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Memorandum

Federal Reserve Proposes Significant Changes to Control Rules

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On April 23, 2019, the Federal Reserve issued a proposed rulemaking that would clarify and, in some respects, revise its existing framework for determining whether a company has the ability to exercise a "controlling influence" over another company for purposes of the Bank Holding Company Act ("BHC Act") and the Home Owners' Loan Act ("HOLA"). The proposal includes a tiered framework of major factors and thresholds generally structured so that, as an investor's ownership percentage in a target company increases, the investor's additional relationships and other controlling influence factors with the target company must decrease in order to avoid a presumption of control. The proposal also would include several other presumptions of control, new rules for how a company can terminate an existing control relationship, and additional provisions to clarify how the presumptions would apply in particular circumstances.

As a whole, the proposal generally would codify a significant portion of the Federal Reserve's current practice with respect to "controlling influence" determinations. However, the proposal also includes some liberalizing changes to the current "controlling influence" framework, including adjustments to (i) the scope and type of relationships an investor with less than a 15% voting interest in a target company could have with such target company without triggering a presumption of control (which is particularly important for investments by banking organizations in fintech companies and other start-ups), (ii) the number of director representatives at a target company that an investor would be permitted to have without triggering a presumption of control (currently limited to 1) and the ability of those director representatives to serve on the audit, compensation, and executive committees, or serve as chair of the board or any committees, and (iii) the terms on which a parent company or other controlling stockholder may divest control of a subsidiary. In addition, the proposal would provide more flexibility for significant stockholders to engage in proxy contexts or other kinds of stockholder activism without triggering a control presumption.

Following is a high-level summary of key features of the proposal.

Background

Control is a core concept under the BHC Act and related statutes. Most importantly, the concept of "control" is used to determine whether the BHC Act applies to a particular investor, since any company that directly or indirectly controls a bank is a bank holding company subject to the BHC Act's activity restrictions and the Federal Reserve's supervisory oversight. The BHC Act's concept of "control" is also a key determinant in the applicability of the Volcker Rule, the ability of a bank holding company to engage in nonbanking activities, and other restrictions on a banking organization's affiliations.

For purposes of the BHC Act, 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% or more of any class of voting securities of the second company; (ii) controls in any manner the election of a majority of the directors of the second company; or (iii) directly or indirectly exercises a controlling influence over the management or policies of the second company.[1] In addition, the BHC Act provides that a company controlling less than 5% of any class of voting securities of another company is presumed *not* to control the second company.

While the first two prongs of the BHC Act's control analysis involve relatively straightforward rules, the third "controlling influence" prong involves a fact-based determination by the Federal Reserve that has historically involved the assessment of a variety of factors, including:

- the size and structure of the first company's voting and total equity investment in the second company;
- the first company's rights to director representation, the first company's director representative's service on committees or as chairman of the board, and any common management, employees, or directors between the two companies;
- any covenants or other agreements that allow the first company to influence or restrict management decisions of the other company; and
- the nature and scope of the business relationships between the two companies.

While the Federal Reserve has issued various public policy statements to provide guidance regarding the "controlling influence" prong (most recently in 2008), the Federal Reserve's general framework for determining whether a company is able to exercise a controlling influence over another company has not previously been consolidated to a single source and many of the specific standards have not been issued publicly. This lack of transparency regarding the Federal Reserve's control framework has historically

[1] The definition of control for purposes of HOLA is substantially similar. Although this memorandum discusses control in the context of the BHC Act, the control concepts and the proposed rules would generally apply equally to savings and loan holding companies under HOLA, with the exception that "control" under HOLA includes an additional prong based on an investor's contributed capital in a target company.

caused significant frustration among investors and financial institutions seeking to engage in capital raising or strategic transactions.

In this context, the proposal is intended to bring transparency and consistency to issues of control and clarify when common situations may give rise to control concerns.

Tiered Framework for Presumptions of Control

In general, the proposal would create a tiered series of presumptions of control keyed off of three threshold levels of voting ownership by one company in a second company: 5%, 10% and 15%. For each level of voting ownership, the proposal would specify the degree to which the two companies could have other specified relationships without triggering a presumption of control.

A. Less Than 5% Voting Securities

As noted above, the BHC Act provides a statutory presumption that a company that controls less than 5% of any class of voting securities of another company is presumed not to control the second company.

While a company controlling less than 5% of any class of voting securities of another company could, under current Federal Reserve practice, be found to exercise a "controlling influence" over the second company based on other factors, the proposal clarifies that such a company would generally only control the second company if it controls a majority of the board of directors of the second company (and thereby meets the second prong of the BHC Act's "control" definition) or controls more than one-third of the second company's total equity. Thus, a shareholder with less than 5% voting interest and less than one-third total equity would not be restricted in its ability to have business relationships (including with respect to the size and nature of the business relationships as well as whether the business relationships are on market terms) and management or employee interlocks with the target company. Further, the proposal would impose no restrictions on the ability of such a shareholder to have its representatives serve as chair of the second company's board of directors or on committees of the second company's board, or initiate proxy contexts regarding the election of directors of the second company.

However, the proposal would presume that a company with a less-than-5%-voting interest in another company controls the second company if the first company has a management agreement under which it can direct or exercise significant influence over the management or operations of the second company, as discussed further below.

B. 5% to 9.99% Voting Securities

For a company that controls between 5% and 9.99% of any class of voting securities of a second company, the proposal would presume that the first company controls the second company if:

- *Total Equity*: The first company holds one-third or more of the total equity of the second company;
- *Director Representation*: The first company controls one-quarter or more of the second company's board of directors, or if the first company's director representatives are able to make or block the making of major operational or policy decisions of the second company (*e.g.*, through supermajority voting requirements, individual veto rights, or any similar provisions that would allow a minority of the board to control major operational or policy decisions of the second company);
- *Business Relationships*: The first company has business relationships with the second company that generate 10% or more of the total annual revenues or expenses of either the first or second company;
- *Management Interlocks*: More than one employee or director of the first company serves as a senior management official of the second company, or if any employee or director of the first company serves as the chief executive officer (or an equivalent role) of the second company; or
- *Contractual Powers*: The first company has any contractual right that significantly restricts the discretion of the second company over major operational or policy decisions. The proposal includes a non-exclusive list of such contractual rights (which list is generally consistent contractual rights that the Federal Reserve views as limiting under current practice, although the proposed list appears to loosen a company's ability to contract for informational access without being deemed to control the second company). As discussed below, the Federal Reserve noted that many of these contractual restrictions are permissible in loan agreements, but would not be permissible if the creditor is also a 5% or larger voting shareholder.

C. 10% to 14.99% Voting Securities

For a company that controls between 10% and 14.99% of any class of voting securities of a second company, the proposal would presume that the first company controls the second company if:

- *Total Equity*: The first company holds one-third or more of the total equity of the second company;
- *Director Representation*: The first company controls one-quarter or more of the second company's board of directors, or if the first company's director representatives are able to make or block the making of major operational or policy decisions of the second company (*e.g.*, through supermajority voting requirements, individual veto rights, or any similar provisions that would allow a minority of the board to control major operational or policy decisions of the second company);
- *Board Chair/Committees*: The first company's director representatives hold more than one-quarter of the positions on any board committee with power to bind the second company without the need for additional action by the full board of directors (*e.g.*, the audit committee, compensation committee, and executive committee);

- *Business Relationships*: The first company has business relationships with the second company that generate 5% or more of the total annual revenues or expenses of either the first or second company, or that are not on market terms;
- *Management Interlocks*: More than one employee or director of the first company serves as a senior management official of the second company, or if any employee or director of the first company serves as the chief executive officer (or an equivalent role) of the second company;
- *Contractual Powers*: The first company has any contractual right that significantly restricts the discretion of the second company over major operational or policy decisions; or
- *Proxy Contests*: The first company solicits proxies to appoint one-quarter or more of the total number of directors on the second company's board.

D. 15% to 24.99% Voting Securities

For a company that controls between 15% and 24.99% of any class of voting securities of a second company, the proposal would presume that the first company controls the second company if:

- *Total Equity*: The first company holds 25% or more of the total equity of the second company;
- *Director Representation*: The first company controls one-quarter or more of the second company's board of directors, or if the first company's director representatives are able to make or block the making of major operational or policy decisions of the second company (*e.g.*, through supermajority voting requirements, individual veto rights, or any similar provisions that would allow a minority of the board to control major operational or policy decisions of the second company);
- *Board Chair/Committees*: The first company's director representatives hold more than one-quarter of the positions on any board committee with power to bind the second company without the need for additional action by the full board of directors (*e.g.*, the audit committee, compensation committee, and executive committee), or if any director representative of the first company also serves as the chair of the board of directors of the second company;
- *Business Relationships*: The first company has business relationships with the second company that generate at least 2% of the total annual revenues or expenses of either the first or second company, or that are not on market terms;
- *Management Interlocks*: Any employee or director of the first company serves as a senior management official of the second company;
- *Contractual Powers*: The first company has any contractual right that significantly restricts the discretion of the second company over major operational or policy decisions; or
- *Proxy Contests*: The first company solicits proxies to appoint one-quarter or more of the total number of directors on the second company's board.

Notably, an investor's director representative serving as chair of the target company's board of directors would not trigger a presumption of control unless the investor has at least a 15% voting interest in the target company, and there would no longer be a restriction on a director representative of any investor chairing a committee.

A summary of these tiered presumptions of control is attached in the Appendix.

Exceptions and Other Presumptions

A. Exceptions to Control Presumptions

Consistent with the Federal Reserve's existing practice, the presumptions of control described above would not apply if the second company is a registered investment company and (i) the only business relationships between the first company and the investment company are investment advisory, securities brokerage or certain fiduciary services provided by the first company to the investment company; (ii) representatives of the first company occupy 25% or less of the board of directors or trustees of the investment company; and (iii) unless the first company organized and sponsored the second company within the preceding 12 months, the first company controls less than 5% of each class of voting securities of the investment company and less than 25% of the total equity of the investment company.

The presumptions of control described above would also 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.

B. Other Presumptions of Control

In addition to the tiered presumption framework described above, the proposal would include several additional presumptions of control that would apply regardless of a company's voting interest in another company.

First, the proposal would presume that a company controls another company if the first company has a management agreement under which the first company can direct or exercise significant influence over the management or operations of the second company. Management agreements that trigger a presumption of control (even for a below-5% voting shareholder) would include any agreement for a company to serve as a managing member, trustee, or general partner of a second company, or exercise similar functions.

Second, the proposal would presume that a company controls an investment fund if the company serves as investment adviser to the fund and controls at least 5% of any class of the fund's voting securities or 25% of the fund's total equity. However, the proposal would allow a twelve-month seeding period during which this presumption of control would not apply to funds organized and sponsored by the investment adviser.

Third, the Federal Reserve would presume that a company controls another company if the first company consolidates the second company under U.S. generally accepted accounting principles. In the proposal, the Federal Reserve requested public input as to whether the fact that an investor accounts for an investment using the equity method of accounting should also trigger a presumption of control.

C. Presumption of Non-Control

Under the proposal, a company would be presumed not to control a second company if the first company controls less than 10% of every class of voting securities of the second company and if the first company does not meet any of the proposed presumptions of control with respect to the second company.

Divestiture

The Federal Reserve historically has taken the position that a company that has controlled another company for a significant period of time may be able to exert a controlling influence over that company even after a substantial divestiture of the first company's equity interest in the second company. As a result, the Federal Reserve typically has applied a stricter standard for determining non-control in divestiture cases than in cases where a company seeks to establish a new non-controlling investment.

The proposal would substantially revise the Federal Reserve's existing standards regarding divestiture of control to effectively provide that a company that previously controlled another company due to ownership of greater than 25% of any a class of voting securities of the second company or the ability to control the election of the majority of the board of the second company (i.e., the first two prongs of the BHC Act's "control" definition) would not be presumed to control the second company immediately upon divesting its equity interest to below 15% of any class of the former subsidiary's voting securities and no longer controlling the majority of the second company's board (as long as the company does not otherwise trigger one of the presumptions discussed above). Following the divestiture, the former controlling shareholder's voting ownership in the former subsidiary would have to remain below 15% of any class of voting securities for two years in order for the company to continue not to be deemed controlling. Alternatively, the proposal would allow a company to divest its interest in a former subsidiary to between 15% and 24.99% of every class of the former subsidiary's voting securities and remain below 24.99% voting for a period of at least two years, at which point the company would be deemed not to control the former subsidiary. In both cases, the divesting company would also need to meet the other requirements for non-control applicable to its ownership level described above. The proposal would eliminate the stricter divestiture standard in circumstances where a company that was previously presumed to control another company (based on one of the presumptions discussed above) no longer falls within one of the control presumptions.

In addition, the presumption of control in a divestiture would not apply if a majority of each class of voting securities of the company that is being sold is acquired by a single shareholder that is unaffiliated with the

divesting company, or if a divesting company sells a subsidiary to a third company and receives stock of the third company as consideration for the sale.

Other Technical Changes

The proposal also includes certain technical clarifications regarding the calculation of voting and non-voting securities, and the number of securities that a person is deemed to control (including clarifications regarding the treatment of convertible securities, options and warrants, as well as securities held by senior management officials).

The proposal clarifies that the definition of "voting securities" does not include limited partnership interests or membership interests in limited liability companies with voting rights that are limited solely to voting for the removal of a general partner or managing member (or persons exercising similar functions at the company) for cause, to replace a general partner or managing member (or persons exercising similar functions at the company) due to incapacitation or following the removal of such person, or to continue or dissolve the company after removal of the general partner or managing member (or persons exercising similar functions at the company). To the extent that an investment fund limits the voting rights of limited partners to these types of defensive voting rights, a banking organization investor in such a fund may no longer require a separate partnership agreement provision to automatically reduce its voting interest to below 5%.

The proposal codifies the Federal Reserve's existing practice of deeming a person to control a security through control of an option or warrant to acquire the security or through control of a convertible instrument that may be converted into or exchanged for the security, whether or not currently exercisable. Under the proposal's "look-through" approach, a person would be deemed to control the maximum number of securities that the person could control upon exercise or conversion of the option, warrant or convertible instrument, even if there were an unsatisfied condition precedent to the exercise or conversion of the instrument or if the instrument was significantly out of the money. Moreover, the proposal includes assumptions that would cause the person to be considered to control the highest possible percentage of the class of securities that could ever be acquired under the terms of the instrument. In the case of a convertible instrument based on a floating rate or price, the proposal would assume that the convertible instrument is exercised or converted at a rate or price that would cause the person to control the highest possible percentage of the class of securities that could ever be acquired under the terms of the instrument. This assumption would not apply to anti-dilution provisions in instruments that allow an investor to acquire additional voting securities "only to maintain the investor's percentage of voting securities in the event the company increases the number of its outstanding securities." It is not clear how other customary anti-dilution provisions (such as upon the payment of non-ordinary course dividends) would be treated under the proposed rule.

The proposal also provides a standard for calculating a company's total equity percentage in a second company that is a stock corporation that prepares financial statements according to GAAP. The calculation would be based on the first company's percentage ownership of each class of such stock of a second company multiplied by the value of shareholders' equity allocated to that particular class of stock under GAAP, all of which would be divided by the second company's total shareholders' equity. For purposes of calculating total equity, the proposal codifies a common Federal Reserve practice of attributing all equity securities owned by a subsidiary to its parent and also attributing a proportional ownership of total equity that is indirectly owned by the first company through the parent of a second company. For example, if Company A owns 10% of the total equity of Company B, and Company B owns 50% of the total equity Company C (such that Company B controls Company C), Company A would be deemed to own 5% of the total equity of Company C (10% of 50%). An investor would only be required to calculate its total equity percentage in another company upon the acquisition or sale of equity instruments in the second company and would not have to recalculate its percentage of total equity ownership solely as a result of changes in the second company's shareholders' equity (e.g., due to earnings or losses).

Finally, the proposal codifies the Federal Reserve's position that customary rights of first refusal, tag-along and drag-along rights, do not reflect control by stockholders over the covered shares as long as they are relatively short-term (e.g., must be exercisable within 30 days) and are on market terms.

Material Changes From Historical Federal Reserve Practice

The substance of the proposal is generally consistent with the Federal Reserve's current control framework, with a "few targeted policy adjustments." While the most significant aspect of the proposal would be a move by the Federal Reserve away from assessing "controlling influence" based on unpublished standards to a more transparent, rule-based framework, the proposal also would have significant impacts in the following areas:

- *Investments in Non-Financial Companies under Section 4(c)(6) of the BHC Act*. Under section 4(c)(6) of the BHC Act, a banking organization may invest in a non-financial commercial company if the investment represents less than 5% of any class of voting shares of the company and the company is not otherwise controlled by the banking organization. Although the proposal does not directly expand this 4(c)(6) authority, it would clarify that a banking organization making a 4(c)(6) investment would not be limited in the amount of business relationships, director representation and committee service (as long as the banking organization did not have more than a majority of the board of the target), officer or employee interlocks, or contractual rights (as long as such rights do not result in a "management agreement") it could have with respect to a target company. This liberalization may be particularly important for banking organizations investing in start-up companies (including fintech companies), where the banking organization is both an investor and a large customer of the start-up company.

- *Board and Committee Representation*. Under current Federal Reserve standards, a non-controlling investor is generally limited to one director representative on a target company's board (with two director representatives permitted under rare circumstances). In addition, current Federal Reserve standards restrict a non-controlling investor's director representative from serving as the chairman of the target company's board or of any board committee, and from serving at all on certain committees (*e.g.*, the executive, audit, or compensation committee). The proposal would significantly liberalize the number of director representatives a non-controlling investor would be permitted to have on a target's board of directors, as well as the ability of such representatives to serve on board committees or as board or committee chair.
- *Business Relationships*. While the proposal would presume an investor's control of another company based on somewhat conservative thresholds of annual revenue and expenses, the proposal notably does not incorporate the Federal Reserve's historical practice of measuring the significance of business relationships based on quantitative metrics of certain business subcomponents (such as loans or deposits) and certain qualitative standards (such as the relevant agreement being terminable at will and nonexclusive). The proposal's use of enterprise-wide balance sheet metrics may allow non-controlling investors to engage in certain business relationships that would otherwise have been deemed controlling under the Federal Reserve's current practice.
- *Terminating Existing Control Relationships*. Under the Federal Reserve's current practice of applying stricter standards for determining non-control in divestiture scenarios than new investment scenarios, the Federal Reserve has at times required a divesting company to reduce its ownership to a less-than-5% voting interest and terminate all but immaterial business relationships with the former subsidiary in order to terminate an existing control relationship. The proposal would significantly relax this divestiture standard and more closely align it to the standard applicable to new non-controlling investments.
- *Equity and Debt Combinations*. The types of contractual rights that the proposal would deem to impermissibly control another company (and that would therefore trigger control if held by an investor with more than a 5% voting interest in the company) include those that are typically included as covenants in financing agreements. The proposal could therefore restrict the ability of a banking organization to provide financing to a borrower in which the banking organization owns at least a 5% voting interest. Such a voting interest, together with any limiting contractual rights included in a standard credit agreement, could trigger a presumption of control over the borrower. This change could limit the ability of banking organizations to provide financing to borrowers that contain both debt and equity components.
- *Proxy Fights, etc.* The Federal Reserve has historically required 10% or larger investors seeking non-control status to sign passivity commitments prohibiting them from commencing proxy solicitations in opposition to management on any matter, and from threatening to sell their shares if management

does not take a requested action. The proposed rules significantly relax these restrictions: any 10% or larger investor may solicit proxies for up to 25% of the seats on a board, or solicit proxies from shareholders on any other issue, whether opposed by management or not. Investors holding less than 10% of a target company's voting shares are not subject to any restrictions on proxy solicitations (although a solicitation to replace a majority of the board could raise control issues under another prong of the statutory definition of control). The proposed rules also would remove the restriction on an investor threatening to sell shares, noting that an investor's ability to exit its investment if it is unhappy with the company's business decisions "imposes important discipline on management".

- *Passivity Commitments*. Under current practice, the Federal Reserve requires non-controlling investors with 10% or more (and occasionally 5% or more) of the voting interests in a banking organizations to provide so-called "passivity commitments" to the Federal Reserve under which the investor makes a series of commitments designed to ensure that it does not attempt to exercise a controlling influence over the banking organization. The Federal Reserve will typically only grant relief from such passivity commitments after the investor had largely exited from the investment. Given that the proposal largely codifies the restrictions included in the standard passivity commitments, it is expected that the Federal Reserve may cease requiring investors to provide such commitments.

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Summary of Tiered Presumptions of Control

A company's interest in a second company will remain non-controlling if, for a given level of voting interest in the second company, the first company's relationships with the second company comply with each of the limits set forth in the table below:

	Less Than 5% Voting	5%–9.99% Voting	10%–14.99% Voting	15%–24.99% Voting
Director Representatives	Less than ½ of second company's board are first company representatives	Less than ¼ of second company's board are first company representatives	Less than ¼ of second company's board are first company representatives	Less than ¼ of second company's board are first company representatives
Director Representative Service as Board Chair	N/A	N/A	N/A	Chair of second company board is not a first company representative
Director Representative Service on Board Committees	N/A	N/A	No more than ¼ of second company board committee with power to bind are first company representatives	No more than ¼ of second company board committee with power to bind are first company representatives
Business Relationships	N/A	Business relationships generate less than 10% of revenues or expenses of either company	Business relationships generate less than 5% of revenues or expenses of either company	Business relationships generate less than 2% of revenues or expenses of either company
Business Terms	N/A	N/A	Business relationships are on market terms	Business relationships are on market terms
Officer / Employee Interlocks	N/A	No more than 1 first company director/employee is a senior management official of second company; No first company director/employee is the CEO of second company	No more than 1 first company director/employee is a senior management official of second company; No first company director/employee is the CEO of second company	No first company director/employee is a senior management official of second company
Contractual Powers	No management agreement between the companies	No first company rights that significantly restrict discretion of second company	No first company rights that significantly restrict discretion of second company	No first company rights that significantly restrict discretion of second company
Proxy Contests (directors)	N/A	N/A	First company does not solicit proxies to replace more than permitted number of directors	First company does not solicit proxies to replace more than permitted number of directors
Total Equity	Less than 1/3 total equity of second company controlled by first company	Less than 1/3 total equity of second company controlled by first company	Less than 1/3 total equity of second company controlled by first company	Less than ¼ total equity of second company controlled by first company

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