

# The Federal Reserve's New "Control" Framework: Somewhat Greater Opportunities for Minority Investments

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On January 30, 2020, the Board of Governors of the Federal Reserve System issued a final rule that would update and revise, to some degree, its framework for finding "control" under the Bank Holding Company Act of 1956, as amended (BHC Act).

The new control rule (Control Rule) expands the relationships that an investor can have with a target institution and still be deemed to be non-controlling under the BHC Act. This is relevant both for investments *in banking organizations*, such as by private equity investors, and for investments *by banking organizations*, such as in fintech companies.

The Control Rule has the most benefits for investors below 10 percent voting share ownership, as will be described more fully below. In addition to benefiting from broader consent rights and greater business relationships than previously, such investors also have greater power as shareholders to make use of proxy solicitation to challenge management. At the same time, certain aspects of the Control Rule, such as its approach to calculating total equity of a target company, were not expanded from the original proposal and may hinder new investments.

This Client Alert describes the most significant aspects of the Control Rule, which will be effective on April 1, 2020.

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## I. Statutory Control Under the Bank Holding Company Act

The BHC Act defines "control" in the following manner:

- a company (First Company) directly or indirectly owns, controls, or has power to vote 25 per centum or more of any class of voting securities of a company (Second Company);
- the First Company controls in any manner the election of a majority of the directors or trustees, or persons performing similar functions, of the Second Company; or
- the Federal Reserve determines, after notice and opportunity for hearing, that the First Company directly or indirectly exercises a controlling influence over the management or policies of the Second Company

The Federal Reserve has not held a control proceeding in decades. Instead, it has developed what may be called a "common law of control," through individual interpretations and policy statements, in which it has set forth the factors that govern whether a "controlling influence" would exist in particular investments below 25% voting share ownership. It is this "common law of control" that the Control Rule codifies, and, in some cases expands.

## II. New Presumption of Non-Control – 9.99% Rather Than 4.99%

## Voting Shares

Historically, the Federal Reserve presumed that a company did not have control over another company if it owned less than 5 percent of all classes of that company's voting shares. The Control Rule introduces a new presumption. It states that the Federal Reserve will presume that a First Company does not control a Second Company **if it owns 9.99% or less of all classes of the Second Company's voting shares and no other presumptions of control exist**. The presumptions of control differ depending on whether voting share ownership is between 0% and 4.99%, or between 5% and 9.99%.

### A. Significantly Expanded Rights for Investors at 4.99% Voting Shares or Less

The Control Rule addresses an inconsistency in the Federal Reserve's old control interpretations. Under them, a lender with no equity could impose covenants that could substantially restrict the ability of a bank or company to conduct its business without being deemed to control that company. Notwithstanding the presumption of non-control at 4.99% voting shares, an equity investor with *de minimis* equity ownership could not impose the same restrictions by contract. The Federal Reserve has eliminated this inconsistency, to the benefit of 4.99% or less investors, as described immediately below. Importantly, the Federal Reserve also clarified that the expanded rights for 4.99% or less investors apply both in the case of financial investments as well as nonfinancial investments made under Section 4(c)(6) of the BHC Act.

### B. Presumptions of Control

The Control Rule sets forth differing presumptions of control, depending on the percentage of a class of voting shares in the Second Company that a First Company holds. A summary chart of these presumptions is attached as Appendix 1, and they are as follows (although the Federal Reserve expresses them as presumptions, they act as limitations, so we will describe them in the manner they function):

#### **Control Limitations at 4.99% Voting Share Ownership or Less**

- The First Company may not appoint 50 percent or more of the Second Company's directors
- The First Company may own up to, but not including, one-third of the total equity of the Second Company<sup>[1]</sup>
- There are no limitations on director service as Board Chair or on Board committees
- There are no limitations on solicitation of proxies
- All senior management interlocks are permitted
- The First Company may have contractual rights that limit the Second Company's business, as long as they do not constitute a "management agreement"
- The First Company may have any amount of business relationships with the Second Company, and they are not required to be on market terms

#### **Control Limitations at 5% - 9.99% Voting Share Ownership**

- The First Company may not appoint a quarter or more of the Second Company's directors
- The First Company may own up to, but not including, one-third of the total equity of the Second Company

- There are no limitations on director service as board Chair or on board committees
- There are no limitations on solicitation of proxies
- Only one senior management interlock is permitted, not the CEO
- The First Company may not have contractual rights that significantly restrict discretion
- Business relationships between the two companies must generate less than 10% of (i) the total GAAP-consolidated revenues and (ii) total GAAP-consolidated expenses of the Second Company; they are not required to be on market terms<sup>[2]</sup>

## **Control Limitations at 10% - 14.99% Voting Share Ownership**

- The First Company may not appoint a quarter or more of the Second Company's directors
- The First Company may own up to, but not including, one-third of the total equity of the Second Company
- There are no limitations on director service as board Chair; the First Company may have a quarter or less representation on those board committees having power to bind the organization; otherwise no limitations on committee service
- Proxy solicitations are permitted, except those to replace a quarter of the board of directors or more
- Only one senior management interlock is permitted, not the CEO
- The First Company may not have contractual rights that significantly restrict discretion
- Business relationships between the two companies must generate less than 5% of (i) the total GAAP-consolidated revenues and (ii) total GAAP-consolidated expenses of the Second Company; they are required to be on market terms

## **Control Limitations at 15 - 24.99% Voting Shares Ownership**

- The First Company may not appoint a quarter or more of the Second Company's directors
- The First Company may own up to, but not including, one-third of the total equity of the Second Company
- A First Company director may not be the board Chair of the Second Company; the First Company may have a quarter or less representation on those board committees having power to bind the organization; otherwise no limitations on committee service
- Proxy solicitations are permitted, except those to replace a quarter of the board of directors or more
- No senior management interlocks are permitted
- The First Company may not have contractual rights that significantly restrict discretion
- Business relationships between the two companies must generate less than 2% of (i) the total GAAP-consolidated revenues and (ii) total GAAP-consolidated expenses of the Second Company; they are required to be on market terms

## **C. “Management Agreements” Versus “Rights That Significantly Restrict Discretion”**

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A 4.99% or less voting share investor is able to exercise the greatest amount of influence over a target bank or company. The only limitation on such investors is that they may not have “management agreements” with the Second Company. Such agreements give significant influence over the “general management or overall operations of the Second Company;” the Control Rule gives as an example the rights of a general partner over a partnership or managing member over a limited liability company.

Investors with between 5% and 24.99%, by contrast, are more restricted: they may not have contractual rights that significantly restrict discretion. The Control Rule provides examples of rights that do, and do not, act in this matter.

Rights that significantly restrict discretion include:

- Prohibitions on entering into new lines of business, making substantial changes to or discontinuing new lines of business
- Restricting the Second 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
- Restricting the Second Company’s payment of dividends
- Restricting the Second Company’s ability to authorize or issue additional junior debt or equity securities
- Restricting the Second 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 First Company to have the same status as other securities of the same class
- Restricting the removal or selection of any independent accountant, auditor, investment adviser or investment banker by the Second Company
- Restricting the Second Company’s ability to significantly alter accounting methods and policies

Rights that do not significantly restrict discretion include:

- Restricting the Second Company’s ability to issue securities senior to securities owned by the First Company
- Requiring the Second Company to provide reports or other information of the type ordinarily available to common stockholders
- Requiring that the First Company be able to purchase additional securities issued by the Second Company in order to maintain its percentage ownership in the Second Company
- Requiring that the Second Company ensure that any securityholder that intends to sell its securities of the Second Company provide other securityholders of the Second Company or the Second Company the opportunity to purchase the securities first
- Requiring the company take reasonable steps to ensure the preservation of tax status or tax benefits

### III. Federal Reserve Math for Calculating Percentage of Voting Shares

The various presumptions in the Control Rule are keyed off percentages of classes of voting shares. The Control Rule largely retains existing practice for calculating these percentages, which is highly conservative: if an investor has options, warrants, or securities that are convertible at its option into voting shares of the Second Company, it controls ***the maximum number of voting shares that it could hold if it exercised all its***

**options and all similar rights held by other investors are not exercised at all.** There are no exceptions for out-of-the-money options. One exception to this general rule is if, by the terms of the instrument, an investor's rights may be exercised only simultaneously with other investors. Second, and consistent with existing practice, there is an exception for preferred stock and similar instruments that give a holder the right to elect directors if dividends are not paid for a period of time and that otherwise have no voting rights; they are deemed voting securities only when the right to vote arises. A third is a purchase agreement to acquire securities that has not closed. A fourth is for rights to maintain an investor's current voting share percentage.

In addition, if an investor is subject to an agreement whereby the rights of another holder of voting shares is restricted by the investor, it is deemed to control those shares. The Control Rule provides six exceptions to this rule:

- Market terms rights of first refusal; rights of last refusal; tag-along rights; and drag-along rights
- Restrictions incidental to a bona fide loan
- Lock-up restrictions pending the consummation of an acquisition
- An arrangement that requires a current shareholder of a company to vote in favor of an acquisition
- Restrictions necessary to preserve a particular tax status or tax assets against impairment
- Short-term revocable proxies

In terms of percentage of votes, the Control Rule states that an investor controls the greater of (i) the number of voting shares it controls divided by the number of issued and outstanding voting shares of that class, and (ii) the number of votes that the investor could cast divided by the number of votes that may be cast under all the issued and outstanding voting shares of that class.

## IV. Restrictions on Non-Voting Shares

The Control Rule retains the Federal Reserve's historical limitations on the ability of shares that are initially non-voting to become voting. These limitations are strict, and therefore may affect the attractiveness of holding substantial blocs of non-voting shares notwithstanding the Control Rule's permitted percentage of total equity of up to one-third.

Non-voting shares may become voting shares in the hands of a transferee only in the following circumstances:

- In a transfer back to the issuer of the shares
- In a widespread public distribution
- In transfers in which no transferee or group of associated transferees would receive 2 percent or more of any class of outstanding voting securities of the issuer
- In a transfer to a transferee that would control more than 50 percent of every class of voting securities of the issuer without counting the transferred shares.

Such shares are also subject to strict transfer limitations.

## V. Federal Reserve Math for Calculating Total Equity

The Control Rule's general approach to calculating the percentage of total equity owned by an investor is based on U.S. GAAP, with the Federal Reserve stating that if the Second Company is not a stock corporation or does not prepare U.S. GAAP financial statements,

total equity will be calculated “so as to be reasonably consistent” with the U.S. GAAP methodology, “taking into account the legal form of the second company and [its] accounting system.”

Under the general approach, the first step is to determine the percentage of each class of voting and nonvoting common or preferred stock issued by the Second Company that the First Company controls. *Pari passu* preferred stock is treated as one class of preferred stock. One then multiplies the percentage of each class of stock controlled by the First Company by the value of shareholders’ equity allocated to the class of stock under GAAP, with retained earnings allocated to common stock. The final step is to divide the First Company’s value of shareholders’ equity, as calculated under the previous test, by the total value of the Second Company’s shareholders’ equity, as determined under GAAP. The percentage of total equity is calculated at the time of the First Company’s investment and is required to be recalculated only if and when the First Company acquires additional equity. Although this method of calculating total equity was criticized by commenters with justification, the Federal Reserve was unwilling to depart from the test in the Control Rule, which may hamper certain investments.

## VI. Special Rule for Investment Funds

There is a special presumption of control for investment funds. A company will be presumed to control an investment fund if it is the fund’s investment adviser and directly or indirectly, or acting through one or more persons, controls 5 percent or more of any class of voting securities of the fund, or controls 25 percent or more of the total equity of the fund. To allow for a seeding period, the presumption does not apply if the investor organized and sponsored the investment fund within the preceding 12 months.

## VII. Divestiture of Control

The Control Rule modifies the Federal Reserve’s traditional “tear down” rules under which an investor that had BHC control of a company was required to divest its shares below 10 percent voting share ownership in order to shed control. The Control Rule states that a sale to below 15 percent will divest control once two years have passed. There is an exception if after the divestment, 50 percent or more of each class of voting securities of the divested company is controlled by a person that is not a senior management official or director of the divesting company, or by a company that is not an affiliate of the divesting company.

## Conclusion

The Control Rule is a victory for regulatory transparency in that after over 40 years of interpretations, the Federal Reserve has used the notice and comment process to promulgate a regulation on this most important aspect of bank holding company law. Investors – both those who wish to invest in banking organizations, and banking organizations that wish to make non-controlling investments themselves – have gained some incremental benefits, although these are really focused at the level of investments of 9.99% voting shares and below. The framework in the Control Rule, moreover, is just that – a framework. Particular investments will continue to have particular facts that the framework will not clearly answer and for which judgment will be required.

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# APPENDIX 1

## Summary of Tiered Presumptions

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**(Presumption triggered if any relationship exceeds the amount on the table)**

	Less than 5% voting	5-9.99% voting	10-14.99% voting	15-24.99% voting
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
Business Terms Officer/Employee Interlocks	N/A	N/A	Market Terms	Market Terms
	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less

[1] In the case of an investment in a savings-and-loan holding company, the relevant total equity percentage is 25% or less in all cases.

[2] In the case of non-GAAP financial statements, the Federal Reserve will rely on the non-GAAP financials, “while taking differences in accounting standards into account as appropriate.”

Gibson Dunn’s lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm’s Financial Institutions Practice Group, or the following:

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