Client Alert | Financial Institutions Advisory

Federal Reserve Finalizes Rule Updating Controlling Influence Framework

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Authors: Duane Wall, Glen R. Cuccinello, Max Bonici, John Wagner

On January 30, the Federal Reserve released a highly anticipated final rule that substantially updates and clarifies the agency's regulatory framework for determining when an investor exercises a controlling influence over a bank or other company under the Bank Holding Company Act and the Home Owners' Loan Act.

The final rule liberalizes in a number of significant ways the control standards that are currently employed by the Board of Governors of the Federal Reserve System (**Federal Reserve**) and its staff. Its most dramatic impact is to bring **clarity and transparency** to the standards, considerations and calculation methodologies applied by the Federal Reserve and its staff in making control determinations, especially with regard to the particular combinations of voting and nonvoting equity investments, board and board committee representation, personnel interlocks, business relationships and contractual arrangements that can lead to a determination that a minority investor has control.

The final rule largely tracks the Federal Reserve's April 2019 proposed rule, with key changes, including: (1) taking into account the significance of business relationships between an investor and a company only from the perspective of the company, not the investor; (2) a standardized presumption of control based on an investor's total equity ownership of at least 33.33%; (3) the elimination of one of the investment fund control standards; and (4) modifications to proposed definitions. The final rule becomes effective **April 1, 2020**.

This alert focuses on the changes made by the final rule to the Federal Reserve's existing, public framework for determining whether a controlling influence exists for purposes of the Bank Holding Company Act (**BHCA**).[1] In this alert, we refer to an **investor** as a company under the BHCA that acquires the securities of any **bank** or **company**.[2] Unless otherwise specified, references in this alert to ownership or control of a company also refer to ownership or control of a bank, and references to ownership of securities also include controlling the securities or holding them with power to vote.

Key takeaways

- ☐ **Banking organizations may generally make non-controlling investments in other companies and divest control of formerly controlled companies more easily. Divestitures of investments will no longer be subject to the previous stricter standard.**
- ☐ **Non-banking investors (e.g., investment funds, private equity) may generally make non-controlling investments in banking organizations more easily.**

Executive summary

- **An investor that controls less than 10% of any class of a company's voting securities is generally presumed not to control that company. Formerly, the presumption only applied to investments in less than 5% of any class of a company's voting securities.**
- **Investors may have a larger representation on a company's board of directors without triggering a presumption of control, but no more than specified limits. Formerly, only one director was generally permitted.**
- **Investors may have greater levels of business relationships with companies under certain circumstances, where the investor owns 14.99% or less of any class of voting securities. Larger voting ownership stakes, however, can result in more stringent restrictions on business relationships. The magnitude of an investor's business relationships is measured from the company's perspective.**
- **The Federal Reserve does not intend to require investors to provide standard-form passivity commitments in most cases going forward, as it has done in the past as a condition for a determination that the investor would not have control. The Federal Reserve, however, will use passivity commitments in special situations and specific contexts.**
- **The final rule does not change the separate control analysis required under the Change in Bank Control Act or the Federal Reserve's regulations concerning insider loans (Regulations O) or transactions with affiliates (Regulation W).[3]**
- **The final rule is consistent with what appears to be a new era in Federal Reserve transparency and tailoring, including the revised enhanced prudential standards[4] and the potential changes to the Federal Reserve's supervisory approach outlined in January 2020.**
- **While the final rule is an improvement over the former framework, the new framework's effectiveness will ultimately turn on the extent to which the Federal Reserve staff follows it in practice.**
- **Although the final rule formally codifies substantial amounts of previous Federal Reserve policies and practices as rebuttable presumptions, the Federal Reserve has reserved its authority to determine whether an investor has a controlling influence over a company, regardless of whether or not these presumptions are triggered.**
- **Independent of the new control framework, the Federal Reserve may still review investments involving banking organizations for potential safety and soundness concerns.**

In addition to the above key takeaways, this alert's executive summary includes a chart on page 3 that provides an overview of each of the control presumptions and the relationships or factors associated with those presumptions.

Following the executive summary, we have attached a detailed analysis that discusses each control presumption, considering whether it changes or maintains the existing control framework, and certain implications or observations. We describe each control presumption from the vantage point of an investor who seeks to make a non-controlling investment and avoid triggering each presumption of control.

Executive summary

The following chart summarizes the conditions for an investor seeking to avoid key presumptions of control under the final rule. General relaxations of prior Federal Reserve practice or policy are shaded blue; changes that are relatively more restrictive are shaded black; and those essentially unchanged have no shading.

	Benefits from presumption of non-control			
Voting securities (any class)	**Less than 5%**	**5–9.99%**	**10–14.99%**	**15–24.99%**
Number of directors	Less than half of company board may consist of representatives of investor	Less than a quarter of company board may consist of representatives of investor	Less than a quarter of company board may consist of representatives of investor	
Director service as board chair	**No limitation**	**No limitation**	**No limitation**	No representative of investor may serve as chair of company's board
Director service on board committee	**No limitation**	**No limitation**	Investor representatives on company board may represent a quarter or less of the members of any committee with power to bind the company (e.g., compensation, audit, executive committees)	
Business relationships	**No limitation**	No presumption of control if business relationships with investor account for less than 10% of **company's** revenues or expenses	No presumption of control if business relationships with investor account for less than 5% of **company's** revenues or expenses	No presumption of control if business relationships with investor account for less than 2% of **company's** revenues or expenses
Business terms	**No limitation**	**No limitation**	No presumption of control if business relationships between investor and company are on market terms	
Officer/ employee interlocks	**No limitation**	No presumption of control if only 1 interlock between investor and company, provided the person does not serve as company's CEO	No presumption of control if only 1 interlock between investor and company, provided the person does not serve as company's CEO	No interlocks permitted between investor and company
Contractual powers of investor over company	No presumption of control so long as no management agreements	Investor may not have any contractual rights that significantly restrict company's discretion	Investor may not have any contractual rights that significantly restrict company's discretion	
Proxy contests	**No limitation**	**No limitation**	Investor may not solicit proxies to replace more than permitted number of directors	
Total equity	Investor's ownership must be less than 1/3 of company's total equity	Investor's ownership must be less than 1/3 of company's total equity	Investor's ownership must be less than 1/3 of company's total equity	Investor's ownership must be less than 1/3 of company's total equity

Background

The issue of control, and in particular the circumstances under which a minority investor may be regarded as exercising a controlling influence over a bank or other company, is regarded by many observers as the single most important regulatory issue under the BHCA and also as a critical regulatory issue under the Home Owners' Loan Act (**HOLA**) and the US federal bank regulatory regime generally. The final rule liberalizes in a number of significant ways the control standards that are currently employed by the Federal Reserve and its staff. However, the most dramatic impact of the final rule is to bring **clarity and transparency** to the standards, considerations and calculation methodologies applied by the Federal Reserve and its staff in making control determinations, especially with regard to the particular combinations of voting and nonvoting equity investments, board and board committee representation, personnel interlocks, business relationships and contractual arrangements that can lead to a determination that a minority investor has control. As noted in the January 23, 2020 memorandum from the Federal Reserve staff to the Board of Governors seeking approval of the final rule, the "lack of a comprehensive, public control standard has raised concerns about the fairness and transparency of the [Federal Reserve's] control decision-making, as well as potential adverse consequences on banking firms seeking to raise capital or make strategic investments." Randal Quarles, the Federal Reserve's Vice Chair for Supervision, has been a driving force for increasing transparency and consistency in Federal Reserve regulatory policies and practices, and has made that point more colorfully and emphatically in his public pronouncements:

> "[M]any of the control doctrines . . . can in some cases not be discovered except through supplication to a small handful of people who have spent a long apprenticeship in the subtle hermeneutics of Federal Reserve lore, receiving the wisdom of their elders through oral tradition in the way that gnostic secrets are transmitted from shaman to novice in the culture of some tribes of the Orinoco."[5]

The existing Federal Reserve control framework, as codified in the Federal Reserve's Regulation Y under the BHCA (the main control provisions of which were last revised in 1984) and explained in policy statements from 2008 and 1982, has become a less-than-complete or fully up-to-date distillation of the various standards, policies and methodologies employed by the Federal Reserve and its staff in making control determinations and the related calculations of equity ownership stakes. Certain of those standards, policies and methodologies that are currently in effect have not previously been the subject of any formal rulemaking, nor have they always been made public.

Although the Federal Reserve describes the final rule as generally consistent with those current standards and practices under Regulation Y and the BHCA, the final rule makes a number of important liberalizations to the current standards. We discuss those liberalizations and other important provisions more fully below.

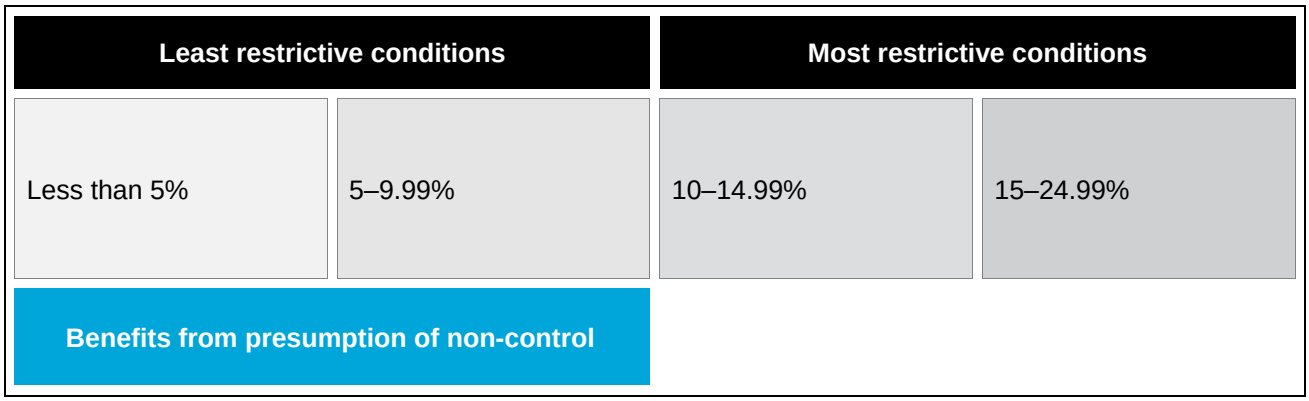
Overview of the new controlling influence framework

The final rule creates a sliding scale under which the level of an investor's ownership of any class of a company's voting securities, within specified ownership tiers up to 24.99%, affects the types and magnitude of the other relationships that the investor may have with the company without being presumed to have a controlling influence over that company. As an investor's control of voting securities increases, the more restrictive the limitations on other control factors become for an investor seeking to avoid triggering presumptions of controlling influence.

The final rule amends Regulation Y and, in doing so, codifies the various factors that constitute the controlling influence test and related definitions and calculation methodologies. Prior to this final rule, the controlling influence test was often an opaque inquiry, developed in a piecemeal fashion, at times through inconsistent determinations from the Federal Reserve that were not always public. The final rule's transparency is a welcome improvement.

1. Tiers of voting security ownership

The key tiers of voting security ownership or control under the new framework are:



The controlling-influence framework applies only when neither of these two bright line statutory tests for control under the BHCA are satisfied[6]:

1. **Ownership test.** The investor owns, controls or has power to vote 25% or more of any class of a company's voting securities, directly or indirectly or acting through one or more persons.
2. **Board-control test.** The investor controls in *any* manner the election of a majority of the directors.

2. Control hearings

Under the new framework, an investor must respond to a preliminary determination of controlling influence and may rebut the presumptions of control by submitting a written response to the Federal Reserve, for instance, detailing its relationships with the company and requesting a hearing or proceeding, which the Federal Reserve must grant if material facts are in dispute. In addition, the Federal Reserve may, in its discretion, order such a hearing. During a control hearing, the Federal Reserve considers any applicable presumptions of non-control or control and any facts to rebut the presumptions. The Federal Reserve then issues a final determination as to whether the investor has a controlling influence over the company. A finding of control could require the investor to: (1) apply or provide notice to the Federal Reserve to maintain the relationship or (2) terminate the relationship. To date, control hearings, while possible under Regulation Y, have been more the exception than the rule. It is unclear whether the Federal Reserve will order control hearings moving forward.

More generous rebuttable presumption of non-control

Under the final rule, and as described above, an investor enjoys a presumption of non-control if it has under 10% (i.e., up to 9.99%) of each class of a company's voting securities, assuming it does not also trigger any other rebuttable presumption of control that applies under the 10% voting ownership threshold. This is an increase from the Federal Reserve's traditional control presumptions in Regulation Y, which generally provide for a presumption of non-control only where an investor owns less than 5% of any class of a company's voting securities, which is also the approach taken in the BHCA.

Although the final rule provides much more clarity and transparency for the control analysis than has previously been a matter of public record, it remains unclear whether there would be anything resembling a presumption of non-control for an investor that owns between 10% and 24.99% of any class of a company's voting securities but otherwise does not trigger any of the control factors identified in the final rule. The Federal Reserve has noted, however, that only in "unusual circumstances" would the Federal Reserve expect to find that an investor controls a company where the investor is not presumed to control that company under the final rule's new framework. A determination of whether "unusual circumstances" exist, however, is ultimately a discretionary matter for the Federal Reserve.

Specific rebuttable presumptions of control

Under the final rule, a minority investor can be presumed to have control over a company based on the specific ownership tier applicable to the investor's voting equity stake in the company, which then determines the types of other relationships between the investor and the company that would trigger a presumption of control. Most of the triggers apply at the threshold of 10% or more of any class of voting securities, with the most stringent triggers applying at an ownership stake of 15% or more. Less stringent triggers apply to an ownership stake of between 5% and 9.99%.

Although not stated in the final rule, the more presumptions of control that an investor triggers, the lesser the likelihood that the investor could successfully rebut a preliminary determination of control by the Federal Reserve. Nevertheless, under the new control framework the Federal Reserve could determine that a controlling influence exists where an investor triggers only one presumption of control.

The following sections explain each of the presumptions of control individually. In each case, we list the conditions by ownership tier of a company's voting securities that allow an investor to make the maximum investment without triggering a specific presumption of control. Whether the Federal Reserve would determine that a controlling influence exists, however, would likely be based on specific facts and circumstances of the relationships between an investor and a company, rather than any one presumption alone.

Please refer to the chart on page 3 for an overview of the presumptions and key thresholds.

1. Board of directors and board committee representatives

Number of director representatives

The final rule relaxes the Federal Reserve's practice of generally allowing a noncontrolling investor to have only one director representative on a company's board of directors (depending on whether there are other control factors).

In practical terms, for an investor to benefit from the new ability to have more than one director representative on a board of directors, the company's board of directors would have to be sufficiently large.To avoid a presumption of control under the final rule:

Less than 5%	5–9.99%	10–14.99%	15–24.99%
• Representatives of the investor or its subsidiaries must account for less than half of the total number of seats on the company's board of directors.[7]	• Representatives of the investor or its subsidiaries must account for less than a quarter of the total number of seats on the company's board of directors.		

Total number of board seats	3–4	5–6	7–8	9–10	11–12
Maximum number of director representatives of the investor, where investor owns less than 5% of any class of a company's voting securities (i.e., director representatives must account for less than half of total number of board seats)	1	2	3	4	5
Maximum number of director representatives of the investor, where investor owns between 5% and 24.99% of any class of a company's voting securities (i.e., director representatives must account for less than one-quarter of total number of board seats)	0	1	1	2	2

This may be of particular note to banking organizations considering investments in non-bank companies. It is common for large companies, particularly those that are publicly traded, as well as large diversified banks and even regional banks, to have boards of directors with 10 or more members.[8] Even among smaller institutions, it is common for banking organizations to have a larger number of board members than non-bank companies. For instance, smaller or younger companies, in which a banking organization may want to make non-controlling investments, may not necessarily have such large boards. In these cases, the banking organization must restrict its voting securities (any class) to less than 5% to hold multiple seats on the company board, unless the company's board size were to be increased. Accordingly, some investors may not realize a tangible benefit from the new relaxation if the size of the board remains relatively small.

The final rule defines the term **"director representative"** to mean any individual that represents the interests of an investor through service on a company's board of directors. Such individuals generally include:

- A current officer, employee or director of the investor;
- An individual who served within the last two years as an officer, employee or director of an investor; or
- An individual that an investor nominates or proposes to serve in that capacity.

A director representative does not include a non-voting observer entitled to attend meetings of the company's board. Although the proposed rule would have included the immediate family members of an investor's employee, director or agent, the final rule does not consider such individuals to be director representatives.

Control, however, is presumed if an investor (or its subsidiary) controls 5% or more of any class of a company's voting securities and can make or block the making of that company's (or its subsidiary's) major operational or policy decisions. The Federal Reserve has explained in the final rule's preamble that this provision applies to supermajority voting requirements, individual veto rights, or any similar unusual provisions that allow a minority of the company's board to control effectively the major operational or policy decisions of the company.

Director representative as chair of the board

The final rule also relaxes the former strict prohibition—for an investor seeking to avoid control of a company—on having a director representative serving as chair of a company's board of directors in

circumstances where the investor had a voting ownership stake (any class) of between 10% and 24.99% in a company.

Less than 5%	5–9.99%	10–14.99%	15–24.99%
• The investor may have a director representative who serves as chair of the company's board without triggering this presumption.			• The investor may not have a director representative who serves as chair of the company's board.

Director representatives on company board committees that can take actions binding the company or any subsidiary

Previously, only an investor that owned less than 5% of any class of a company's voting securities could have a director representative serving on a committee of the company's board of directors with the authority to bind the company (or any of its subsidiaries) without the need for approval of the full board of directors. The final rule relaxes that limitation, as follows:

Less than 5%	5–9.99%	10–14.99%	15–24.99%
• An investor (or its subsidiary) may have any number of director representatives on any committee of a company's board without triggering this presumption.		• An investor may not have director representatives accounting for more than one-quarter of a company board committee that has the power to bind the company (or its subsidiary)—for instance, the audit, compensation, executive or similar committees.	

2. Business relationships

The Federal Reserve has traditionally imposed quantitative limitations on the business relationships between a non-controlling investor and a company and has looked for qualitative immateriality in those relationships. Under the final rule, as an investor's (or its subsidiary's) ownership or control of voting securities rises, the magnitude of its business relationships with the company—**as measured by the company's total consolidated annual revenues *or expenses***—must decline. Although that approach had been reflected in the Federal Reserve's 2008 policy statement on equity investments in banks and bank holding companies, the final rule identifies the particular quantitative limits that will apply to the different tiers of voting equity ownership. The Federal Reserve will not consider the magnitude of those business relationships in relation to the annual revenues or expenses of the investor, but rather only the magnitude in relation to the company on a consolidated basis.

For purposes of the business relationships calculation, revenues and expenses refer to their common meaning under US GAAP. As a result, a company's consolidated income statement for the preceding fiscal year should contain the information necessary to determine revenues and expenses for purposes of the required annual measurement of those items. In addition, revenue refers to gross income, not income net of expenses.

The final rule generally eases the quantitative limits applied to investors that own between 5% and 14.99% of any class of a company's voting securities, as follows.

Less than 5%	5–9.99%	10–14.99%	15–24.99%
• An investor is not presumed to control the company based on its business relationships with the company.	• An investor may have business relationships with the company accounting for up to 9.99% of that **company's revenues or expenses** without triggering this presumption.	• An investor may have business relationships with the company accounting for up to 4.99% of that **company's revenues or expenses** without triggering this presumption.	• An investor may have business relationships with the company accounting for up to 1.99% of that **company's revenues or expenses** without triggering this presumption.

The new framework constitutes a liberalization of the Federal Reserve's proposed rule, which would have taken into consideration the magnitude of the business relationships in relation to the annual revenues of both the investor and the company. Nevertheless, the quantitative limitation remains an important restriction on business relationships for investors in the highest ownership tier of voting securities. Investors that have or seek to develop meaningful business relationships with the companies in which they invest must carefully consider these limitations to avoid triggering this presumption of control.

The Federal Reserve may still raise controlling influence concerns under specific facts and circumstances consistent with historical precedent (e.g., relationships with special qualitative significance, such as those that are difficult to replace or that are necessary for core functions) and may, independent of a control analysis, object to relationships on the grounds that they raise safety and soundness or other concerns for any banking organization involved.

Market terms

The Federal Reserve's framework also takes into account whether the investor and company have any business relationships that are not on market terms.

Less than 5%	5–9.99%	10–14.99%	15–24.99%

• An investor may have business relationships that are not on market terms without triggering this presumption.	• An investor may only have business relationships on market terms to avoid triggering this presumption of control.

Previously, the Federal Reserve has typically required a non-controlling investor to make passivity commitments providing that all business relationships with the company would be on market terms, with reference to the standard that applies to transactions by banks with their affiliates (i.e., terms offered in good faith that are substantially similar to or at least as favorable to the bank as those involving nonaffiliated companies). In addition, the Federal Reserve has looked to whether business relationships were non-exclusive and terminable without penalty by the banking organization. The final rule, however, would not look to these last two factors. As explained in more detail below, the Federal Reserve explains in the preamble to the final rule that it does not intend to obtain its traditional standard-form passivity commitments in the ordinary course going forward, although it may require an investor to provide control-related commitments in specific contexts.

Threats to alter or terminate business relationships

Additionally, there is no presumption of control based on an investor's threat to alter or terminate business relationships, though such actions may be relevant to a control analysis.

3. Senior management interlocks

The final rule relaxes some of the Federal Reserve's traditional restrictions on officer and employee interlocks between an investor and a company. The Federal Reserve's standard-form passivity commitments generally did not permit a non-controlling investor to have *any* interlock with a company if it owned 5% or more of any class of the company's voting securities.

Under the new framework, an interlock occurs when an individual serves as an employee or director of the investor as well as a senior management official of the company, meaning the individual participates or has the authority to participate (other than as a director) in major policymaking functions of the company. As a result, whether an individual is a senior management official depends on his or her function, not title.

The final rule does, however, permit an investor to have multiple junior employee interlocks (i.e., with those who are not senior management officials), which in the Federal Reserve's view would not increase the investor's ability to influence operations and policies at the company.

<table>
<tr><td>Less than 5%</td><td>5–9.99%</td><td>10–14.99%</td><td>15–24.99%</td></tr>
<tr><td>• An investor may have any number of interlocks with the company without triggering this presumption.</td><td colspan="2">• An investor may have no more than one interlock with the company, and the interlock cannot be the CEO (or an equivalent person).

• If the interlock is a CEO, an investor with 5–14.99% of any class of a company's voting securities is presumed to control the company.</td><td>• An investor may not have any interlocks with the company.</td></tr>
</table>

4. Contractual powers

The Federal Reserve recognizes that covenants and certain contractual rights are customarily included in commercial agreements, including loan agreements, but can nonetheless raise control concerns. A non-controlling investor may not enter into a management contract or any other agreement or understanding with a company—other than to serve as investment adviser (discussed below)—by which the investor directs or exercises significant influence or discretion over the general management, overall operations, or core business or policy decisions of the company. The Federal Reserve applies this blanket presumption of control at every ownership tier of a company's voting securities. Examples of agreements that would be treated in this manner include arrangements whereby an investor is a managing member, trustee or general partner of the company, which are positions that the Federal Reserve has traditionally regarded as controlling, or by which the investor otherwise exercises similar powers and functions. Nevertheless, the Federal Reserve explained in the proposed rule's preamble that routine outsourcing agreements, such as IT services agreements, would not trigger a presumption of control.

The final rule provides as follows with regard to covenants and other "limiting contractual rights" that a non-controlling investor may seek to impose with regard to a company.

Less than 5%	5–9.99%	10–14.99%	15–24.99%
• An investor may have **limiting contractual rights** so long as it does not enter into management agreements that would trigger the blanket presumption described above.	• An investor may not have any limiting contractual rights with respect to the company, ***except*** in the case of: ○ **Merger agreements with, or agreements to make a controlling investment in,** a company that are reasonably expected to **close within one year** and are designed so that the company continues to operate in the ordinary course until consummation of the merger or investment; or ○ A requirement that a company take a specific action necessary for consummation of the merger or investment.		

A limiting contractual right is defined as an investor's contractual right to restrict significantly (directly or indirectly) the company's discretion—including its management and directors—over its operational and policy decisions. The Federal Reserve provided examples of what it considers to be limiting contractual rights that expand on examples the Federal Reserve has identified in previous policy statements and other guidance, as well as examples that the Federal Reserve does not consider to be limiting contractual rights. We have reproduced this list in **Appendix A**.

5. Proxy contests

The Federal Reserve has traditionally raised controlling influence concerns where an investor that owns 10% or more of any class of a company's voting securities solicits proxies from shareholders of the company on any issue. The final rule meaningfully relaxes the Federal Reserve's traditional practice in this area.

In the case of proxy solicitations for the election of directors, however, the final rule treats such proxy solicitations in the same general manner as director representation on the company board for purposes of the presumptions of control. The following is the new framework under which a non-controlling investor may solicit proxies from company shareholders with regard to the election of directors without triggering a presumption of control:

Less than 5%	5–9.99%	10–14.99%	15–24.99%
• An investor **may solicit proxies** with respect to the election of directors without triggering this presumption.		• An investor may propose a number of director representatives to the board of directors of a company (or its subsidiary) if the total of the investor's **proposed** director representatives **and existing** director representatives is **less than 25% of the board seats.**	

As noted above, the rebuttable presumption of control is only triggered in proxy solicitations concerning directors, and there is no general presumption of control for an investor that solicits proxies from the shareholders of a company on other shareholder issues. Neither is there a presumption of control based on threats to dispose of securities. As a result, the final rule gives non-controlling investors greater latitude to exercise shareholder rights, exit investments and engage with the target company and other shareholders on various issues other than director elections.

6. Total equity

The final rule codifies a method for calculating the total equity ownership by an investor in a company, as explained below. This calculation method would apply to a company that is a stock corporation that prepares financial statements using US GAAP. For other companies, the Federal Reserve would employ a calculation method that is "reasonably consistent" with the final rule's standard calculation and would take into account any differences in legal form or accounting system used by the company to prepare its financial statements.

Under the final rule, a non-controlling investor must own less than 33.33% of the company's total equity under any of the ownership tiers listed below.[9]

Less than 5%	5–9.99%	10–14.99%	15–24.99%
• Less than **33.33%**	• Less than **33.33%**	• Less than **33.33%**	• Less than **33.33%**

Total equity calculation method

$$\text{Total equity} = \frac{\text{(Investor's common equity) + (Investor's preferred equity, for each class of preferred stock issued)}}{\text{(Issuer shareholder equity)}}$$

Please refer to **Appendix B** for a detailed explanation of the calculation method.

7. Investment funds

The final rule codifies a specific rebuttable presumption of control concerning an investor that acts as an investment adviser to a company that is an investment fund. It also creates an exception from this rule for investors that have organized and sponsored (and not merely invested in) an investment fund within the preceding 12 months to allow for an initial seeding period for the fund.

An investor may serve as an investment adviser to a company that is an investment fund without triggering a presumption of control (after any permissible seeding period) only if:

- The investor does not own 5% or more of any class of voting securities of the fund; and
- The investor owns 24.99% or less of the total equity of the fund.

The following illustrates how this approach would apply to the different ownership tiers of a company's voting securities.

<table>
<tr><td>Less than 5%</td><td>5–9.99%</td><td>10–14.99%</td><td>15–24.99%</td></tr>
<tr><td>• A non-controlling investor may serve as an investment adviser to a company that is an investment fund only if the investor owns 24.99% or less of the total equity of the fund.</td><td colspan="3">• An investor in any of these ownership tiers of voting securities would be presumed to control a company that is an investment fund if the investor also served as the fund's investment adviser.</td></tr>
</table>

For the purposes of the final rule, "investment adviser" is defined as an entity that:

- Is registered as an investment adviser (RIA) with the Securities and Exchange Commission under the Investment Advisers Act of 1940;

- Is registered as a commodity trading advisor (CTA) with the Commodity Futures Trading Commission under the Commodity Exchange Act;
- Is a non-US equivalent of a RIA or CTA; or
- Engages in certain financial and investment advisory activities specified in Regulation Y.[10]

Although the rule does not define "investment fund," the Federal Reserve explains in the preamble to the final rule that the term includes "a wide range of investment vehicles" (e.g., registered investment companies, companies exempt from registration under the Investment Company Act, and non-US equivalents; commodity funds; REITs).

The proposed rule included an exception for registered investment companies under the Investment Company Act, which the Federal Reserve did not include in the final rule on the grounds that the proposed exception had only minimal value incremental to the general investment fund exception and added unnecessary complexity. Some commenters to the proposed rule argued that the exception for registered investment companies would have been more restrictive than existing Federal Reserve practice and precedent and would not have covered non-US equivalents.

8. Divestitures

In a significant change from the Federal Reserve's traditional practice, the final rule's framework will treat divestitures more similarly to initial investments for purposes of the control analysis. The Federal Reserve has traditionally applied stricter standards to divestiture and looked to various indicia of (lingering) control over extended periods of time. The Federal Reserve has indicated that it will no longer apply the stricter approach in the divestiture context, although in certain cases, an investor that divests down to an ownership level of 15% or more of any class of a company's voting securities will have to wait two years until it is no longer presumed to control the company.

Less than 5%	5–9.99%	10–14.99%	15–24.99%
• If a formerly controlling investor lowers its voting securities in a company to less than 15% of each class, there is no presumption of control.			• There is a **two-year presumption of control** for an investor that previously had controlled 25% or more of any class of a company's voting securities and lowers its control of voting securities to 15–24.99%.[11] • However, if an unaffiliated investor controls 50% or more of the voting securities of the company, there is no presumption of

	control for the investor that retains 15–24.99% of any class of voting securities.

The Federal Reserve explained in the final rule's preamble that its divestiture policy statement, with its focus on reducing relationships between the investor and the company to lower levels than would be applicable for new non-controlling relationships, remains "relevant." That is the case notwithstanding the adoption of the new framework and the fact that the statutory provision that was the impetus for the policy statement was removed from the BHCA in 1996,[12] as the original divestiture policy statement reflects the Federal Reserve's longstanding position concerning divestiture and lingering business relationships. This may signal at least one area where precedential creep from the Federal Reserve's traditional practice might influence the application of the new framework. It is not clear if such policy remains "relevant" only when the presumption may be triggered (i.e., at 15% or above in any class of voting securities) or if it may also end up being applied at ownership levels below that threshold.

The Federal Reserve also explained in the final rule's preamble that where an investor divests control of a company by selling all of its voting securities to a buyer in exchange for consideration that is less than 25% of each class of the buyer's voting securities, and does not trigger control presumptions with respect to the buyer, the investor is not presumed to control the company because it no longer has any voting securities of that company. No waiting period applies either in such a case.[13]

9. Combined ownership by an investor and associated individuals

The proposed rule would have retained the existing so-called **5-25 presumption** of control in Regulation Y,[14] under which a holder of at least 5% of a class of a company's voting securities was presumed to control the company if the aggregate ownership of the company's voting securities by the investor and the investor's associated individuals was at least 25%, and added a new **15-50 exception** to the 15-25 presumption of control. The final rule does not retain the 5-25 presumption of control of a company *as a presumption*. Rather, it lives on in a modified form as an attribution rule in the provision for control by a company over voting securities. Essentially, under the final rule, an investor that owns 5% or more of any class of a company's voting securities also owns or controls **any securities** (i.e., voting and nonvoting) issued by the company **that** are owned by **(1) the investor's (or subsidiary's) senior management officials and directors or controlling shareholders** or **(2) their immediate family members**.

The final rule provides for a new 15-50 exception to the above rule for attribution of securities to an investor. The 15-50 exception also applies where the company's voting securities are owned by both the investor and the investor's associated persons, but it entails a different calculation than applies for the 5-25 presumption. Under the new 15-50 exception, the investor is not deemed to control a company's voting securities that are owned by associated persons of the investor where:

- The investor (or its subsidiary) owns less than 15% of each class of a company's voting securities; and
- The investor's (or its subsidiary's) officers and directors, **and their immediate family members**, own, control, or have the power to vote 50% or more of each class of a company's voting securities.

The Federal Reserve's rationale for this exception is based on its understanding that when individuals control an outright majority, the individuals, and not the investor that employs them, truly exercise control.

10. Fiduciary exception

An investor (or a subsidiary) may control a company's (or a subsidiary's) securities in a fiduciary capacity without triggering any of the rebuttable presumptions of control. However, if the company is a depository institution or a depository institution holding company, the securities must be held in a fiduciary capacity without sole discretionary authority to exercise voting rights to avoid triggering the presumption of control. Accordingly, the fiduciary exception parallels the fiduciary exceptions in sections 3 and 4 of the BHCA and is consistent with traditional Federal Reserve practice.[15]

The previous fiduciary exception in Regulation Y only applied to a subset of control presumptions,[16] whereas under the final rule, the fiduciary exception applies to *all* presumptions of control involving ownership of shares.

11. Accounting consolidation

An investor that consolidates a company on its financial statements under US GAAP is presumed to control the company. This bright-line presumption applies regardless of whether consolidation is required under US GAAP due to ownership of voting securities or the variable interest standard. The Federal Reserve notes in the final rule's preamble that it is likely to have control concerns where an investor controls another company on its financial statement under different accounting standards as well, especially where the accounting standards are similar to US GAAP. The presumption, however, does not apply when an investor applies the equity method of accounting to its investment in a company under US GAAP.[17]

Presumptions do not bind the Federal Reserve

Although the new framework should add more clarity and simplicity for many investors seeking to make non-controlling investments in companies, it is important to remember that the presumptions do not bind the Federal Reserve.

- Because the **presumption of non-control is rebuttable**, the Federal Reserve may determine based on the specific facts of a transaction or relationship that the presumption does not apply.
- The Federal Reserve has explained in the final rule's preamble that it may raise controlling influence concerns under specific facts and circumstances consistent with historical precedent, such as relationships with special qualitative significance (e.g., relationships that are difficult to replace and are necessary to core functions).
- The final rule codifies a reservation of authority to clarify that the Federal Reserve may take any supervisory or enforcement action otherwise permitted by law, including an action to address unsafe or unsound practices or conditions, or violations of law. The Federal Reserve also notes in the final rule's preamble that safety and soundness concerns may arise in the absence of, or in addition to, controlling influence concerns.

Other clarifications

1. Application to the BHCA

In response to questions from commenters, the Federal Reserve clarified in the final rule's preamble that the final rule is intended to apply to all questions of control under the BHCA (and HOLA). This includes all questions of activities restrictions under the BHCA. For instance, the Federal Reserve clarified in response to one question that the new framework applies for purposes of section 4(c)(6) of the BHCA and the Federal Reserve's related interpretation in Regulation Y. Accordingly, it seems that if an investor has less than 5% of any class of voting securities (and does not trigger the presumptions of control under the new framework), the investment should qualify for purposes of section 4(c)(6) and the related interpretation.

2. Calculating voting ownership

The final rule includes a methodology for calculating an investor's total equity percentage in a company that is a stock corporation that prepares financial statements in accordance with US GAAP. The methodology has three steps:

- **Step one**: Calculate the investor's total equity (controlled directly or indirectly through its subsidiaries) in the company to determine the percentage of each class of the company's voting and nonvoting common or preferred stock controlled by the investor.
- **Step two**: Multiply the percentage of each class of stock controlled by the investor by the value of shareholders' equity allocated to the class under US GAAP, with retained earnings allocated to common stock.
- **Step three**: Divide the investor's dollars of shareholders' equity by the total shareholders' equity.

The final rule includes various clarifications to the calculation methodology. For one, the final rule provides that *pari passu* classes of preferred stock are treated as a single class. The methodology includes an anti-evasion provision that requires an investor to count as equity any debt that the investor holds in the company that is functionally equivalent to the company's equity, and the final rule includes a non-exclusive list of factors that the Federal Reserve would examine in determining whether to treat particular debt instruments as functionally equivalent to equity. In the final rule's preamble, the Federal Reserve indicates that it expects to reclassify debt as equity only under unusual circumstances, but investors are presumably expected to apply the factors identified in the final rule in making their own evaluation of the control implications of an acquisition of debt instruments with one or more equity-like features. The final rule also allows the investor to exclude from the calculation of its equity ownership interest an equity instrument that is functionally equivalent to debt.

The calculation of total equity must be done each time that an investor acquires control over equity instruments of a company (including any debt instruments that are functionally equivalent to equity). The calculation is not required when the investor disposes of equity, so as to prevent a divestiture from causing an increase in total equity due to balance sheet changes at the company. While the methodology was designed specifically for, and applies by terms only to, stock corporations, the Federal Reserve has indicated that it would generally apply the methodology in other circumstances as appropriate.

3. Nonvoting securities

The final rule includes a new definition of "nonvoting securities," replacing the existing Regulation Y definition of "nonvoting shares." Consistent with the definition of "nonvoting shares" currently in Regulation Y, common shares, preferred shares, limited partnership interests, limited liability company interests and similar interests are not considered voting securities if:

- Any voting rights are limited to the type customarily provided by statute with regard to matters that would significantly and adversely affect the rights or preference of the security, such as the issuance of additional amounts or classes of senior securities, the modification of the terms of the security, the dissolution of the issuer or the payment of dividends by the issuer when preferred dividends are in arrears;
- The securities represent an essentially passive investment or financing device and do not otherwise provide the holder with control over the issuer; and
- The securities do not entitle the holder to select or vote for the selection of directors, trustees or partners (or persons exercising similar functions) of the issuer.

However, with regard to the third prong of the definition of "nonvoting securities," the final rule clarifies that a security is not considered to be a voting security where it entitles the holder with the right to vote to remove a general partner or managing member for cause, the right to vote to replace a general partner or managing member that has been removed for cause or has become incapacitated, or the right to vote to dissolve the issuer or to continue the issuer's operations following the removal of a general partner or managing member.

4. Threats to dispose of securities

Although historically the Federal Reserve has considered an investor's threats to dispose of large blocks of voting or nonvoting securities in an effort to influence the policy and management decisions of a company as potentially raising controlling influence concerns (especially for investors that control 10% or more of any class of a company's voting securities), the new framework does not include any presumption of control for making threats to dispose of securities, as mentioned above.

5. Voting securities held by a non-subsidiary

The Federal Reserve has not included the express statement from the proposed rule that an investor (or company) does not control securities that are controlled by a non-subsidiary of that investor (or company). The Federal Reserve indicated in the final rule's preamble that it continues generally to take the view that an investor (or company) should not be deemed to control securities held by an entity in which the investor (or company) has some ownership stake or other interest but which does not meet the BHCA criteria for being a subsidiary of that investor (or company). The Federal Reserve did not include this provision in the final rule to avoid creating an expectation that an investor (or company) would never be deemed to control securities held by a non-subsidiary. For example, a party generally is deemed to control securities held by a non-subsidiary if the party has an option to acquire those securities.

6. Convertible securities

The final rule clarifies the Federal Reserve's traditional "look-through" approach for analyzing the effect of options and warrants to acquire securities and convertible instruments on the holder's ownership stake in the issuer. Under this approach, a person would control:

- All securities that the person could control upon exercise of any options or warrants; and
- All securities that the person could control as a result of the conversion or exchange of a convertible instrument controlled by the person.

A person would be deemed to control the maximum number of securities that could be obtained under the terms of the option, warrant or convertible instrument. The person's percentage ownership of a class of voting securities or of the total equity of the issuer would be calculated as if the securities controlled by the person as a result of the options, warrants or conversion features were issued and outstanding. In contrast, none of the securities controlled by any other person as a result of options, warrants or conversion features would be deemed to be issued and outstanding—i.e., the calculation would be made on the assumption that no other person had exercised any options, warrants or conversion features. However, if a person could only exercise an option, warrant or conversion feature when all outstanding options, warrants or conversion features for the class did so simultaneously, the percentage of the resulting securities that would be deemed to be controlled by the person would reflect the exercise of *all* outstanding options, warrants or conversion features for that class, rather than only those held by the person.

The final rule provides for several limited exceptions to this look-through approach, as were contained in the proposed rule but with the addition of a new exception concerning preferred securities. Under those exceptions, the following arrangements would not lead to a person being deemed to control an issuer's voting securities:

- Ownership of financial instruments that may convert into voting securities but by their terms may not become voting securities in the hands of the current owner or affiliate and may only convert to voting securities following a transfer (i) to the issuer, (ii) in a widespread public distribution, (iii) in transfers where no transferee or group of associated transferees would receive 2% or more of any class of voting securities of the issuer, or (iv) to a transferee that controls 50% or more of every class of voting securities before the transfer;
- Purchase agreements to acquire securities that have not yet closed (e.g., pending closing, regulatory approval, due diligence);

- Ownership of options, warrants or convertible instruments allowing an investor to acquire additional voting securities to maintain the investor's percentage of voting securities when a company increases the number of its outstanding voting securities; and
- Ownership of preferred securities that have no voting rights unless the issuer fails to pay dividends for six or more quarters, which are only considered voting securities if a sufficient number of dividends are missed and the voting rights are active. However, securities with springing voting rights that do not meet this exception are generally considered to be voting securities under the look-through approach.

7. Restrictions on securities

The final rule incorporates the provision in existing Regulation Y that an investor controls securities if the investor is a party to an agreement or understanding under which the rights of the owner or holder of the securities are restricted in any manner, unless the agreement or understanding is covered by an exception specified in the rule. While some of the exceptions are new additions to Regulation Y, the additions are generally consistent with existing Federal Reserve practice and include the following:

- Rights of first refusal, rights of last refusal, tag-along rights, drag-along rights or similar rights that are on market terms and that do not impose significant restrictions on the transfer of the securities;
- Arrangements that restrict the rights of an owner or holder of securities when the restrictions are incidental to a *bona fide* loan transaction;
- Arrangements that restrict the ability of a shareholder to transfer securities for a reasonable amount of time pending the consummation of an acquisition of the securities;
- Arrangements that require a current shareholder of a company to vote in favor of a proposed acquisition of the company, or against competing transactions, if the restriction continues only for a reasonable amount of time necessary to complete the transaction;
- Arrangements among the shareholders of a company designed to preserve the tax status or tax benefits of a company, such as qualifying as a Subchapter S Corporation or to preserve tax assets (such as net operating losses) against impairment; and
- Short-term revocable proxies.

8. Use of passivity commitments; current passivity commitments

Future use of passivity commitments

In what portends to be a significant change to how the Federal Reserve staff makes control determinations, the Federal Reserve explains in the final rule's preamble that it does not intend to obtain standard-form passivity commitments under ordinary circumstances going forward.

In unusual or special circumstances, as determined by the Federal Reserve (for which there is no stated criteria), the Federal Reserve may require certain passivity commitments. In addition, the Federal Reserve has indicated that it will continue to obtain control-related commitments in specific contexts, for example, for employee stock ownership plans and mutual fund complexes.

Current passivity commitments

The Federal Reserve has also clarified that it does not plan to revisit structures that it has already reviewed with regard to control issues unless there are material changes to the underlying facts and circumstances. Therefore, while there is no formal grandfathering provision for commitments or structures reviewed by the Federal Reserve that may be more generous than the new framework allows, there appears to be a *de facto* grandfathering for these arrangements. If an investor, however, did not subject its investment structure to Federal Reserve review and instead has relied on a previous understanding of Federal Reserve policy or practice that was more lenient in some manner than the new framework allows, the Federal Reserve has indicated that those investors may contact Federal Reserve staff.

Appendix A: Limiting contractual rights

1. Examples of what constitutes a limiting contractual right:

The final rule amends Regulation Y to include a non-exhaustive list of examples of contractual rights that allow the investor to restrict significantly a company's discretion over operational and policy decisions. These limiting contractual rights include rights that allow the investor to restrict or to exert significant influence over the company's decisions related to:

- Activities in which the company may engage, including a prohibition on entering into new lines of business, making substantial changes to or discontinuing existing lines of business or entering into a contractual arrangement with a third party that imposes significant financial obligations on the company;
- How the company directs the proceeds of the investor's investment;
- Hiring, firing or compensating one or more senior management officials of the company, or modifying the company's policies or budget concerning the salary, compensation, employment or benefits plan for its employees;
- The company's ability to merge or consolidate, or its ability to acquire, sell, lease, transfer, spin-off, recapitalize, liquidate, dissolve or dispose of subsidiaries or assets;
- The company's ability to make investments or expenditures;
- The company achieving or maintaining a financial target or limit, including, for example, a debt-to-equity ratio, a fixed charges ratio, a net worth requirement, a liquidity target, a working capital target or a classified assets or nonperforming loans limit;
- The company's payment of dividends on any class of securities, redemption of senior instruments or voluntary prepayment of indebtedness;
- The company's ability to authorize or issue additional junior equity or debt securities, or to amend the terms of any equity or debt securities issued by the company;
- The company's ability to engage in a public offering or to list or de-list securities on an exchange, other than a right that allows the securities of the investor to have the same status as other securities of the same class;
- The company's ability to amend its articles of incorporation or by-laws, other than in a way that is solely defensive for the investor;
- The removal or selection of any independent accountant, auditor, investment adviser or investment banker employed by the company; or
- The company's ability to significantly alter accounting methods and policies, or its regulatory, tax or liability status (e.g., converting from a stock corporation to a limited liability company).

2. Examples of what does not constitute a limiting contractual right

The final rule also amends Regulation Y to include a non-exhaustive list of examples of rights that would not allow an investor to significantly restrict, directly or indirectly, the discretion of a company over its operational and policy decisions. Those rights include:

- A right that allows the investor to restrict or to exert significant influence over decisions relating to the company's ability to issue securities senior to the securities owned by the investor;
- A requirement that the investor receive financial reports or other information of the type ordinarily available to common stockholders;

- A requirement that the company maintain its corporate existence;
- A requirement that the company consult with the investor on a reasonable periodic basis;
- A requirement that the company provide notices of the occurrence of material events affecting the company;
- A requirement that the company comply with applicable statutory and regulatory requirements;
- A market standard requirement that the investor receive similar contractual rights as those held by other investors in the company;
- A requirement that the investor be able to purchase additional securities issued by the company in order to maintain the investor's percentage ownership in the company;
- A requirement that the company ensure that any securityholder that intends to sell its securities of the company provide other securityholders of the company or the company itself the opportunity to purchase the securities before the securities can be sold to a third party; or
- A requirement that the company take reasonable steps to ensure the preservation of tax status or tax benefits, such as status of the company as a Subchapter S corporation or the protection of the value of net operating loss carry-forwards.

Appendix B: Total equity calculation

As explained above, this method applies to stock corporations that prepare financial statements under US GAAP. Other companies must calculate total equity in a reasonably consistent way, with appropriate adjustments.

Investor common equity equals:

$$\frac{\text{(\# of shares of company's common stock that investor controls)}}{\text{(total \# of shares of the company's common stock issued and outstanding)}} \times \text{Company shareholders' equity not allocated to the class of preferred stock under US GAAP}$$

subject to a floor of zero.

Note: If there are multiple classes of common stock outstanding and different classes have different economic interests (e.g., 3:1) in the company on a per share basis, adjust the number of shares of common stock proportionally so that each share has the same economic interest (e.g., 3 adjusted shares for one class of shares, and 1 adjusted share for the other class of shares).

Retained earnings are allocated to common stock.

Investor preferred equity equals

$$\frac{\text{(\# of shares of the class of company's preferred stock that investor controls)}}{\text{(total \# of shares of the class of preferred stock issued and outstanding)}} \times \text{Company shareholders' equity allocated to the class of preferred stock under US GAAP}$$

subject to a floor of zero.

Note: If there are different classes of preferred stock with equal seniority (i.e., pari passu classes of preferred stock), the pari passu shares are treated as a single class. If pari passu classes of preferred stock have different economic interests in the company on a per share basis (e.g. 3:1), adjust the number of shares of preferred stock proportionally so that each share has the same economic interest (e.g., 3 adjusted shares for one class of shares, and 1 adjusted share for the other class of shares).

$$\text{Total equity} = \frac{\text{(Investor common equity) + (Investor preferred equity for each class of preferred stock issued)}}{\text{(Issuer (i.e., Company) shareholders' equity)}}$$

Although issuer shareholders' equity is not defined in the final rule, we believe it refers to **the total amount of shareholders' equity of the company under US GAAP.**

As noted, this measure ***includes*** the principal amount of **all debt instruments** and the market value of all other interests that are **functionally equivalent to equity** that are outstanding.

AMERICAS

New York

Ian Cuillerier
Partner, New York
T +1 212 819 8713
E icuillerier@whitecase.com

Glen Cuccinello
Counsel, New York
T +1 212 819 8239
E glen.cuccinello@whitecase.com

Edward So
Partner, New York
T +1 212 819 7006
E edward.so@whitecase.com

Duane Wall
Partner of Counsel, New York
T +1 212 819 8453
E dwall@whitecase.com

Francis Zou
Partner, New York
T +1 212 819 8733
E francis.zou@whitecase.com

Washington, DC

Era Anagnosti
Partner, Washington, DC
T +1 202 637 6274
E era.anagnosti@whitecase.com

Steve Chabinsky
Retired Partner of Counsel,
Washington, DC
T +1 202 626 3587
E steven.chabinsky@whitecase.com

Nicole Erb
Partner, Washington, DC
T +1 202 626 3694
E nicole.erb@whitecase.com

Shamita Etienne-Cummings
Partner, Washington, DC
T +1 202 626 3695
E shamita.etienne@whitecase.com

Jeremy Kuester
Counsel, Washington, DC
T +1 202 637 6284
E jeremy.kuester@whitecase.com

Prat Vallabhaneni
Partner, Washington, DC
T +1 202 626 3596
E prat.vallabhaneni@whitecase.com

EMEA

Berlin

Henning Berger
Partner, Berlin
T +49 30 880911 540
E henning.berger@whitecase.com

Dubai

Adrianus Schoorl
Local Partner, Dubai
T +971 4 381 6273
E adrianus.schoorl@whitecase.com

Frankfurt

Dennis Heuer
Partner, Frankfurt
T +49 69 29994 1576
E dennis.heuer@whitecase.com

Matthias Kasch
Partner, Frankfurt
T +49 69 29994 1219
E matthias.kasch@whitecase.com

Hamburg

Carsten Loesing
Local Partner, Hamburg
T +49 40 35005 265
E carsten.loesing@whitecase.com

Helsinki

Tanja Törnkvist
Partner, Helsinki
T +358 9 228 64 351
E tanja.tornkvist@whitecase.com

Istanbul

Asli Basgoz
Partner, Istanbul
T +90 212 354 2013
E asli.basgoz@whitecase.com

London

Jonathan Rogers
Partner, London
T +44 20 7532 2163
E jonathan.rogers@whitecase.com

Patrick Sarch
Partner, London
T +44 20 7532 2286
E patrick.sarch@whitecase.com

Julia Smithers Excell
Partner, London
T +44 20 7532 2229
E julia.smithers.excell@whitecase.com

Stuart Willey
Partner, London
T +44 20 7532 1508
E stuart.willey@whitecase.com

Ingrid York
Partner, London
T +44 20 7532 1441
E ingrid.york@whitecase.com

Madrid

Yoko Takagi
Partner, Madrid
T +34 91 7876 320
E yoko.takagi@whitecase.com

Milan

Iacopo Canino
Partner, Milan
T +39 0200688 340
E iacopo.canino@whitecase.com

Paris

Grégoire Karila
Partner, Paris
T +33 1 55 04 58 40
E gregoire.karila@whitecase.com

Thomas Le Vert
Partner, Paris
T +33 1 55 04 15 67
E thomas.levert@whitecase.com

Jean-Pierre Picca
Partner, Paris
T +33 1 55 04 58 30
E jeanpierre.picca@whitecase.com

Emilie Rogey
Partner, Paris
T +33 1 55 04 16 22
E emilie.rogey@whitecase.com

Stockholm

Martin Järvengren
Partner, Stockholm
T +46 8 506 32 371
E martin.jarvengren@whitecase.com

Warsaw

Tomasz Ostrowski
Partner, Warsaw
T +48 22 50 50 123
E tostrowski@whitecase.com

Marcin Studniarek
Partner, Warsaw
T +48 22 50 50 132
E marcin.studniarek@whitecase.com

ASIA-PACIFIC

Tokyo

Nels Hansen
Partner, Tokyo
T +81 3 6384 3240
E nels.hansen@whitecase.com

White & Case LLP
1221 Avenue of the Americas
New York, New York 10020-1095
United States

T +1 212 819 8200

White & Case LLP
701 Thirteenth Street, NW
Washington, District of Columbia 20005-3807
United States

T +1 202 626 3600

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1 The BHCA and the Home Owners' Loan Act (HOLA) have substantially similar definitions of control. As a result, the final rule also amends Regulation LL, which implements HOLA, in an essentially similar manner.

Nevertheless, there are key differences between HOLA and the BHCA: (1) HOLA governs control of savings associations by *individuals* and companies (the BHCA concerns control of banks by companies); (2) under HOLA, a person controls a company if that person has more than 25% of any class of that company's voting securities (under the BHCA, more than 24.99%); (3) under HOLA, a person that contributes more than 25% of the capital of a company controls that company; and (4) HOLA does not include the BHCA presumption of non-control for a company with less than a 5% voting interest in another company. Accordingly, the final rule amends Regulation LL so that for purposes of HOLA, contributed capital has the same meaning as total equity as used by the Federal Reserve in control analyses under the BHCA. As a result, the maximum total equity a non-controlling investor may have under Regulation LL and HOLA is 25% or less (compared with less than 33.3% for purposes of Regulation Y and the BHCA).

2 The Federal Reserve's control framework under the final rule and the BHCA do not apply to, for instance, individuals who make investments, or other persons who do not meet the definitional requirements under the BHCA (e.g., qualified family partnerships).

3 The Federal Reserve noted in the preamble to the final rule that it may consider conforming revisions to other elements of its regulatory framework, including the Change in Bank Control Act, Regulation O, and Regulation W.

4 *See* our December 2019 article, *Tailored enhanced prudential standards for non-US banks*.

5 Transcript of Open Board Meeting, Federal Reserve (April 23, 2019), https://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20190423.pdf.

6 If either of these two statutory tests is met, the investor is conclusively determined to have control without any analysis under the controlling-influence test and its rebuttable presumptions of control and non-control.

7 Control of a majority of board seats would satisfy the board test under the BHCA.

8 According to one report, the average board size for S&P 500 companies is 11; for large diversified banks on S&P, approximately 14; and for regional banks on S&P 500, 13. Spencer Stuart, 2019 U.S. Spencer Stuart Board Index, 2019, https://www.spencerstuart.com/-/media/2019/ssbi-2019/us_board_index_2019.pdf. In addition, one Federal Reserve study found that the average number of board members at a sample of US banks from 1999–2015 was 13. Owen, Ann L., and Judit Temesvary. "Gender Diversity on Bank Board of Directors and Performance," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, February 12, 2019, https://doi.org/10.17016/2380-7172.2270.

9 Please refer to note 1 for HOLA and Regulation LL considerations.

10 Currently at 12 CFR 225.28(b)(6)(i)–(iv).

11 Starting at the time voting equity became less than 25%.

12 Former section 2(g)(3) of the BHCA 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.

13 The draft final rule's footnote 54, which accompanies a simplified explanation, cites to the same Federal Reserve legal interpretation that appears in the preamble to the proposed rule, which accompanies a more detailed explanation, 84 Fed. Reg., 21634, 21645 (May 14, 2019).

14 Currently at 12 CFR 225.31(d)(2)(ii).

15 This exception would also apply in Regulation LL to provide parallel treatment under the BHCA and HOLA.

16 12 CFR 225.31(d)(2)(iv).

17 The preamble to the final rule also includes a discussion of the interaction of the final rule and the intermediate holding company (IHC) requirements of the Federal Reserve's Regulation YY (Enhanced Prudential Standards), under which a non-US banking organization that is required to form a US IHC must hold all ownership interests in US subsidiaries through its US IHC. The Federal Reserve notes that, in general, ownership interests under the IHC requirements do not include contractual relationships, including contractual relationships that result in consolidation of a company under the variable interest entity standard. As a result, where a US branch of a non-US bank has a contract with an entity (the Federal Reserve uses the example of an asset-backed commercial paper conduit) that causes that entity to be consolidated by the US branch under the variable interest entity standard, the contract is not an ownership interest and, therefore, may remain between the branch and the conduit.