests (directors)</b>	N/A	N/A	No soliciting proxies to replace more than permitted	No soliciting proxies to replace more than

<sup>10</sup> See 2008 Policy Statement; Proposal at 17.

			number of directors	permitted number of directors
<b>Total Equity</b>	Less than one third	Less than one third	Less than one third	Less than one quarter

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Other proposed changes and exclusions to the presumptions of controlling influence:

- Management agreements. Expand the universe of agreements and understandings presumed to constitute control from management agreements (including where the investor is a managing member, trustee or general partner, or exercises a similar function) to any agreement or understanding conveying the ability to direct core business or policy decisions. Routine outsourcing agreements, such as IT services agreements, would not qualify.
- Investment advice. Presumption of control where an investment adviser to an investment fund controls 5% or more of any class of voting securities or 25% or more of the total equity capital subject to an initial 12-month seeding period. Investment fund would be defined to include both investment companies registered under the Investment Company Act of 1940, as amended (the “1940 Act”), and funds exempt from registration under the 1940 Act.
- Divestiture of control. Substantially revise existing standards regarding divestiture of control.
- Registered funds. Limited exception from all of the control presumptions if the second company is a registered investment company and certain other relationships are limited.
- Presumption of non-control. Expand the rebuttable presumption of non-control if none of the proposed presumptions of control is met and the investor owns less than 10% of every class of the voting securities.

### 3. Stay Tuned

While the Board’s proposal appears to play with the same set of control cards, it represents a significant shuffling of the deck, with potentially significant impact. In particular, the proposal could spur partnerships between banks and fintech companies by helping define non-controlling relationships. In addition, by refining controlling influence standards, the Proposal may encourage investments in bank and bank holding company equity by non-bank investors.

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<sup>11</sup> Summary of Tiered Presumptions, Appendix to Memorandum from Staff to Board of Governors, Notice of proposed rulemaking to revise the Board’s rules for determining whether a company has control over another company (April 16, 2019), available at <https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-proposal-chart-20190423.pdf>.