MAYER | BROWN

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Legal Update

Federal Reserve Proposes Significant Revisions to Regulatory Control Rules

On April 23, 2019, the Board of Governors of the Federal Reserve System (the "Board") approved a long-awaited proposal (the "Control Proposal" or "Proposal") to revise its rules for determining whether one company has a "controlling influence" over another company for purposes of the US Bank Holding Company Act of 1956, as amended ("BHCA").[1] If adopted, the Control Proposal would represent the first material modification to the Board's control regulations since 1984 and would bring significantly more clarity and transparency to an opaque area of the law that has evolved primarily through staff interpretations and opinions delivered in the context of individual transactions—often without being made public or reduced to writing. Comments on the Proposal are due 60 days after its publication in the *Federal Register*, which is expected to occur shortly.

I. Key Takeaways

As discussed in more detail below, certain aspects of the Control Proposal would formalize, clarify and potentially strengthen what most regard as current Board precedent and policy. Other aspects of the Proposal would break new ground, in certain cases liberalizing and in other cases restricting controlling influence standards as compared to prevailing industry understandings and practice. Before turning to a detailed review of the Control Proposal, we note several significant takeaways and potential considerations for public comment:

- **Tiered Framework of Controlling Influence Presumptions.** The centerpiece of the Control Proposal is a "tiered framework" of presumptions for evaluating when a particular investment results in a controlling influence and when it does not, based primarily on readily identifiable objective criteria. This represents a significant improvement over the Board's current approach, where the various "indicia of control" are relatively easy to identify but far more difficult to quantify with certainty or reduce to an actionable legal conclusion absent a potentially protracted engagement with Board staff. Provided that the Board in practice adheres to the approach suggested by the Proposal (i.e., effectively precluding the possibility of a control determination where a presumption of controlling influence is not triggered) the Control Proposal should substantially reduce legal uncertainty and the attendant regulatory drag on many kinds of minority investments.

- **Reinvigorating the Presumption of Noncontrol for Less than Five Percent Investments.** The Control Proposal could breathe new life into the statutory presumption of noncontrol for investments not exceeding five percent of any class of voting securities of another company. While this presumption has long been part of the BHCA, and is already stated in Regulation Y, the Board's highly restrictive approach in recent years on "business relationship" issues in particular—that is, the potential for controlling influence to arise from one company relying on another for a portion of its revenue—had significantly undermined the practical significance of the presumption. Among other things, the Proposal suggests that investments involving less than five percent of a class of the voting securities of another company would not be subject to any "business relationships" test and also would not be susceptible to being viewed as controlling solely on the basis of minority investor veto or consent rights. This represents a potentially significant favorable development for bank holding companies that seek to hold fintech and other portfolio investments under section 4(c)(6) of the BHCA, although the Proposal does not address how these issues should be evaluated for purposes of the "passivity" requirement of section 4(c)(6), which is a distinct but closely related analysis. Comments might seek clarity from the Board on this point.
- **Clarifying Statements.** The Control Proposal provides greater clarity on a number of particularly nettlesome controlling influence issues, including (i) how to evaluate the impact of creditor's rights arising under a loan facility or other financing arrangement as part of controlling influence analysis; and (ii) how to define and calculate "total equity" within the meaning of the Board's controlling influence framework, including the appropriate characterization of subordinated debt and other equity-like instruments. The Proposal should provide additional comfort to lenders and other providers of financing that they will not be viewed as having a controlling influence over a borrower as a result of contractual restrictions on the borrower's activities, provided that the lender does not also hold five percent or more of any class of the borrower's voting securities.
- **Change in Tone.** Finally, the Control Proposal reflects a welcome recognition of the statutory framework of the BHCA, including the procedural safeguards established with respect to controlling influence determinations. The Proposal emphasizes throughout that control due to controlling influence can arise only after notice and an opportunity for hearing, and that the tiered presumptions set forth in the Proposal are intended to assist the Board in conducting control hearings. While we do not expect formal control hearings to become the norm, the Board's apparent attempt to anchor the controlling influence framework more closely to its statutory underpinnings (i.e., as compared to some earlier Board policy pronouncements) represents a potentially significant shift in tone and may portend a substantive re-balancing of the approach taken by Board staff with respect to these issues.

While the Control Proposal is on balance, a clear step in the right direction in terms of clarity and transparency, not all of the positions set forth in the Proposal are favorable to the industry.

- **Highly Restrictive Revenue Limits for Larger Minority Investments.** For investments involving 15 percent to 24.99 percent of a class of a company's voting securities, a proposed revenue test of just two percent (and presumption of control above that level) is highly restrictive—more

restrictive in our experience than prevailing industry practice. The revenue test levels for investments involving five percent to 9.99 percent and 10 percent to 14.99 percent of a class of a company's voting securities (i.e., 10 percent and five percent of annual revenues and expenses, respectively) are arguably more consistent with existing Board precedent, although even these restrictions have proven problematic for many investments, particularly in fintech and other startups where revenues can both be highly volatile and often materially diverge from expectations. Further, the Control Proposal is silent regarding how a company should determine when revenue is "generated" by a particular business relationship. Commenters may seek clarity, for example, as to whether this is intended to refer only to direct payments from one company to another or whether more amorphous "referral" or similar types of revenue could be attributed to a particular relationship.

- **Restrictive Approach to "Limiting Contractual Rights."** The Control Proposal would establish a new defined term—"limiting contractual rights"—and a presumption of control for any investor that holds five percent or more of a class of voting securities and any such right. The non-exhaustive list of examples of limiting contractual rights, however, is broad and includes certain "protective" rights of the kind that are often sought by minority investors. Taken together, the highly restrictive approach on business relationships and on limiting contractual rights may suggest an implicit Board policy objective that minority investments, in most cases, should be (i) limited to less than five percent of any class of a company's voting securities and held under section 4(c)(6) or (ii) treated as controlling for BHCA purposes. It is unclear what the industry appetite may be for noncontrolling investments in excess of five percent of a class of voting securities given the significant restrictions that will attach to those investments.
- **No Consideration of Other Larger Shareholders in the Tiered Framework.** The Control Proposal acknowledges that the Board's controlling influence analysis has historically included consideration of the presence (or not) of other large, countervailing shareholders to mitigate the potential for a particular minority investor to exercise a controlling influence over a target company. However, the proposed tiered framework would not include this factor or assign any particular weight to the existence of other larger (or even majority) shareholders in assessing whether an investor has a controlling influence. The Board suggests that taking account of this factor within the framework could create undue complexity and points out that the Board could rely on its retained discretion to evaluate the impact of other shareholders as part of a "facts and circumstances" analysis. Commenters may want to consider a mechanism for assigning weight to the existence of other large shareholders within the Board's proposed framework, in order to avoid the possible need to revert to the Board's historical transaction-specific approach for analyzing controlling influence in any investment where other large countervailing shareholders are present.
- **Registered Investment Companies and Other Investment Funds.** The Control Proposal includes several significant provisions related to the treatment of investment funds, including investment companies that are registered with the US Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940 ("RICs"). In particular, the Proposal generally would treat an investment fund, including a RIC, as a controlled subsidiary of

a bank holding company ("BHC") (i) if the BHC serves as investment adviser to the fund or RIC and (ii) controls five percent or more of a class of voting securities or 25 percent or more of the total equity of the fund or RIC. The Proposal would provide a seeding period exemption, but only for the first 12 months after formation. This aspect of the Proposal is seemingly out of alignment not only with prevailing industry practice for seeding, but also with other Board regulations and guidance (e.g., under the Volcker Rule) that have recognized a minimum initial seeding period of at least three years. Moreover, many BHCs currently take the view that a RIC for which the BHC provides investment advice is not controlled by the BHC so long as it reduces its seed investment to less than 25 percent of a class of the RIC's voting securities (a position also taken by the Board in the context of the Volcker Rule).

- **Look-Through Approach to Convertible Instruments.** In an interesting and potentially impactful provision of the Control Proposal, the Board proposes that a holder of options or warrants to acquire voting securities or an instrument convertible into voting securities would be treated as controlling the underlying voting securities "even if there were an unsatisfied condition precedent" to the exercise of the option/warrant or conversion of the instrument. While the Proposal suggests this approach is "consistent with the Board's longstanding precedent," citing the 2008 Policy Statement,[2] it in fact arguably goes beyond the 2008 Policy Statement with respect to instruments with contingent exercise or conversion features. Specifically, the 2008 Policy Statement states that "nonvoting shares that may be converted into voting shares *at the election of the holder* of the shares, or that *mandatorily convert* after the passage of time, should be considered voting shares at all times" (emphasis added). Because an unsatisfied condition precedent means that a holder does not have the right to elect conversion of the instrument and the instrument by definition does not "mandatorily convert after the passage of time," this aspect of the look-through approach to non-voting instruments appears to exceed some of the Board's prior precedent.

Significantly, the Control Proposal does not provide any transition period or otherwise address its potential impact on existing investments and relationships, including those that may have been entered into based on an understanding of the Board's controlling influence precedent that would be altered if the Proposal is adopted. Commenters may seek additional clarity on this point as well.

II. Detailed Analysis of the Proposal

We have summarized below (i) background on the Board's control framework for BHCs, including foreign banking organizations ("FBOs") that are or are deemed to be BHCs; (ii) the new, codified and revised presumptions of control in the Control Proposal; (iii) the new presumptions of noncontrol; (iv) the new defined terms that would be codified by the Proposal; and (v) how the Proposal would apply to savings and loan holding companies ("SLHCs").

BACKGROUND

Under the BHCA, a company that controls a bank is a BHC subject to source of strength obligations, activities restrictions, capital and liquidity requirements, and Board examination authority and reporting obligations, among other legal and regulatory obligations. Nonbank companies that are controlled by BHCs are also subject many of these restrictions and requirements. Additionally, companies that control, or are under common control with, a bank (i.e., BHCs and their nonbank subsidiaries) are subject to

prohibitions against proprietary trading and certain covered fund relationships under the Volcker Rule. In practice, these requirements, restrictions, and prohibitions create strong incentives for some investors to structure investments in BHCs and banks to avoid control. Likewise, BHCs often seek to structure investments in other nonbank companies in a manner that avoids establishing control.

Currently, the BHCA provides that a company *controls* another company if the first company:

i. 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 second company;

ii. Controls in any manner the election of a majority of the directors of the second company; or

iii. Directly or indirectly exercises a controlling influence over the management or policies of the second company.[3]

Board 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."[4] The Board has adopted regulations that implement and interpret the statutory definition of "control" and has published various interpretations and policy statements. However, as a practical matter, the meaning of the "controlling influence" prong of the definition has been developed primarily through staff determinations on individual transactions, often without any public record (and certainly without formal notice and comment rulemaking). The Control Proposal is intended to replace much of the opacity historically associated with controlling influence analysis and to "bring transparency and consistency to issues of control and clarify when common situations may give rise to control concerns."[5]

PRESUMPTIONS OF CONTROL

Regulation Y currently contains several "presumptions of control" that articulate certain fact patterns and circumstances that the Board has historically viewed as giving rise to potential controlling influence.[6] The Control Proposal would supplement the existing set of presumptions with a new and expanded "tiered" framework of presumptions. This framework would be "structured so that, as an investor's ownership percentage in the target company increases, the additional relationships and other factors through which the investor could exercise control generally must decrease in order to avoid triggering the application of a presumption of control."

In addition to the tiered framework, the Proposal would add to and modify the presumptions of control and noncontrol already contained in Regulation Y and would add presumptions related to divestitures of control. The presumptions of control would be equally applicable to BHCs, SLHCs, and FBOs. The Proposal does not propose any presumptions specially tailored to the non-US operations of FBOs.

Board Discretion and Reliance on the Proposed Framework of Presumptions

Before turning to the content of the controlling influence presumptions themselves, we note that the value of the Control Proposal and the framework it establishes will depend almost entirely on the manner in which the Board and Board staff implement the framework in practice. If the "presumptions" set out in the Proposal are routinely subject to exceptions and second-guessing by staff and, thus, do not provide sufficient certainty and comfort that they can be relied upon by industry participants in the normal course of business, then the impact of the new framework is likely to be minimal.

Fortunately, however, the Board's initial statements on this point are encouraging. While the Board of course does not relinquish

discretion to determine on a case-by-case basis that a particular arrangement amounts to control, the preamble to the Control Proposal includes positive language that suggests the presumptions should in practice provide substantially greater certainty for regulated entities than has been the case in the past. Specifically, the Board states that "[a]bsent unusual circumstances, the Board generally would not expect to find that a company controls another company where the first company is not presumed to control the second company under the [Proposal]."[7] While this and similar statements in the Proposal are qualified elsewhere, the overall intent of the Proposal appears to be that both the Board and industry will typically be able to rely on the presumptions set out in the regulation, as opposed to being required to subject each new investment to an often inconclusive "facts and circumstances" analysis requiring consultation with Board staff.[8]

New Framework for Evaluating Control

Under the tiered framework of the Control Proposal, a company (the "first company" or "investor") would need to evaluate several factors to determine whether the first company would be presumed to control another company (the "second company" or "target company"). The evaluation will be structured so that, as an investor's ownership percentage in the target company increases, the additional relationships and other factors through which the investor could exercise control generally will need to decrease to avoid triggering the application of a presumption of control. The proposed tiered framework is summarized in a chart that was attached to the Proposal and is reproduced at Appendix A in this Legal Update.

Standardization of Control Factors in the Tiered Framework of Presumptions

The control factors or "indicia of control" in the proposed tiered framework (e.g., number and role of directors, degree of business relationships, management interlocks, total equity, etc.) are drawn from the Board's past policy statements, including the 2008 Policy Statement. However, the tiered framework standardizes and in some cases liberalizes the application of those control factors.

Directors and Director Service. The Control Proposal would allow investors who control five percent or more but less than 25 percent of any class of voting securities of a target company to elect directors constituting less than a quarter of the members of the board of directors of the target company without triggering a presumption of control. (Under current policy, an investor that holds 10 percent to 24.9 percent of a class of the voting securities generally may have only one or, in certain cases, two directors.) It also indicates that a less than five percent investor could have a quarter or more of the members of the board without triggering a presumption of control, so long as the investor does not control a majority of the board of directors of the target company.

The proposed framework also would include three new presumptions of control relating to positons on the board of directors or a committee of the target's board:

i. The first company controls 15 percent 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 directors of the second company. Historically, the Board allowed an investor to have a director representative serve as chair of the target company only if the investor controlled less than 10 percent of any class of voting securities.

ii. The first company controls five percent or more of any class of voting securities of the second company and has director representatives on the second company's

board who are able to make or block the making of major operation or policy decisions (i.e., supermajority voting rights, individual veto rights and similar unusual provisions).

iii. The first company controls 10 percent or more of any class of voting securities of a 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 with power to bind the company without the need for additional action by the full board of directors (examples cited by the Board include the audit committee, compensation committee and executive committee).

Business Relationships. The framework would include four presumptions of control relating to business relationships:

i. The first company controls five 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 first company or the second company.

ii. The first company controls 10 percent or more of any class of voting securities of a second company and has business relationships that generate in the aggregate five percent or more of the total annual revenues or expenses of the first company or the second company.

iii. The first company controls 15 percent or more of any class of voting securities of a second company and has business relationships that generate in the aggregate two percent or more of the total annual revenues or expenses of the first company or the second company.

iv. The first company controls 10 percent or more of any class of voting securities of a second company and has any business relationships with the second company that are not on market terms.

As noted above, the Control Proposal is silent as to how a company should determine whether revenue is "generated" by a particular business relationship. The Proposal requests comment regarding the standards the Board should apply to determine whether a business relationship is on market terms.

Senior Management Interlocks. The framework would include three presumptions of control addressing senior management interlocks:

i. The first company controls five percent or more of any class of voting securities of a second company and has more than one senior management interlock with the second company.

ii. The first company controls 15 percent or more of any class of voting securities of a second company and has any senior management interlock with the second company.

iii. The first company controls five percent or more of any class of voting securities of a second company and has an employee or director who serves as the chief executive officer (or an equivalent role) of the second company.

Contractual Limitations. The Control Proposal would include a presumption of control if the first company owns five percent or more of any class of voting securities of the second company and if the first company has any "limiting contractual right" that significantly restricts the discretion of the second company over major operational or policy decisions. A first company with less than five percent of each class of voting securities of a second company apparently would not be presumed to control the second company even if the first company has such limiting contractual rights. Another potential issue for comment, however, is the extent to

which the Control Proposal's treatment of limiting contractual rights should be interpreted in relation to the "passivity" requirement for investors under section 4(c)(6) of the BHCA. On the one hand, the Proposal indicates that an investor holding less than five percent of any class of voting securities would not be presumed to control a target company on the basis of limiting contractual rights, but the Proposal does not address whether such rights are (or may be) appropriate for a passive investor. (Indeed, a similar question could be raised for less than five percent investors in relation to other control factors, including director representation and business relationships.) Attached at Appendix B are non-exhaustive lists of the types of contractual provisions that would or would not trigger this presumption.

Proxy Contests (Directors). The Control Proposal would include a presumption of control for situations where an investor (i) controls 10 percent or more of any class of voting securities of a target company and (ii) 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 target company. Previously, any solicitation of proxies that was contrary to the recommendations of the target company's board of directors could raise controlling influence concerns.

Total Equity. The Control Proposal would include in more standardized form the following presumptions of control related to total equity:

i. An investor has zero to 14.99 percent of any class of voting securities of the target company but more than one-third of the total equity of the target company.

ii. An investor has 15 percent to 24.99 percent of any class of voting securities of the target company and 25 percent or more of the target company's total equity.

Presumptions That the Board Is Not Proposing to Adopt

Proxies (Not Director-Related). The preamble to the Control Proposal notes that the Board has historically had controlling influence concerns if an investor with control over 10 percent or more of a class of voting securities of a target company solicits proxies from the shareholders of the target company on any issue. However, the Board states that it is not proposing such a presumption (as part of the tiered framework or otherwise).

Threats to Exit. The preamble to the Control Proposal also notes that the Board has historically "viewed threats to dispose of large blocks of voting or nonvoting securities in an effort to try to affect the policy and management decisions of the second company as presenting potential controlling influence concerns." However, the Board states that it is not proposing a presumption of control based on threats to dispose of securities in recognition that (i) an investor should be able to exit its investment and (ii) the possibility of an investor exit imposes discipline on management of the target company.

Standalone Presumptions of Control

The Control Proposal also would add to and modify presumptions of control that are contained in Regulation Y and would operate outside of the tiered presumption framework:

i. **Management Agreements.** The Control Proposal would modestly expand the existing presumption of control in Regulation Y (12 C.F.R. § 225.31(d)(2)(i)) for agreements or understandings that allow an investor to exercise significant influence and discretion regarding the general management or core operations of the target company to include (a) other types of agreements that allow the investor to direct or exercise significant influence over the core business or policy decisions of the target company; and, consistent with

longstanding Board policy, (b) agreements where the first company is a managing member, trustee or general partner of the second company or exercises similar functions. This expanded presumption is not intended to encompass routine outsourcing agreements.

ii. **Investment Advice.** The Control Proposal would include a presumption of control that is adopted from the affiliate transaction restrictions rules ("Regulation W") for where the first company serves as investment adviser (registered or unregistered) to a second company that is an investment fund and the first company controls five percent or more of any class of voting securities of the second company or 25 percent or more of the total equity of the second company.[9] The presumption would not apply if the first company organized and sponsored the investment fund within the preceding twelve months to allow for a seeding period. As noted above, the Volcker Rule relies on the definition of control in the BHCA to determine if a company is a banking entity that is subject to the prohibition on certain covered fund activities, and the Proposal's permitted seeding period is inconsistent with the period provided for in the Volcker Rule.

iii. **Accounting Consolidation.** The Control Proposal would include a presumption of control when the first company consolidates the second company under US generally accepted accounting principles ("GAAP"). The Board requests comment on whether a similar presumption should apply when the first company accounts for the second company using the GAAP equity method of accounting.

iv. **"5-25" Presumption.** The Control Proposal would revise the presumption of control at 12 C.F.R. § 225.31(d)(2)(ii) ("5-25 Presumption"). Currently, the 5-25 Presumption applies if (a) the first company controls at least five percent of a class of voting securities of the second company and (b) the senior management officials and directors of the first company (together with their immediate family members) and the first company in the aggregate own 25 percent or more of a class of voting securities of the second company. Under the Control Proposal, the 5-25 Presumption would not apply if the first company controls less than 15 percent of each 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) control 50 percent or more of each class of voting securities of the second company.

Investment Company Exception. The Control Proposal also would include a limited exception for BHCs from the presumptions of control with respect to RICs. The conditions of the exception are that the RIC (a) has no business relationships with the first company beyond investment advisory, custodian, transfer agent, registrar, administrative, distributor or securities brokerage services; (b) does not have 25 percent or more of its board of directors or trustees made up of representatives of the first company; and (c) does not trigger the investment advice presumption of control. This would allow BHCs and their subsidiaries to continue to provide RICs with administrative services related to investment advisory, securities brokerage, and private placement that the Board has previously determined are closely related to banking under section 4 of the BHCA, without being presumed to control the RIC on that basis.

Comment Request on Further Tailoring. In the preamble to the Control Proposal, the Board requests comment on whether the

proposed presumptions of control should vary for companies that are widely held versus narrowly held or are majority-owned by a third party. As noted above, the Proposal does not assign any weight or significance to the presence of other large, unaffiliated investors for purposes of assessing controlling influence (notwithstanding that the presence of such other investors has traditionally been a factor in the Board's analysis). The preamble suggests that including such tailoring could greatly increase the complexity of the proposal and make the presumptions more difficult to apply in practice.

PRESUMPTION OF DIVESTITURE OF CONTROL

The Control Proposal would revise the current standards regarding when a divestiture of control is effective, while retaining in certain respects the general principle that a divestiture of control requires a given relationship to be reduced below the level that would trigger control in the context of a new investment.

Under the Proposal, a controlling investor that reduces its interest to less than 15 percent of any class of voting securities generally would cease to control the target company if no other presumptions of control were present and if the investor's interest did not rise to 15 percent or more during the first two years after the divestiture. As noted in the cover memo to the Board, typically the Board has required a reduction of the investor's interest to less than 10 percent of any class of voting securities.

A controlling investor that reduces its interest to more than 15 percent but less than 25 percent of a class of voting securities of the target company, however, would be presumed to continue to control the target company for a two-year period. Upon expiration of the two year period, the divestiture of control would be complete if no other presumptions of control were present and if the investor's interest did not rise to 25 percent or more.

Alternatively, a divestiture would be effective if a majority of each class of voting securities of the target company being divested are controlled by a single individual or company that is unaffiliated with the investor, even if the investor continues to hold between 15 and 25 percent of any class of such securities (e.g., an investor sells 80 percent of the voting securities of a wholly owned company to a third party). The presumption of continued control for divestitures would not apply if an investor sells a subsidiary to a third company and receives stock of the third company as compensation (e.g., an investor sells 100 percent of the target company to a third party in exchange for 20 percent of a class of the third party's voting securities).

PRESUMPTION OF NONCONTROL

The Control Proposal would expand the existing rebuttable presumption of noncontrol for investors that control less than five percent of every class of voting securities of the target company and do not trigger any of the other presumptions of control. The threshold would be raised to 10 percent. It would not, however, eliminate or alter the requirement that a BHC or SLHC have legal authority for each investment it makes in excess of five percent of any class of voting securities.

OTHER DEFINITIONAL ISSUES

The Control Proposal would formally define several terms that are used in conjunction with the presumptions of control:

First Company and Second Company. These terms are defined by reference to the investor and the target company. The preamble notes that the subsidiaries of both companies will be included in the analysis of the application of the presumptions, but are not included in the definitions of "first company" or "second company." The preamble also notes that joint ventures will be treated as subsidiaries of the first company but not of the second company in order to avoid the second company's

relationships with the joint venture being treated as relationships with the first company for purpose of applying the presumptions.

Nonvoting Securities (Previously Nonvoting Shares). The Control Proposal would clarify the current definition of "nonvoting shares." Specifically, nonvoting shares would be referred to instead as nonvoting securities and would be defined (i) in a manner that would allow equity instruments issued by companies other than stock corporations (e.g., member interests in a limited liability company) and common stock to qualify as nonvoting securities if voting rights are sufficiently limited and (ii) to include defensive voting rights that are commonly found in investment funds that are organized as limited liability companies and limited partnerships.

Calculation of Voting Percentage. The Control Proposal would codify various Board practices for determining whether a target company's voting securities are owned, controlled or held with power to vote by an investor and would provide rules for determining the percentage of a class of a target company's voting securities that are attributed to an investor. This information is needed to determine if an investor has 25 percent or more of a class of a target company's voting securities or has a holding of sufficient size so as to trigger one of the presumptions of control. The codified practices would be as follows.

i. **Ownership, Control and Holding with Power to Vote.** A person would control 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 would control a security if the person has the power to vote the security, other than due to holding a short-term, revocable proxy.

ii. **Options, Warrants and Convertible Instruments.** A person would be deemed to control a security through control of an option or warrant to acquire the security or through control of a convertible instrument that may be converted into or exchanged for the security. This is, in part, a recodification of a principle currently expressed in Regulation Y's standalone presumptions of control. However, under the "look-through" approach set out in the Proposal, the holder of an option on a voting security (and presumably the holder of a warrant or convertible instrument as well) would be deemed to control the voting security "even if there were an unsatisfied condition precedent" to the exercise of the option. The Board's summation of its position in 2008, however, stated that nonvoting instruments convertible into voting securities would only be treated as voting if they were convertible "at the election of the holder" or if the instrument "mandatorily convert[s]" over time—neither of which is true in the case of an option/warrant or conversion feature that is subject to an unsatisfied condition precedent.

iii. **Control over Securities.** A person controls securities if the person is a party to an agreement or understanding under which the rights of the owner or holder of securities are restricted in any manner, unless the restriction falls under the exceptions specified under the rule. It would explicitly codify that multiple persons may simultaneously control the same securities by different means.

iv. **Calculation of the Percentage of Voting Securities.** The Control Proposal would codify the Board's practices for calculating the percentage of a class of voting securities that are controlled by a person to determine both the number of shares the person controls and the voting power of such shares. The Control Proposal would provide that the percentage of a class of

voting securities controlled by a person would be the greater of (a) the number of voting securities of the class controlled by the person divided by the number of issued and outstanding shares of the class of voting securities (expressed as a percentage) and (b) the number of votes that the person could cast divided by the total number of votes that may be cast under the terms of all the voting securities of the class that are issued and outstanding (expressed as a percentage). It also would provide that a person controls all voting securities controlled by the person and any subsidiaries of the person.

Calculation of Total Equity Percentage. The Control Proposal would include a standard for calculating an investor's total equity percentage in a second company that is a stock corporation that prepares financial statements according to GAAP. The standard would consist of a three-step calculation:

i. First, determine the percentage of each class of voting and nonvoting common or preferred stock issued by the second company that the first company controls.

ii. Second, multiply the percentage of each class of such stock controlled by the first company by the value of shareholders' equity allocated to the class of stock under GAAP.

iii. Third, divide the first company's dollars of shareholders' equity determined under the second step by the total shareholders' equity of the second company, as determined under GAAP.

The standard would provide for adjustments (a) to account for more complex structures, (b) for non-stock and non-GAAP companies and (c) for anti-evasion measures in situations where debt or other interests are functionally equivalent to equity.

Director Representative. In connection with the presumptions related to director representation, the Control Proposal would define situations in which a director of a target company is treated as a director representative of an investor. These include if the director (i) is a current director, employee or agent of the company; (ii) was a director, employee or agent of the investor within the preceding two years or (iii) is an immediate family member of an individual who is a current director, employee or agent of the company or was a director, employee or agent of the investor within the preceding two years. In addition, the Proposal states that a director would be a director representative of an investor if the director was proposed to serve as a director by the investor, whether by exercise of a contractual right or otherwise, and that a nonvoting observer would not be a director representative.

APPLICATION TO SLHCS

According to the Control Proposal, The control framework for control of savings associations and other companies by SLHCs under the Home Owners' Loan Act ("HOLA") is "nearly identical" to the framework for BHCs under the BHCA.[10] However, while the controlling influence prong is similarly defined in both statutes, the Board notes four differences between the definitions of control in HOLA and the BHCA:

i. The definition of control in HOLA applies to both individuals and companies controlling other companies, while the BHCA is limited to companies controlling other companies.

ii. Under HOLA, a person controls a company if the person has more than 25 percent of the company's voting securities, while under the BHCA the standard is 25 percent or more of the company's voting securities.

iii. HOLA specifies that a general partner of a partnership controls the partnership, a trustee of a trust controls the trust and a person that has contributed more than 25 percent of the capital of a company controls the company, while the BHCA itself does not directly address such situations.

iv. HOLA does not provide a statutory presumption of noncontrol for a first company with less than five percent of every class voting securities of a second company.

The Control Proposal states that the Board believes that the controlling influence prong of HOLA's definition of control is sufficiently similar to the BHCA's to allow the Board to use the same presumptions of control and related provisions with SLHCs under Regulation LL, including the presumption of control based on total equity ownership. The Proposal notes that, while total equity ownership may appear to be inconsistent with HOLA's prong for contributed capital, the total equity ownership presumption will rely on GAAP equity, not contributed capital.

Appendix A

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	Less than 5% of revenues or expenses	Less than 2% of revenues or expenses
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	Less than one third	Less than one third	Less than one third	Less than one quarter

Appendix B: Examples of Types of Contractual Provisions

Examples of Contractual Provisions That Would Provide an Investor the Ability to Restrict Significantly the Discretion of a Target Company:

i. Restrictions on activities in which a target company may engage, including a prohibition on (a) entering into new lines of business, (b) making substantial changes to or discontinuing existing lines of business, (c) entering into a contractual arrangement with a third party that imposes significant financial obligations on the target company or (d) materially altering the policies or procedures of the target company;

ii. Requirements that a target company direct the proceeds of the investment to effect any action, including to redeem the target company's outstanding voting shares;

iii. Restrictions on hiring, firing or compensating senior management officials of a target company, or restrictions on significantly modifying a target company's policies concerning the salary, compensation, employment or benefits plan for employees of the target company;

iv. Restrictions on a target company's ability to merge or consolidate, or on its ability to acquire, sell, lease, transfer, spin-off, recapitalize, liquidate, dissolve or dispose of subsidiaries or major assets;

v. Restrictions on a target company's ability to make significant investments or expenditures;

vi. Requirements that a target company achieve or maintain certain fundamental financial targets, such as a debt-to-equity ratio, a net worth requirement, a liquidity target or a working capital requirement;

vii. Requirements that a target company not exceed a specified percentage of classified assets or nonperforming loans;

viii. Restrictions on a target company's ability to pay or not pay dividends, change its dividend payment rate on any class of securities, redeem senior instruments or make voluntary prepayment of indebtedness;

ix. Restrictions on a target company's ability to authorize or issue additional junior equity or debt securities, or amend the terms of any equity or debt securities issued by the company;

x. Restrictions on a target company's ability to engage in a public offering or to list or de-list securities on an exchange;

xi. Restrictions on a target company's ability to amend its articles of incorporation or by-laws, other than limited restrictions that are solely defensive for the investor;

xii. Restrictions on the removal or selection of any independent accountant, auditor or investment banker; or

xiii. Restrictions on a target company's ability to alter significantly accounting methods and policies or its regulatory, tax or corporate status, such as converting from a stock corporation to a limited liability company.

Examples of Contractual Provisions That Generally Would Not Raise Significant Controlling Influence Concerns:

i. A restriction on a target company's ability to issue securities senior to the non-common stock securities owned by the investor;

ii. A requirement that a target company provide the investor with financial reports of the type ordinarily available to common stockholders;

iii. A requirement that a target company maintain its corporate existence;

iv. A requirement that a target company consult with the investor on a reasonable periodic basis;

v. A requirement that a target company comply with applicable statutory and regulatory requirements;

vi. A requirement that a target company provide the investor with notice of the occurrence of material events affecting the target company or its significant assets;

vii. A market standard "most-favored nation" requirement that the investor receive similar contractual rights as those held by other investors in a target company; or

viii. Drag-along rights, tag-along rights, rights of first or last refusal, or stock transfer restrictions related to preservation of tax benefits of a target company, such as S-corporation status and tax carry forwards, or other similar rights.

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Endnotes

[1] Federal Reserve Board invites public comment on proposal to simplify and increase the transparency of rules for determining control of a banking organization (Apr. 23, 2019), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190423a.htm.

[2] Board announces the approval of a policy statement on equity investments in banks and bank holding companies (Sept. 22, 2008), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20080922c.htm.

[3] 12 U.S.C. § 1841(a)(2). There is a separate definition of "control" in the affiliate transaction restrictions of sections 23A and 23B of the Federal Reserve Act and Regulation W that is not addressed in the Control Proposal. 12 C.F.R. § 223.3(g).

[4] Board Staff Memorandum (April 16, 2019), available at https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-proposal-board-memo-20190423.pdf.

[5] Speech by Vice Chairman for Supervision Randal K. Quarles at the American Bar Association Banking Law Committee Annual Meeting (Jan. 19, 2018), available at https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm ("Under Board's control framework--built up piecemeal over many decades--the practical determinants of when one company is deemed to control another are now quite a bit more ornate than the basic standards set forth in the statute and in some cases cannot be discovered except through supplication to someone who has spent a long apprenticeship in the art of Fed interpretation.").

[6] See 12 C.F.R. § 225.31.

[7] The Board reiterates this point by stating elsewhere in the preamble that it "would not expect to find that a company controls another company unless the first company triggers a presumption of control with respect to the second company."

[8] Board Chairman Powell and Vice-Chairman Quarles underscored this objective in their opening statements on the Control Proposal, emphasizing the intent to bring both greater transparency and predictability to the Board's controlling influence rules.

[9] See 12 U.S.C. § 371c(b)(1)(D); 12 C.F.R. § 223.2(a)(6). The Control Proposal would define an investment adviser for purposes of the proposed presumptions of control as a company that is (i) registered as an investment adviser with the SEC; (ii) registered as a commodity trading advisor with the US Commodity Futures Trading Commission; (iii) a non-US equivalent of such US-registered companies; or (iv) engaged in certain financial and investment advisory activities described in section 225.28(b)(6) of Regulation Y.

[10] See 12 U.S.C. § 1467a(a)(2).