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Legal Update

US Federal Reserve Board Approves Final Rule Significantly Revising Control Rules

On January 30, 2020, the Board of Governors of the Federal Reserve System ("Board") approved a final rule ("rule" or "final rule") to revise and codify its approach for determining whether one company has control over another company for purposes of the US Bank Holding Company Act of 1956 ("BHCA") and the Home Owners' Loan Act ("HOLA"), as amended.[1] The rule amends Regulations Y and LL, which implement the BHCA and HOLA, respectively.

The final rule, which substantially revises and augments the existing regulatory framework for interpreting the controlling influence prong of the statutory test for control, largely mirrors the proposed rule[2] that was issued in April 2019 ("proposal"). While in many respects the final rule codifies the Board's existing control standards, it also introduces new concepts and raises critical questions about how the Board will implement the rule in practice.

This Legal Update explains and analyzes key aspects of the Board's rule and highlights changes from the proposal. The final rule will take effect on April 1, 2020.

Key Takeaways

Before turning to a detailed review of the rule, we note several significant takeaways and potential considerations:

- **Framework for Determining Control Is Expanded and Codified:** The rule introduces several "presumptions of control" into the Board's regulations. The centerpiece of the rule is a "tiered framework" of presumptions where the level of voting share ownership is assessed in combination with relationship-based factors to determine whether one company is presumed to control another. Although the tiered framework structure is new, many of the presumptions that comprise the framework are generally consistent with the Board's historical practices.
- **Accounting Consolidation Triggers a "Presumption of Control":** The final rule diverges sharply from the Board's current approach to control with respect to the treatment of accounting consolidation. Under the final rule, a company that consolidates a second company on its financial statements under US GAAP is presumed to control the second company regardless of its voting equity level in the

company. This presumption is likely to impact a number of arrangements previously considered non-controlling.

- **Control Through "Business Relationships" Measures Revenue and Expenses:** One of the factors considered in the "tiered framework" is the extent of the investor company's business relationships with the investee company, defined quantitatively through measurement of revenues and expenses. This marks a shift from the Board's historical approach, which focused primarily on revenue only. In a change from both the proposal and the Board's historical practice, the final rule measures the significance of the business relationship from the perspective of the investee company only.
- **Rule Does Not Apply to Other Regulatory Definitions of "Control":** The definitions of "control" in the final rule apply only to Regulations Y and LL and do not extend to or modify the concepts of control under the Change in Bank Control Act or the Board's Regulation O or Regulation W.
- **Consultation with Board Staff Not Eliminated:** Historically, the Board, through Board staff, decided most questions of control based on the specific facts and circumstances presented by each particular case. When the proposal was introduced in April 2019, comments by the Board and Board staff framed it as a "broadly applicable and uniform set of rules to address the large majority of control fact patterns" that would reduce the "substantial compliance and uncertainty burden" created by the case-by-case approach to control. However, the final rule does not appear to eliminate the need for consultation with Board staff to the extent promised. On the contrary, several provisions in the final rule emphasize the fact-specific nature of the control determination and refer companies to contact the Board or its staff to seek clarification.
- **No Transition Period to Conform:** Notably, the final rule does not (i) provide a transition period to allow firms to conform or report existing investments, and (ii) include any grandfathering provisions for any types of existing arrangements, structures or investments.

Background

"Control" is a foundational concept under the BHCA and HOLA. Under the BHCA, 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, and is subject to subject to the Board's supervision and regulation, including examination, periodic reporting, and restrictions on engaging in activities that are not financial in nature or incidental or complementary to a financial activity.[3] A company that is controlled by a BHC or SLHC similarly is subject to Board supervision and regulation and restrictions regarding its activities.[4] Additionally, companies that control a bank (i.e., BHCs) or are controlled by or under common control with a bank (i.e., the bank's affiliates) are subject to prohibitions against proprietary trading and certain covered fund relationships under the Volcker Rule.

The BHCA defines control through a three-pronged test. A company has control over 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 other company; (ii) controls in any manner the election of a majority of the directors of the other company; or (iii) 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 other company (emphasis added). [5]

The meaning of the "controlling influence" prong of the definition has been developed primarily through staff determinations on individual transactions, often without any public notice or comment, rendering the applicable legal doctrine opaque to other companies and their counsel. Even Board staff acknowledge that the control framework "is not provided in a single document and many of the specific standards have not been issued publicly."[6] The complexity and relative lack of transparency of this case-by-case approach to control made it difficult for banking firms and investors in banking firms to determine whether a particular proposed investment could give rise to control concerns.

Analysis

The rule is intended to improve the predictability and simplicity of the Board's control framework by establishing a broadly applicable and uniform set of rules to address the large majority of control fact patterns. The central element of the rule is the addition of a new tiered framework of "presumptions of control" based on combinations of (i) voting interest levels and (ii) factors indicating the potential for one company to control another, such as management interlocks or board influence. The rule supplements the tiered framework with standalone presumptions and provides long-sought clarity around several control-related concepts, such as how total equity interest is to be calculated.

This Legal Update describes (i) the formal and informal procedures for determination of control; (ii) the new presumptions of control related to the "tiered framework," including the relationship-based control factors; (iii) the additional standalone presumptions of control separate from the "tiered framework"; (iv) the specific circumstances that result in non-control; (v) additional definitions related to control amended or added by the rule; (vi) the application of the rule to SLHCs and foreign banking organizations ("FBOs"); and (vii) the interaction of the rule with other regulatory definitions of control.

DETERMINATION OF CONTROL

The BHCA provides that control due to controlling influence arises following a Board determination that a company controls another company. Since the 1980s, the Board has not issued formal control determinations (i.e., following notice and the opportunity for a hearing) as contemplated in the BHCA and Regulation Y. Rather, Board staff have reviewed proposed transactions and situations that potentially present controlling influence concerns and communicated their views to investors and target companies.[7] Several places in the final rule explicitly contemplate a continued need for informal consultations with Board staff to determine whether structures present the possibility of a "controlling influence."

Continued Board Staff Role

Although one of the stated aims of the proposal was to reduce the need for fact-specific determinations by Board staff, several provisions in the final rule emphasize the fact-specific nature of control determinations. Companies are encouraged to contact the Board or its staff for clarification regarding:

- Whether certain contractual provisions are "limiting contractual rights" that would trigger a presumption of control;
- Whether a particular holding of securities would qualify for the fiduciary exception;
- Whether a particular individual would be considered to be a director representative; and
- Whether certain equity instruments would be excluded from total equity.

Non-Exclusive Framework

Notwithstanding the proposal's stated goal of establishing a "broadly applicable and uniform set of rules"[8] for applying the controlling influence prong, the final rule retains the Board's discretion to find that a "controlling influence" exists, including in situations that do not trigger any of the presumptions of control. For example, in connection with "business relationships" in the new tiered presumption framework, the final rule states that "[a]lthough 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."[9]

Reassessment of Existing Arrangements, Structures and Investments

The need for fact-specific consultation with Board staff may also extend to existing arrangements, structures or investments that have not been explicitly reviewed by a component of the Federal Reserve System (e.g., Board, Board staff, Reserve Bank). The final rule (i) does not provide a transition period to allow firms to conform or report existing arrangements, structures or investments, and (ii) does not include any grandfather provision for non-conforming existing arrangements, structures or investments. In general, the Board "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." However, in cases where structures that could trigger a presumption of control under the rule have not been previously reviewed by "the Federal Reserve System," companies are encouraged to "contact the Board or its staff to discuss potential actions."

Moving forward, we expect determinations regarding the existence of "controlling influence" to continue to be made through informal discussions and fact-specific opinion letters with respect to (i) new arrangements, structures or investments and specific relationships and (ii) existing arrangements, structures or investments that may arguably trigger a presumption of control under the rule that have not previously been reviewed by a component of the Federal Reserve System. The need for clarification regarding existing arrangements, structures or investments could place significant pressure on Board staff and the industry between now and the April 1 effective date.

PRESUMPTIONS OF CONTROL RELATED TO THE "TIERED" FRAMEWORK

A presumption that one company has a "controlling influence" on another applies where the first company controls at least a specified level of a class of voting securities of the second company, plus another specified relationship with the second company based on the existence of one or more "control factors," such as director representation on the second company's board, total equity ownership in the second company, or business relationships with 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.

The tiered framework of presumptions of control, with the voting interest levels and the control factors, is summarized in the table below. A presumption of control is triggered if any relationship exceeds the amount on the table.

		Control of a Percentage of a Class of Voting Securities			
		Less than 5%	**5-9.99%**	**10-14.99%**	**15-24.99%**
Relationship-Based Control Factors	**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

The tiered framework in the final rule is largely consistent with the framework described in the proposal with several notable differences discussed below.

Director Representation

The definition of director representative in the final rule has been narrowed from the definition in the proposal. In particular, the final rule's definition of director representatives does not per se include immediate family members of a first company's directors, employees, and agents. Under the final rule, "director representative" is defined as an individual that represents the interests of the first company through service on the board of directors of a second company. The final rule provides a non-exclusive list of examples of persons generally considered to be director representatives.[10]

The final rule adopts the proposal's presumptions with respect to the number of director representatives on the board of another company, including those serving as chair or on board committees with power to bind the second company.

Business Relationships

Notwithstanding the requests of many commenters, the final rule retains the quantitative threshold levels that were included in the proposal. However, in a moderate narrowing compared to the proposal, the final rule requires evaluation of revenues and expenses from the perspective of the second company only (not both companies).[11] While this clarification is helpful, the quantitative thresholds remain very restrictive and could present problems for some existing arrangements, structures or investments and potentially limit future arrangements involving small or start-up entities.

Under the rule, a company will be presumed to control another company when:

- 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; or
- 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 final rule adopts the proposal's presumption of control for business relationships that are not on market terms.

The rule does not include a presumption of control based on threats to alter or terminate business relationships, although the Board indicated that such actions may be relevant to determinations of control.

Senior Management Interlocks

The rule defines "senior management official" to be any person with authority to participate (other than as a director) in major policy making functions of a company. The Board emphasized that this definition is to be interpreted based on the function that a person serves rather than a person's official title. The Board noted that it will consider providing additional clarity around this definition at a later time.

Contractual Limits on Major Operational or Policy Decisions

Under the rule, a company is presumed to control another company if the first company controls five percent or more of any class of voting securities of the second company and also has a "limiting contractual right" with respect to the second company. A limiting contractual right is a contractual right that allows a company to significantly restrict the discretion of a second company, including its senior management officials and directors, over major operational or policy decisions.

To help clarify the definition, the rule includes nonexclusive lists of examples of contractual rights that are generally (i) considered to be limiting contractual rights or, alternatively, (ii) not considered to be limiting contractual rights. The Board explained how common contractual revisions will be evaluated against the definition of limiting contractual right:

- **Activities Restrictions:** A contractual prohibition on engaging in particular activities is generally a limiting contractual right. However, a contractual provision that provides a reasonable and non-punitive mechanism for an investing company to reduce its investment to comply with the activities restrictions of the BHCA or HOLA is generally not a limiting contractual right.
- **Provisions Prohibiting "Materially Altering Policies and Procedures":** In response to a comment, the Board stated that a contractual right that restricts "materially altering policies or procedures" is generally considered a limiting contractual right, explaining that it "is similar to the example of a limiting contractual right provided in the final rule related to amendments to the articles or bylaws of a company."
- **Contractual Rights to Investor Information:** The Board clarified that a contractual right to information ordinarily available to common shareholders, whether or not the information is financial in nature, is generally not a limiting contractual right. Similarly, an investor's right to access information regarding the relationship between the investor and the investee company is generally not a limiting contractual right.
- **Restrictive Loan and Bond Covenants:** Commenters expressed concern that the definition of limiting contractual right would cover standard loan or bond covenants, including in situations where a company has parallel debt and equity investments in a target company and the debt investment document contains a limiting contractual right.

  The Board acknowledged that it has "long recognized that … many loan agreements contain restrictive covenants and that the existence of these covenants has not been sufficient, in itself, to constitute a controlling influence. Thus, the Board generally has not viewed restrictive covenants in the context of loan transactions or commercial services to raise controlling influence concerns."

  However, the final rule does not specifically exempt restrictive covenants in debt agreements from the definition of limiting contractual right and does not foreclose the possibility that a restrictive covenant embedded in a market-standard loan agreement could nonetheless be a limiting contractual right that would trigger a presumption of control.
- *Comparison to Management Agreements*: The Board explained that its concern with limiting contractual rights generally arises from the combination of a limiting contractual right and control over a material share of voting securities. This contrasts with the approach to management agreements, which raise control concerns regardless of the share of voting securities controlled.

Total Equity Ownership

With respect to the presumptions of control based on total equity ownership, the final rule contains two key changes from the proposal that simplify the presumptions.

First, it simplifies the total equity presumption so that a company will be presumed to control a second company only when the first company controls one-third or more of the total equity of the second company (i.e., without regard to the first company's voting securities ownership percentage). Under the proposal (and the Board's 2008 Policy Statement), an investor with a voting interest of 15 percent or more in another company could avoid control only by keeping its total equity percentage in the other company below 25 percent.

Second, it simplifies the threshold for SLHCs. Because of the difference between the BHCA and HOLA, the relevant total equity threshold for SLHCs under the final rule will be 25 percent, not the one-third that applies to BHCs.[12]

The rule also provides a more detailed description of the calculation of total equity. This is discussed in detail in the section below titled "Calculation of Total Equity."

Historical Presumptions of Control Not Included in Final Rule

At least two factors that have historically raised concerns of controlling influence were not included in the presumptions of control in the rule.

- **No Presumption of Control for Solicitation of Proxies on Issues:** The Board historically has raised controlling influence concerns if a company with control over 10 percent or more of a class of voting securities of a second company solicits proxies from the shareholders of the second company on any issue. The rule does not include a general presumption of control for a company that solicits proxies from the shareholders of another company. Under the rule, a non-controlling investor generally may act as a shareholder and engage with the target company and other shareholders on issues through proxy solicitations. As discussed above, the rule does include a presumption of control related to soliciting proxies for the election of directors.
- **No Presumption of Control for Threats to Dispose of Securities:** The Board traditionally has raised controlling influence concerns if a company with control over 10 percent or more of a class of voting securities of a second company threatens to dispose of its investment if the second company refuses to take some action desired by the first company. The rule does not include a presumption of control based on one company attempting to exercise control over another company by threatening to dispose of its voting or non-voting securities in the second company.

Passivity Commitments

Historically, the Board has 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. The Board's standard passivity commitments usually included prohibitions or limitations on (i) an investor's representation on the board of the banking organization, (ii) direct and indirect business relationships with the banking organization, (iii) management and employee interlocks, (iv) acquisition of additional equity of the banking organization, and (v) serving as an investment or management adviser to the banking organization.

The Board stated that it does not intend to continue obtaining the standard passivity

commitments in the ordinary course but 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. It is unclear what the Board views as "special situations" or how "control-related commitments" will differ from the standard passivity commitments.

Companies that have previously made passivity commitments to the Board may contact the Board or the appropriate Federal Reserve Bank to seek relief from these commitments. Companies that have provided commitments in connection with TARP securities may also seek relief. Absent unusual circumstances, the Board expects to be receptive to such requests for relief.

STANDALONE PRESUMPTIONS OF CONTROL

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

Management Agreements

The Board's existing regulations include a presumption of control for management agreements under which a company can direct or exercise significant influence over the management or operations of another company.[13] The rule slightly expands the existing management agreement presumption by expressly identifying additional types of agreements or understandings that raise controlling influence concerns, including agreements where a company is a managing member, trustee, or general partner of another company.

Investment Advice and Investment Funds

The rule adds a presumption of control for certain investment advisers of investment funds. The presumption applies where a company serves as investment adviser to an investment fund and controls 5 percent or more of any class of voting securities of the fund or 25 percent or more of the total equity of the fund. The final rule did not adopt the proposal's limited exception for investment companies registered with the SEC under the Investment Company Act of 1940.

The presumption of control will not apply if the investment adviser organized and sponsored the investment fund within the preceding twelve months. This provision allows the investment adviser to avoid triggering the presumption of control over the investment fund during the initial seeding period of the fund.[14] Notwithstanding comments, the one-year seeding period in the final rule does not align with the rules applicable to hedge fund and private equity fund investments under the Volcker Rule.

The final rule also addressed two Board precedents related to investment advisers:

- **Board Precedent Regarding Investments in Advised Investment Funds:** The proposal stated that the "proposed presumption of control for service as an investment adviser to an investment fund is intended to be consistent with the Board's precedents regarding when an investment adviser controls an advised investment fund under the BHC Act and the Glass-Steagall Act." The proposal cited a Board precedent in which the Board concluded that, under certain conditions, 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.[15] Many commenters argued that the proposal's 5 percent threshold was inconsistent with this precedent and argued that the threshold should be raised to 25 percent.

The final rule retains the proposal's 5 percent threshold. The Board described the precedent as "an unusual case based in part on statutory provisions that are no longer in effect." The Board noted that the threshold of 5 percent of any class of voting securities "is consistent with the preponderance of Board precedent in this area."[16]

- **Board Precedent Regarding Mutual Fund Families:** The final rule is silent on the status of certain control letters from the General Counsel of the Board to mutual fund families and investments made in accordance with those letters. However, the issue appears to be addressed through the general statement that "the Board does not intend to revisit existing structures that were previously reviewed by the Federal Reserve System and have not changed materially."

Presumption of Control for Accounting Consolidation

Despite significant concerns from commenters, the final rule retains the presumption that a company that consolidates a second company on its financial statements under US GAAP controls the second company. This presumption is inconsistent with prior Board pronouncements and is likely to capture a number of arrangements previously considered non-controlling.

The final rule provides additional details regarding how this presumption is to be applied.

- **Variable Interest Entities:** Under the rule, a company that consolidates another company under the US GAAP variable interest entity standard is deemed to control the second company. A company that is consolidated under the variable interest entity standard often will be controlled under one of the other presumptions of control in the rule, such as the management agreement presumption.

  While the rule is limited to the definition of control in the Regulations Y and LL, the Board provided an interpretation of "ownership interest" under Regulation YY in the discussion of variable interest entities:

  > In general, ownership interest under the intermediate holding company requirements does not include contractual relationships, including contractual relationships that result in consolidation of a company under the variable interest entity standard. Thus, for example, where a US branch of a foreign bank has a contract with an asset-backed commercial paper conduit that causes the conduit to be consolidated by the branch under the variable interest entity standard, the contract is not an ownership interest and therefore may remain between the branch and the conduit.

- **Consolidation Under Non-GAAP Standards:** The presumption of control where one company consolidates a second company for purposes of US GAAP covers, by its terms, only those companies that prepare financial statements under US GAAP. The Board noted that it is likely to have the same control concerns where a company consolidates another company on its financial statements under another accounting standard particularly if the other accounting standard has consolidation standards that are similar to the consolidation standards under US GAAP. This arguably expands the consolidation presumption beyond US GAAP and may require detailed ongoing analysis of how "similar" non-US accounting standards are to US GAAP.

- **Equity Method of Accounting:** The proposal sought comment on whether the Board should presume that a company controls a second company if the first company applies the equity method of accounting with respect to its investment in the second company. The final rule does not adopt this presumption of control.

Presumption of Control After Divestiture

The Board and Board staff historically have taken the position that a company that has controlled another company may be able to exert a controlling influence over that company even after a substantial divestiture (the "tear down" rule).[17] As a result, the Board typically has applied a stricter standard for terminating control than for establishing new non-controlling investments.[18]

The rule substantially revises the Board's existing standards regarding divestiture of control. Under the rule, a formerly controlling company can escape presumed control by (i) divesting to a voting interest of less than 15 percent; or (ii) divesting to a voting interest of less than 25 percent and waiting two years.

The divestiture presumption does not apply if a majority of each class of voting securities of the second company is controlled by a single unaffiliated individual or company following divestiture. The exception only applies when an unaffiliated person controls 50 percent or more of the outstanding securities of each class of voting securities of the company being divested. The divesting shareholder is only required to own a majority of the class of voting securities that the divesting shareholder is selling, not a majority of every class of voting securities of the second company.

Presumption of Control for Combined Ownership & Management ("5-25 Presumption")

The Board has historically applied a presumption, known as the "5-25 presumption," that a company controls a second company when (i) the first company controls at least 5 percent of any class of voting securities of the second company and (ii) 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.

The "5-25 presumption" has been integrated into the final rule's definition of "control over securities through associated individuals and subsidiaries." This differs from the proposal, which included the "5-25 presumption" as a standalone presumption.

The presumption of control does not apply if (i) the first company controls less than 15 percent of each class of voting securities of the second company and (ii) 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.

Fiduciary Exception to Presumption of Control

The rule retains the existing Regulation Y exception from the presumption of control for securities held in a fiduciary capacity.[19] Thus, the presumptions of control do not apply to the extent that a company controls voting or nonvoting securities of a second company in a fiduciary capacity without sole discretionary authority to exercise the voting rights.

The rule does not provide broader clarity around the scope of the fiduciary exception. The Board noted that the fiduciary exception in the final rule is intended to align with the Board's traditional understanding of the scope of the fiduciary exceptions in the BHCA and Regulation Y and encourages companies to contact the Board or its staff to seek clarification as to whether a particular holding of securities qualifies for the fiduciary exception.

REBUTTABLE PRESUMPTION OF NON-CONTROL

The rule also contains a presumption of non-control for investments under 10 percent of voting securities that do not trigger any other presumption of control.

Under the rule, a company is presumed not to control a second company if (i) the first company controls less than 10 percent of every class of voting securities of the second company and (ii) no other presumptions of control apply. This modestly expands the existing statutory and pre-existing regulatory presumption of non-control where the first company controls less than 5 percent of any class of voting securities of the second company.

The filing requirements applicable to bank holding companies and savings and loan holding companies for investments in 5 percent or more of any class of voting securities of a company are not impacted as a result of the presumption of non-control, thus apparently continuing the gap between the definition of control under the BHCA and the definition of control in the Board's reporting forms (e.g., FR Y-10).

OTHER CONTROL-RELATED DEFINITIONS AND CALCULATIONS

The proposal defined several control-related items in a manner consistent with the Board's current practice but that previously have not been codified in regulation. The final rule adopts these provisions with minor adjustments.

First Company and Second Company

The rule adds two new defined terms, "first company" and "second company," to clarify the application of presumptions of control. The final rule provides additional context on how the rule will apply to subsidiaries and joint ventures:

- **Subsidiaries:** For purposes of controlling influence, the Board historically has considered the relationships between one company and its subsidiaries, on the one hand, and another company and its subsidiaries, on the other hand. The Board confirmed that it will continue to group a parent company with its subsidiaries under the rule.
- **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. This provision prevents the second company's relationships with a joint venture subsidiary with the first company from being considered a relationship with the first company for purposes of the presumptions of control.

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 has the power to vote the security, other than due to holding a short-term, revocable proxy. These definitions are consistent with Board precedent and with the language of the BHCA.[20]

The rule builds on these general statutory and regulatory definitions with additional tests for determining whether a person "controls"

specific types of securities in specific circumstances.[21]

- **Control of Options, Warrants and Convertible Instruments (Look-Through Approach):** The final rule is generally consistent with the proposal with respect to these provisions. However, the final rule includes an additional exception not included in the proposal that applies to preferred securities that have no voting rights unless the issuer fails to pay dividends for six or more quarters. Such securities are only considered to be voting securities if a sufficient number of dividends are missed and the voting rights are active. This additional narrow exception to the look-through approach is consistent with Board precedent and helps to address a common feature of preferred securities. Securities with springing voting rights that do not fit into this exception generally will be considered to be voting securities under the look-through approach.
- **Control Over Securities Through Restrictions on Rights:** Consistent with current regulations, the rule provides that 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 one of six exceptions specified in the rule. This standard could result in multiple persons being considered to have control over the same securities.
- **Control of Securities by Non-Subsidiary:** The proposal provided that a person controls all voting securities controlled by any subsidiary of the person, and that a person generally does not control any voting securities controlled by any non-subsidiary of the person. The final rule does not include the express statement from the proposal that a company does not control securities that are controlled by a non-subsidiary of the company. The Board explained that a company generally should not be deemed to control securities held by a non-subsidiary of the company, and that the provision was removed to avoid the creation of an expectation that a company would never be deemed to control securities held by a non-subsidiary.
- **Control of a Percentage of a Class of Voting Securities:** Determining the percentage of a class of voting securities controlled by a person requires two calculations – one for the number of shares of the class of voting securities controlled by the person, and another for the number of votes that may be cast by the person on the voting securities controlled by the person. Determination of the percentage of a class of a company's voting securities controlled by the person will be based on the greater of the results of the two calculations.
- **Reservation of Authority:** The Board reserves the authority to determine that securities that would otherwise be considered controlled or not controlled by a person are actually controlled or not controlled by that person.

Calculation of Total Equity Percentage

The final rule's GAAP-based core methodology for determining a company's total equity percentage in another company is largely consistent with the proposal. The final rule includes a technical correction to the formula for total equity so that *pari passu* classes of preferred stock (i.e., classes of preferred securities of the same seniority in liquidation) are treated as a single class. Key provisions of the rule's methodology include:

- **Treatment of Debt as Equity:** The rule includes a provision whereby debt or other interests may be treated as equity if the interests are functionally equivalent to equity. The Board expects to reclassify debt

as equity under the rule only under unusual circumstances to prevent evasion of the rule.

- **Flexibility for Excluding Nominally Equity Instruments From Total Equity if Functionally Equivalent to Debt:** The rule provides flexibility for excluding nominally equity instruments from total equity if the equity instruments are determined to be functionally equivalent to debt. The rule also provides a non-exclusive list of characteristics that may indicate that an equity instrument is functionally equivalent to debt, including: protections generally provided to creditors; a limited term; a fixed rate of return or a variable rate of return linked to a reference interest rate; classification as debt for tax purposes; or classification as debt for accounting purposes. This provision is intended to provide flexibility for unusual structures and is expected to be used rarely. Companies are encouraged to consult with the Board or its staff in order to determine whether equity instruments would be excluded from total equity.
- **Change Regarding Recalculation of Total Equity on Sale or Divestiture:** The final rule is narrower than the proposal in that it requires calculation of total equity only when a first company acquires control over additional equity of a second company. The first company is not required to recalculate its total equity when it sells or otherwise disposes of equity of the second company. This change will prevent a divestiture from causing an increase in total equity due to balance sheet changes at the second company.

APPLICATION TO SLHCS AND FBOS

The rule applies equally to BHCs and SLHCs to the maximum extent permitted by law. Consistent with this principle, the rule incorporates the control presumptions and related revisions into the Board's Regulation LL for SLHCs in essentially the same manner as into the Board's Regulation Y for BHCs. However, as noted below in the discussion of total equity calculations, minor differences in their respective statutory authorities required a revision in the final rule to reflect that contributed capital for purposes of HOLA generally has the same meaning as total equity as used by the Board in the context of control under the BHCA. Other than the provisions related to total equity, the final rule creates an essentially consistent control framework between Regulation Y and Regulation LL.

The rule does not include any presumptions or exclusions specially tailored to the non-US operations of FBOs, nor does it modify the Board's Regulation K. In response to several comments expressing concern that certain of the presumptions could have extraterritorial reach by attributing control over companies outside the United States, especially by FBOs, and requests for clarification that lawful home country activities and relationships currently in existence should not be upset by the proposal, the Board noted that the statutory framework for control does not contemplate different definitions of control for companies in different jurisdictions. The Board characterized the rule as "generally consistent with the Board's current practice," stating that it does not expect the final rule to "result in substantially different outcomes for questions of controlling influence involving foreign companies."

INTERACTION WITH OTHER REGULATIONS

The rule is intended to apply to questions of control under the BHCA and HOLA. Section 4(c)(6) of the BHCA permits BHCs to invest in up to 5 percent of the voting shares of any company, but these investments must be passive or non-controlling. As a result, the control framework in the rule applies for purposes of section 4(c)(6) and, in particular,

the Board's interpretation of section 4(c)(6) located in section 225.137 of the Board's Regulation Y.

Notwithstanding extensive support from industry, the final rule does not extend to or modify the concepts of control under the Change in Bank Control Act[22] or the Board's Regulation O[23] and Regulation W.[24] In her short statement accompanying the final rule, Federal Reserve Board Governor Brainard made specific note of the importance of monitoring "how the control framework interacts with other regulations that involve ownership thresholds in order to ensure the different elements of the Board's regulatory framework in totality are functioning as intended and to identify and address any inconsistencies, as appropriate." The Board stated that it may in the future consider conforming revisions to these other elements of its regulatory framework.

The rule also does not explicitly modify Regulation YY but, as discussed above, interprets the definition of ownership interest in Regulation YY in relation to asset-backed commercial paper conduits.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Thomas J. Delaney
+1 202 263 3216
tdelaney@mayerbrown.com

Jeffrey P. Taft
+1 202 263 3293
jtaft@mayerbrown.com

Matthew Bisanz
+1 202 263 3434
mbisanz@mayerbrown.com

Logan S. Payne
+1 202 263 3268
lpayne@mayerbrown.com

Endnotes

[1] Board, *Federal Reserve finalizes rule to simplify and increase the transparency of the Board's rules for determining control of a banking organization* (Jan. 30, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200130a.htm.

[2] 84 Fed. Reg. 21634 (May 14, 2019).

[3] 12 U.S.C. §§ 1841(a)(2) and 1467a(a)(2).

[4] 12 U.S.C. §§ 1843 and 1467a(c).

[5] The three-pronged test for "control" is the BHCA test. 12 U.S.C. § 1841(a)(2); 12 C.F.R. § 225.2(e) (all citations are to the Code of Federal Regulations prior to the amendments made by this final rule). The definition of control in HOLA is substantially similar. *See* 12 U.S.C. § 1467a(a)(2); 12 C.F.R. § 238.2(e). As discussed further below, one difference between the BHCA and HOLA is that the definition of control under HOLA includes situations where a company has contributed more than 25 percent of the capital of another company.

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

[7] While the final rule makes minor modifications to the formal procedures for determining control, there is no indication that the Board intends to rely exclusively on formal control proceedings.

[8] Opening Statement on Proposal to Revise the Board's Control Rules by Vice Chair for Supervision Randal K. Quarles (April 23, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/quarles-opening-statement-20190423.htm.

[9] The final rule does not provide a rubric for Board staff to examine qualitative characteristics in a consistent manner beyond a statement that significant relationships may include those that are difficult to replace and are necessary for core functions. The final rule also does not appear to limit this expansive footnote to the tiered framework, potentially putting at risk investments held under section 4(c)(6) of the BHCA. *See e.g.*, FRB Ltr. of Mar. 4, 1996

(recognizing a controlling influence without control of any voting securities).

[10] Examples of persons who would be considered to be director representatives include (i) individuals who are officers, employees, or directors of the first company, (ii) individuals who were officers, employees, or directors of the first company within the preceding two years, and (iii) individuals who were nominated or proposed by the first company to be directors of the second company.

[11] The final rule also clarifies that the quantitative thresholds are based on total consolidated annual revenues and expenses as these terms are commonly understood in the context of US generally accepted accounting principles ("GAAP"), and that revenue is understood to mean gross income, not income net of expenses. Principles of consolidation are also meant to be applied as generally implemented in the context of GAAP.

[12] Because of a unique "25 percent of contributed capital" prong in the HOLA definition of control, the proposal included a "total equity" presumption of control in addition to the "contributed capital" statutory standard of control for savings and loan holding companies. The final rule does not include a presumption of control based on total equity for savings and loan holding companies. Instead, the preamble to the final rule states that contributed capital under HOLA generally means the same thing as total equity in the Board's regulations implementing the BHCA. Accordingly, the relevant total equity threshold for SLHCs under the final rule will be 25 percent, not the one-third that applies to BHCs. This is consistent with precedents interpreting contributed capital under HOLA.

[13] *See* 12 C.F.R. §§ 225.31(d)(2)(i), 238.21(d)(2)(i).

[14] The proposed presumption of control for serving as an investment adviser to an investment fund was intended to be consistent with the Board's precedents regarding when an investment adviser controls an advised investment fund under the BHCA.

[15] *See* Letter to H. Rodgin Cohen, Esq., dated June 24, 1999, *available at* https://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/1999/19990624/.

[16] Final Rule at 43.

[17] *See, e.g.*, 12 C.F.R. § 225.138. The divestiture policy statement indicates that divestiture is a special consideration for purposes of control and that the Board's normal rules and presumptions regarding control may not always be appropriate in the context of divestiture.

[18] *See, e.g.,* 12 C.F.R. § 225.139 ("2(g)(3) policy statement"). The 2(g)(3) policy statement describes the implementation of section 2(g)(3) of the BHCA (Congress removed section 2(g)(3) from the BHCA in 1996). Section 2(g)(3) created a rebuttable presumption that a transferor continued to control securities of a company transferred to a transferee if the transferee was indebted to the transferor or if there were certain director or officer interlocks between the transferor and transferee. The 2(g)(3) policy statement remains relevant because it reflects the Board's longstanding position that terminating control requires reducing relationships to lower levels than would be consistent with a new non-controlling relationship.

[19] *See* 12 C.F.R. § 225.31(d)(2)(iv); *see also* 12 U.S.C. § 1841(a)(5)(A).

[20] *See, e.g.*, 12 U.S.C. §§ 1841(a)(2)-(3) and 1842(a).

[21] These standards effectively replace the presumptions for control over voting securities currently in 12 C.F.R. § 225.31(d)(1). In this discussion, "person" has the meaning provided in 12 C.F.R. § 225.2(l) and 12 C.F.R. § 238.2(j).

[22] 12 U.S.C. § 1817(j).

[23] 12 C.F.R. pt. 215. The analysis conducted in the context of the proposal identified issues under Regulation O and resulted in the US banking regulators issuing temporary no-action relief in late-2019. See Board, SR 19-16 (Dec. 27, 2019).

[24] 12 C.F.R. pt. 223.