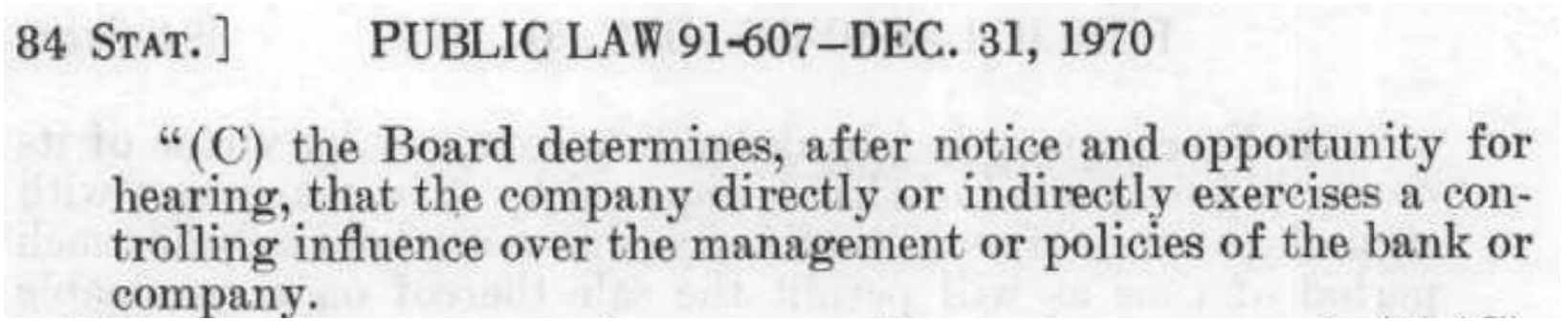
Implementation of the Federal Reserve's Control Rules

How to Have Control (or Avoid It)

ABA Banking Law Committee
Enforcement, Insider Liability, and
Troubled Banks Subcommittee

Agenda

- Panelist Commentary
  - Jarryd Anderson (moderator), Wells Fargo & Co.
  - Matthew Bisanz, Mayer Brown LLP
  - Joseph Silvia, Howard and Howard PLLC



84 STAT.] PUBLIC LAW 91-607—DEC. 31, 1970

"(C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

Background

Background

- "Control" is a foundational concept under the Bank Holding Company Act of 1956 (BHCA) and Home Owners' Loan Act (HOLA)

- A company that indirectly or directly controls a bank or savings association is a considered a bank holding company (BHC) or savings and loan holding company (SLHC), respectively
  - BHCs and SLHCs are subject to supervision and regulation by the Federal Reserve
  - Regulations include restrictions on nonbank activities, among others
- A company that is controlled by a BHC or SLHC similarly is subject to Federal Reserve supervision and regulation and restrictions regarding its activities

Background (cont.)

- Under the BHCA, a company has control over another company if the first company:
  - Directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;
  - Controls in any manner the election of a majority of the directors of the other company; or
  - The Federal Reserve determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a *controlling influence* over the management or policies of the other company (emphasis added)
- The Federal Reserve adopted regulations that implemented and interpreted aspects of the statutory definition of "control" and published various interpretations and policy statements
- Similar definition applies under HOLA, which the Federal Reserve inherited in 2011

Controlling Influence Prong

- The "controlling influence" prong involves a fact-based determination regarding whether a company has the ability to exercise a controlling influence over another company
- The meaning of the "controlling influence" prong of the definition was developed primarily through staff determinations on individual transactions, often without any public notice or comment
  - "discovered … through supplication to someone who has spent a long apprenticeship in the art of Fed interpretation"
- Federal Reserve staff have noted that the Board's control framework "is not provided in a single document and many of the specific standards have not been issued publicly"

2019 Proposal and 2020 Final Rule

- In April 2019, the Federal Reserve proposed a rule to clarify, rationalize, and memorialize its approach to the controlling influence prong
  - Replace the approach to regulation of "Federal Reserve lore … receiving the wisdom of their elders through oral tradition"
- In January 2020, the Federal Reserve issued a final rule to review and codify its approach to the controlling influence prong
  - Largely consistent with the proposal
  - Styled as presumptions that would be applied in control proceedings by the Federal Reserve, although such proceedings have not occurred in decades
  - Codifies many existing standards, but introduces new concepts
- Final rule was to become effective on April 1, 2020, but implementation was delayed until September 30, 2020 due to COVID-19

The proposal proposed to amend Regulation Y and Regulation LL to update and clarify the definitions of various control-related terms. This section discusses in detail how the final rule addresses each of these definitions.

Definitional Issues

First Company and Second Company

- Final rule defines "First Company" and "Second Company" to distinguish the parties involved a control determination
  - First Company is the entity whose potential control of the Second Company is being assessed (i.e., the investor)
  - Second Company is the entity whose potential control by the First Company is being assessed (i.e., the target)
- Final rule generally considers the relationships between (i) First Company and its subsidiaries and (ii) Second Company and its subsidiaries
  - For joint ventures, any company that is both a subsidiary of the First Company and the Second Company is treated as a subsidiary of the First Company but not as a subsidiary of the Second Company

Control of Securities

- A person controls a security if the person owns the security or has the power to sell, transfer, pledge, or otherwise dispose of the security
  - In addition, a person controls a security if the person had the power to vote the security, other than due to holding a short-term, revocable proxy
- Final rule also addresses:
  - Control of options, warrants, and convertible instruments
  - Control over securities through restrictions on rights
  - Control of securities through associated individuals and subsidiaries
  - Control of securities by a non-subsidiary
  - Calculation of control of a percentage of a class of voting securities

Calculation of Total Equity Percentage

- Final rule adopts a GAAP-based methodology for determining a First Company's total equity percentage in the Second Company
  - *Pari passu* classes of preferred stock (i.e., classes of preferred securities of the same seniority in liquidation) are treated as a single class
- Final rule includes a provision whereby debt or other interests may be treated as equity if the interests are functionally equivalent to equity
  - Excludes nominally equity instruments from total equity if the equity instruments are determined to be functionally equivalent to debt
- Does not include a proposed provision that would have required a First Company to include a *pro rata* share of equity securities held by a non-subsidiary
- Requires re-calculation of total equity only when a First Company acquires control over additional equity of a Second Company

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 of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
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	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less

Tiered Framework

Tiered Framework

- Centerpiece of the final rule is a tiered framework of presumptions of control based on a First Company's voting interest percentage in the Second Company

- As the First Company's voting interest percentage in the Second Company increases, other factors through which the First Company could exercise a controlling influence generally must decrease in order to avoid triggering the application of a presumption of control

Tiered Framework (cont.)

	(Presumption triggered if any relationship exceeds the amount on the table)			
	Less than 5%	5-9.99%	10-14.99%	15-24.99%
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
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Directors and Board Committees

- Control is presumed if:
  - First Company controls 5 percent or more of any class of voting securities of a Second Company and a quarter or more of the board of directors of the Second Company
  - First Company controls 5 percent or more of any class of voting securities of the Second Company and has director representatives that are able to make or block the making of major operational or policy decisions of the Second Company
  - First Company controls 10 percent or more of any class of voting securities of the Second Company and the director representatives of the First Company occupy more than a quarter of the positions on any board committee of the Second Company that has the power to bind the company without the need for additional action by the full board of directors
  - First Company controls 15 percent or more of any class of voting securities of the Second Company and a director representative of the First Company also serves as the chair of the board of directors of the Second Company

Business Relationships and Terms

- Control is presumed if:
  - The First Company controls 5 percent or more of any class of voting securities of the Second Company and has business relationships with the Second Company that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the Second Company
  - The First Company controls 10 percent or more of any class of voting securities of the Second Company and has business relationships with the Second Company that generate in the aggregate 5 percent or more of the total annual revenues or expenses of the Second Company
  - The First Company controls 15 percent or more of any class of voting securities of the Second Company and has business relationships with the Second Company that generate in the aggregate 2 percent or more of the total annual revenues or expenses of the Second Company
  - The First Company controls 10 percent or more of any class of voting securities of the Second Company and has business relationships with the Second Company that are not on market terms

Business Relationships and Terms (cont.)

- Historically the business relationships factor was interpreted expansively and inconsistently, in some cases limiting non-controlling relationships to even lower levels of revenue than were provided for in the final rule
- Under the final rule, even low to moderate equity investments, combined with modest revenue generation, could trigger the presumption and would require extensive monitoring
- The Federal Reserve left open the possibility that it "may raise controlling influence concerns under specific facts and circumstances consistent with historical precedent, such as relationships with special qualitative significance (for example, relationships that are difficult to replace and are necessary for core functions)"
- Unclear if/how revenue generated from referrals is treated
- Unclear if the Federal Reserve would deviate from the presumption in cases in which the business relationships generated a very large percentage of the Second Company's revenue
  - See e.g., Federal Reserve precedent regarding "orphan subsidiaries" that are controlled by a First Company that has no voting interest

Officer/Employee Interlocks

- Control is presumed if:
  - The First Company controls 5 percent or more of any class of voting securities of the Second Company and has more than one senior management interlock with the Second Company
  - The First Company that controls 15 percent or more of any class of voting securities of the Second Company and has any senior management interlock with the Second Company
  - The First Company controls 5 percent or more of any class of voting securities of the Second Company and has an employee or director who serves as the chief executive officer (or an equivalent role) of the Second Company

Contractual Powers

- Control is presumed if the First Company controls 5 percent or more of any class of voting securities of the Second Company and has a limiting contractual right with respect to the Second Company
- A "limiting contractual right" is a contractual right that allows the First Company to restrict significantly the discretion of a Second Company, including its senior management officials and directors, over major operational or policy decisions
- The final rule contains nonexclusive lists of examples of contractual rights that are generally (i) considered to be limiting contractual rights and (ii) not considered to be limiting contractual rights
  - The final rule does not specifically exempt restrictive covenants in debt agreements

Proxy Contests

- Control is presumed if the First Company controls 5 percent or more of any class of voting securities of the Second Company and solicits proxies to appoint a number of directors that equals or exceeds a quarter of the total directors on the board of directors of the Second Company

- No presumption if the First Company solicits proxies from the shareholders of the Second Company on any issue

- No presumption if the First Company threatens to dispose of its voting or non-voting securities in the Second Company unless a specific action is taken

Total Equity

- Control is presumed if the First Company controls one-third or more of the total equity of the Second Company, regardless of the First Company's voting securities percentage
  - Non-controlling total equity is capped at 25 percent for SLHCs because of additional restrictions in HOLA
- Total equity calculation is based on GAAP with adjustments in the final rule
  - Despite industry comments on the proposal, it remains unclear to calculate total equity for investments in start-ups and companies with negative GAAP equity; a First Company may exceed one-third threshold (potentially to infinity) by making an equity investment in a Second Company with negative equity

In view of the increased importance of determinations by the Board that a company controls a bank or another company, .the Board proposes, pursuant to sections 2 and 5 of the Act, to establish a series of presumptions regarding control, reflecting its judgments based upon its 15 years of experience in administering the Act.

Standalone Presumptions

Standalone Presumptions

- The final rule includes several standalone presumptions of control in addition to, and separate from, the presumptions of control that comprise the tiered framework

- The First Company is presumed to control the Second Company if it triggers any of the standalone presumptions

- Presumptions for divestiture of control and non-control are also addressed through standalone presumptions

Management Agreements

- Control is presumed if the First Company enters into a management agreement with the Second Company to direct or exercises significant influence over the general management or overall operations of the Second Company

- Final rule slightly expands the existing regulatory presumption and expressly identifies additional types of agreements or understandings that raise controlling influence concerns, including agreements where the First Company is a managing member, trustee, or general partner of the Second Company

Investment Advice and Investment Funds

- Control is presumed if the First Company serves as investment adviser to a Second Company that is an investment fund and controls 5 percent or more of any class of voting securities or 25 percent or more of the total equity of the Second Company
  - Presumption does not apply if the First Company organized and sponsored the Second Company within the preceding 12 months (i.e., seeding period)
- The Federal Reserve appears to have rejected a 1999 letter in which it concluded that a company could provide the initial capitalization to mutual funds that it advised and retain up to 25 percent of the voting securities after the initial capitalization period without being deemed to control those funds
  - Preamble to the final rule noted that the precedent was "an unusual case based in part on statutory provisions that are no longer in effect"

Investment Advice and Investment Funds (cont.)

- The preamble to the final rule noted a comment requesting that the Federal Reserve confirm the ongoing applicability of certain control letters from the General Counsel to mutual fund families, and investments made in accordance with those letters
- The final rule is silent on the continuing validity of these letters, but the Federal Reserve may have addressed this issue through its general statement that it "does not intend to revisit existing structures that were previously reviewed by the Federal Reserve System and have not changed materially"

Accounting Consolidation

- Control is presumed if the First Company consolidates the Second Company under US GAAP
  - Includes arrangements where the First Company consolidates the Second Company under the variable interest entity standard
  - Does not cover arrangements where the First Company accounts for an interest in the Second Company under the equity method
- Preamble to final rule notes that the Federal Reserve is likely to have the same control concerns where the First Company consolidates the Second Company under another accounting standard
- Preamble also clarifies that the meaning of "ownership interest" in Regulation YY does not include contractual relationships, including contractual relationships that result in consolidation of a company under the variable interest entity standard

Divestiture of Control

- The First Company is no longer deemed to control the Second Company if the First Company:
  - Divests its voting interest in the Second Company to less than 15 percent or
  - Divests its voting interest in the Second Company to less than 25 percent and waits two years

- Divestiture presumption does not apply if a majority of each class of voting securities of the Second Company would be controlled by a single unaffiliated individual or company after the divestiture by the First Company

Rebuttable Presumption of Non-Control

- The First Company is presumed not to control the Second Company if the First Company (i) controls less than 10 percent of every class of voting securities of the Second Company and (ii) is not presumed to control the Second Company under any of the presumptions of control
  - Modestly broader than the existing 5 percent presumption

- Does not impact the filing requirements applicable to BHCs and SLHCs for investments in 5 percent or more of any class of voting securities of a company (e.g., FR Y-10)

Implementation and Interpretive Issues

"the practical determinants of when the Board will deem one company to control another, can in some cases not be discovered except through supplication to a small handful of people who have spent a long apprenticeship in the subtle hermeneutics of Federal Reserve lore"

Treatment of Existing Arrangements

- The final rule
  - Does not provide a transition period to allow firms to conform or report existing arrangements, structures or investments and
  - Does not include any grandfather provision for non-conforming existing arrangements, structures or investments
- In general, the Federal Reserve "does not expect to revisit structures that have already been reviewed by the Federal Reserve System" unless such structures are "materially altered from the facts and circumstances of the original review"
- Companies may contact the Federal Reserve to discuss potential actions for structures that have not been reviewed by the Federal Reserve System
- April 2020 extension announcement notes that industry had indicated "a desire to consult with Board staff about the effect of the new control rule on various existing investments and relationships"

Interpretation for New Arrangements

- The final rule retains the Board's discretion to find that a "controlling influence" exists in situations that do not trigger any of the presumptions of control
  - E.g., "Though the final rule is expected to cover most controlling influence concerns arising out of business relationships, the Board may raise controlling influence concerns under specific facts and circumstances consistent with historical precedent, such as relationships with special qualitative significance"
  - Unlikely that the Federal Reserve will return to holding formal control proceedings
- Industry is still working to understand how to apply "structures that have already been reviewed by the Federal Reserve System" to new arrangements; relief could be available only for existing arrangements

Interaction with Other Regulations

- The final rule does not extend to or modify the concepts of control under the Change in Bank Control Act or the Federal Reserve's Regulation O and Regulation W
  - Definition of control for purposes of Regulation W includes investment adviser relationships where there the First Company has no voting interest
  - Feedback on the 2019 proposal led to interagency no-action relief in December 2019 for depository institutions and asset managers that become principal shareholders of institutions with respect to certain extensions of credit by institutions that otherwise would violate Federal Reserve's Regulation O
- Federal Reserve states in the preamble to the final rule that it may, in the future, consider conforming revisions to these other elements of its regulatory framework

Foreign Banking Organizations

- Final rule does not include any presumptions or exclusions specifically tailored to the non-US operations of foreign banking organizations, nor does it modify the Federal Reserve's Regulation K
- Preamble to the final rule notes that the statutory framework for control does not contemplate different definitions of control for companies in different jurisdictions
  - Federal Reserve states that the final rule is "generally consistent with the Board's current practice and, as a result, the final rule is not expected to result in substantially different outcomes for questions of controlling influence involving foreign companies."

Passivity Commitments

- Historically, the Federal Reserve required passivity commitments from investors in banks or BHCs with voting interest between 5 percent and 24.99 percent of any class of voting securities, restricting the investor's ability to have a controlling influence over the banking organization
- Under the final rule, the Federal Reserve does not intend to continue obtaining the standard passivity commitments in the ordinary course
  - Companies that have previously made passivity commitments to the Federal Reserve (including in connection with TARP) may contact the Board or the appropriate Federal Reserve Bank to seek relief from these commitments
- The Federal Reserve will continue to obtain control-related commitments in specific contexts, such as commitments from employee stock ownership plans and mutual fund complexes, and in special situations
- Unclear what the Federal Reserve will view as "special situations" or how "control-related commitments" will differ from the passivity commitments

Section 4(c)(6) Exception

- Section 4(c)(6) of the BHCA permits BHCs to invest in up to five percent of the voting shares of any company, but these investments must be passive or non-controlling
- Framework in the final rule applies for purposes of section 4(c)(6) and, in particular, the Board's interpretation of section 4(c)(6) located at 12 C.F.R. § 225.137
- Tiered framework aligns with requirements for section 4(c)(6) authority (i.e., an investment under section 4(c)(6) should not trigger the presumptions in the tiered framework)

"5-25" Presumption

- The final rule does not include the historical presumption that a First Company controls a Second Company if:
  - The First Company controls at least 5 percent of any class of voting securities of the Second Company and
  - The senior management officials and directors of the First Company, together with their immediate family members and the First Company, own 25 percent or more of a class of voting securities of the Second Company

- Instead, the final rule provides that a First Company that controls 5 percent or more of any class of voting securities of the Second Company also controls any securities issued by the Second Company that are controlled by the senior management officials, directors, or controlling shareholders of the First Company, or immediate family members of such individuals
  - Includes an exception where the senior management officials, directors, or controlling shareholders control 50 percent or more of each class of voting securities of the Second Company

Fiduciary Exception

- The presumptions of control do not apply to the extent that the First Company controls voting or nonvoting securities of the Second Company in a fiduciary capacity without sole discretionary authority to exercise the voting rights
- Federal Reserve declined to provide broader clarity around the scope of the fiduciary exception in the final rule and referred companies to the Board or staff to obtain clarification

Next Steps

- Final rule becomes effective on September 30, 2020
- Companies should consider the following steps when implementing:
  - Identify and analyze existing arrangements that may necessitate consultation with Federal Reserve staff
    - Review should be on a global basis
    - Particular emphasis on business relationships, limiting contractual rights, and accounting consolidation
  - Document instances of prior review by the Federal Reserve System
  - Review existing passivity commitments and approach Reserve Bank
  - Consider impact of the final rule on new arrangements or modifications to existing arrangements

Questions?

Contact Information

- Jarryd Anderson
  (202) 416-2509
  jarryd.e.anderson@wellsfargo.com

- Matthew Bisanz
  (202) 263-3434
  mbisanz@mayerbrown.com

- Joseph Silvia
  (312) 456-3659
  jsilvia@howardandhoward.com