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THE FEDERAL RESERVE BOARD BANK HOLDING COMPANY ACT CONTROL PROPOSAL:

OBSERVATIONS AND REFLECTIONS

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Introduction

The Federal Reserve Board's (Board's) proposed Bank Holding Company Act (BHC Act) and Home Owners' Loan Act (HOLA) control regulations (Proposal), published in late April and on which we previously reported, are the culmination of a long-promised initiative by Board officials to bring clarity to a notoriously opaque body of law and administrative principles concerning when a company controls a second company under the BHC Act. As is commonly known in the financial services industry, the BHC Act "control" determination is central to the applicability of the BHC Act to companies that have, or propose to have, investment or other business relationships with banking organizations regulated under the BHC Act, or BHC Act–regulated bank holding companies that establish such relationships with a second company.

The financial services industry, however, has long struggled to understand the precise parameters under which BHC Act "control" may or may not exist, to the extent that such knowledge can be gleaned from Board regulations, orders, interpretations, and other pronouncements over the years. In 1987, political writer William Greider wrote a provocative book on the inner workings of the Board, titled "Secrets of the Temple."[1] Borrowing from this title, one could rightfully view the Board's control principles as one of the agency's "temple secrets" that has withstood scrutiny and full understanding.

Two of the three major statutory determinants of "control"—ownership or control of 25% or more of any class of another company's voting shares, or the authority to elect/appoint a majority of another company's directors or equivalent officials—are relatively straightforward, but do have their own interpretive idiosyncrasies. The primary source of uncertainty in the Board's BHC Act control framework has been the BHC Act statutory language that states that one company controls another when the first company has a "controlling influence" over the management or policies of the second company. Although in principle a "controlling influence" determination can only be made after notice and an opportunity for a hearing, the Board's body of control principles, as often as not, has developed through a limited number of formal Board interpretations,[2] but just as importantly through a large body of staff interpretive letters, informal opinions, and even unpublished staff positions. In turn, the uncertainty associated with the potential presence or absence of control in a particular business context has created a significant level of uncertainty for potential bank investors, as well as organizations seeking to establish relationships with regulated bank holding companies. Similar issues have arisen in the context of HOLA, which applies to the regulation of savings institutions and their holding companies, albeit less so—at least during the time period prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act when the now-defunct Office of Thrift Supervision, and not the Board, administered the HOLA control provisions with respect to savings and loan holding companies.

The Board's control framework Proposal is intended to bring further clarity and certainty to the process of determining the presence or absence of BHC Act control between two companies. It proposes to do so primarily by using a "tiered" approach to determinations of control, taking into account the presence *and interaction* of factors that the Board has traditionally considered in making a "controlling influence" control determination. In addition, however, the Proposal modifies—and not insignificantly—some of the definitional elements that apply to the control determination process, and makes some adjustments to

[1] © 1987, Simon & Schuster.

[2] *See* 12 C.F.R. § 225.142 (1982) (Board policy statement on nonvoting equity investments by bank holding companies); 12 C.F.R. § 225.138 (1977) (Board statement of policy concerning divestitures by bank holding companies); 12 C.F.R. § 225.139 (Board policy statement of equity investments by or in banks and bank holding companies dated September 2008 (proposed to be codified at 12 C.F.R. § 225.144) (the 2008 Policy Statement)).

certain of the relationship thresholds that the Board traditionally has applied in making its control determinations.

Two questions emerge from this proposal. First, could the proposal actually accomplish the purposes for which it was published, namely, to make the process of BHC Act/HOLA control determinations easier and more certain? Second, has the Board "moved the goalposts" in any respect with regard to the factors that contribute to a control determination? In our view, the answer to both questions is a qualified yes.

Tiered Framework

The BHC Act (for bank holding companies) and the HOLA (for savings and loan holding companies) give the Board the authority to determine that a company (the first company) controls another company (the second company), based on the facts presented, after notice and opportunity for a hearing. The proposed framework, outlined below, is arranged in four tiers based on the first company's ownership of any class of voting security—less than 5%, less than 10%, less than 15%, and less than 25%. A voting interest exceeding the particular threshold combined with the presence of one or more other specified relationships would trigger a presumption of control.[3]

The Proposal modifies and clarifies the current rebuttable presumption of control. The basis for the rebuttable presumption is based on a sliding scale that takes major factors and thresholds that the Board has historically viewed as presenting controlling influence concerns into account. Those factors are as follows:

- The size of the total equity investment
- The rights to director representation and committee representation on the board of directors
- The use of proxy solicitations
- Management, employee, or director interlocks
- Covenants or other agreements that allow the influence or restriction of management or operational decisions
- The scope of other business relationships

[3] Note that ownership of voting shares in an amount of 25% or more results in conclusive control of a second company under the BHC Act; this is a statutory threshold, and one that the Board has not proposed to—and probably cannot—change.

SUMMARY OF TIERED PRESUMPTIONS

OWNERSHIP OF CLASS VOTING SECURITIES				
	Less than 5%	**5% to 9.99%**	**10% to 14.99%**	**15% to 24.99%**
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Services as Board Chair	No threshold	No threshold	No threshold	No director representative is chair of the board
Director Service on Board Committees	No threshold	No threshold	A quarter or less of a key committee	A quarter or less of a key committee
Business Relationships	No threshold	Less than 10% of revenues or expenses	Less than 5% of revenues or expenses	Less than 2% of revenues or expenses
Business Terms	No threshold	No threshold	Market terms	Market terms
Officer/ Employee Interlocks	No threshold	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 Contents (Directors)	No threshold	No threshold	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	Less than one third	Less than one third	Less than one third	Less than one quarter

Note: Presumptions of control are triggered if any relationship exceeds the amounts on the table.

This proposed framework is designed to and in fact may increase transparency by the Board by clarifying "whether certain common fact patterns are likely to give rise to a controlling influence." But the presumptions of control or noncontrol that the Board has detailed may not fully provide the necessary clarity for finding if there is a controlling influence, simply because the framework is still highly dependent on facts and circumstances presented by a particular case, and the Board has made it clear that the control determination process is and will remain very facts-and-circumstances based. Put another way, the Proposal will not eliminate all uncertainty in the control evaluation analysis.

That said, the identification of specific control factors in the tiered control framework, along with numerical and other criteria that change according to the tier location of a particular factor within the framework, should assist banking organizations and investors, and their representatives, in better understanding the point at which a control relationship may result between a first company and a second company. Further, the Board has proposed adjustments to the control factors within the tiered framework; for example, by proposing greater latitude in the exercise of proxy voting rights by a potential investor than previously has been the case, and adjusting upward some of the percentage thresholds allowed for potential business relationships between a first company and a second company.

Several Significant Proposed Definitions

The Proposal includes more concrete definitions and guidelines of concepts that are currently subjective and unclear, including definitions to clarify when a first company presumptively controls a second company.

Voting Securities

The proposal provides clarification as to which interests will be treated as "voting securities" (currently referred to as "voting shares"). Under the proposal, "nonvoting securities" would include equity instruments issued by entities other than stock corporations, like limited liability companies and partnerships. The Proposal also does not restrict common stock to being treated only as a voting security. Another important aspect of the nonvoting security definition is that securities with certain defensive voting rights would not be treated as voting securities. These include the rights to remove a general partner or managing member for cause or dissolution after the removal of a general partner or managing member, and the authority to appoint a replacement. This is a subtle but potentially significant proposed change that would be particularly relevant to the private equity community, inasmuch as the ability to remove a general partner or managing member, or appoint a replacement—even for cause—has historically raised potential control issues for bank holding companies making private equity investments, or investors in private funds sponsored by bank holding companies.

The BHC Act defines control, in part, as the ownership or control of 25% of any class of voting securities of another company. Under the Proposal, a person or company would control a security if the person (1) owns the security; (2) has the power to sell, transfer, pledge, or dispose of the security; or (3) has the power to vote the security (except for short-term revocable proxies).

Similar to the power to vote securities, the power to restrict the rights of another person holding voting securities would continue to be treated as control under the Proposal. The Proposal, however, would specify six limited exceptions to this rule:

- Rights of first refusal (or similar rights) are generally excluded unless they last for long periods of time or are below fair market value
- Liens on securities based on genuine loan agreements
- Restrictions incidental to a transaction to purchase the shares
- Pending shareholder votes to acquire the voting securities
- Arrangements to preserve the tax status of an entity
- Short-term revocable proxy votes

In addition, if a first company owns 5% or more of the voting securities of a second company, any securities issued by the second company would be aggregated with that 5%–plus amount to the extent that they are owned by individuals who own or operate the first company (including those individuals' family members).

With these standards for determining which instruments are deemed voting securities, the calculation would be the greater of the percentage of voting shares or the percentage of the total number of votes that may be cast. In this fashion, voting shares with enhanced voting rights would be subject to adjustment for BHC Act and HOLA purposes to reflect their actual level of voting authority over a second company.

Contractual Rights

Contractual rights historically have been, and would continue to be, one of the factors that would indicate a presumption of control. The Proposal, however, would add additional context to this control factor by creating the express notion of a "limiting contractual right," which would be defined to mean a contractual right that significantly restricts, directly or indirectly, the discretion of a first company over major operational or policy decisions of a second company. The result is that a first company would be presumed to control a second company if the first company has a contractual right that significantly restricts, or allows the first company to significantly restrict, the discretion of the second company over major operational or policy decisions.

The Proposal then lists some examples of "limiting contractual rights" that would provide an investor company the ability to restrict significantly the discretion of a second company:[4]

- Restrictions on activities in which a second company may engage, including a prohibition on (1) entering into new lines of business, (2) making substantial changes to or discontinuing existing lines of business, (3) entering into a contractual arrangement with a third party that imposes significant financial obligations on the second company, or (4) materially altering the policies or procedures of the company
- Requirements that a second company direct the proceeds of the investment to effect any action, including to redeem the company's outstanding voting shares
- Restrictions on hiring, firing, or compensating senior management officials of a second company, or restrictions on significantly modifying a company's policies concerning the salary, compensation, employment, or benefits plan for employees of the company
- Restrictions on a second company's ability to merge or consolidate, or on its ability to acquire, sell, lease, transfer, spin off, recapitalize, liquidate, dissolve, or dispose of, subsidiaries or major assets or to make significant investments or expenditures
- Requirements that a second company achieve or maintain certain fundamental financial targets, such as a debt-to-equity ratio, a net worth requirement, a liquidity target, or a working capital requirement, or not exceed a specified percentage of classified assets or nonperforming loans
- Restrictions on a second company's ability to pay or not pay dividends, change its dividend payment rate on any class of securities, redeem senior instruments, make voluntary prepayment of indebtedness, authorize or issue additional junior equity or debt securities, or amend the terms of any equity or debt securities issued by the company
- Restrictions on a second company's ability to engage in a public offering or to list or de-list securities on an exchange

[4] These examples are nonexhaustive, but are based on the Board's experience in reviewing control fact patterns and are useful in providing insight into the types of contract provisions the Board would be examining.

- Restrictions on a second company's ability to amend its articles of incorporation or bylaws, other than limited restrictions that are solely defensive for the investor
- Restrictions on the removal or selection of any independent accountant, auditor, or investment banker to a second company
- Restrictions on a second company's ability to alter significantly accounting methods and policies, or its regulatory, tax, or corporate status, such as converting from a stock corporation to a limited liability company

The Proposal also lists certain examples of contractual provisions that would generally not be considered overly restrictive. The list principally reflects the idea that contractual provisions that are purely defensive for an investor, or that allow an investor reasonable access to information about a company, should not constitute control. In general, these factors do not represent a material departure from past Board administrative practices, but their restatement in a coherent regulation may alleviate some of the uncertainty in their application to specific transactions.

Some Differences Under the Proposed Framework

As noted above in the discussion of the tier framework, the Proposal includes a presumption of control if the first company controls 15% or more of any class of voting securities of a second company and if a representative also serves as the chair of the board of directors. The Board believes that 15% represents a very significant level of ownership that is closer to statutory control at 25% than presumed noncontrol at less than 5%. This position is consistent with the Board's 2008 Policy Statement.

Voting Shares and Total Equity

The Proposal also presumes control if an investor has less than 15% of the voting shares of the second company but more than one-third of the total equity of the second company. The Board also would presume control if an investor had 15% or more of the voting shares of the second company and 25% or more of the second company's total equity. Under these circumstances, the first company is generally not a significant channel for control over the second company. In addition, a presumption of control would be triggered if a company that controls 10% or more of any class of voting securities solicits proxies to appoint a number of directors that equals or exceeds a quarter of the total directors on the board of directors. The Proposal further presumes control if a first company controls 5% or more of any class of voting securities of a second company and controls a quarter or more of the board of director seats, or if the first company has any contractual right that significantly restricts the discretion over major operational or policy decisions of the second company.

Director Representatives

The Board believes that director representatives are a significant channel through which an investor could exercise a controlling influence. Accordingly, the Proposal establishes concrete quantitative limits on director representation, generally limiting such representation to less than one quarter of the second company's board (except for first company holdings of second company voting shares of less than 5%, where second company board representation of less than 50% is allowed).[5] Further, the proposed presumptions consider certain roles that director representatives may have that increase the ability of a particular director to affect the decisions of a company. For example, roles that may have controlling influence concerns include those where a director representative has the power to take action that binds the company, such as being a member of the audit committee. The Board, however, proposes to bring further clarity to when a person is deemed to be a "director representative" for purposes of the director representative presumption, defining a director representative as any person who is a director, employee,

[5] One curious technical point here is whether the Board meant to say "less than 25 percent" rather than "25 percent or less" of a second company's board, which is how the director representation limits have been interpreted in the past by some interested parties.

or agent of the first company or has served in such a capacity within the prior two years, or any immediate family member of such a person. Further, first company directors who are proposed as second company directors would be treated as "director representatives." Nonvoting board observers, however, would not be treated as director representatives.

Management and Other Agreements

The Board further believes that agreements where a company can direct or exercise significant influence over the management or operations of another company also raise significant controlling influence concerns. These agreements include other types of agreements or understandings that allow a company to direct or exercise significant influence over the core business or policy decisions of the second company, such as IT services agreements, to qualify as management agreements. The Proposal includes a nonexclusive list of examples of contractual rights that are considered to be limiting, as well as those that are not considered to be limiting. Examples of some of the contractual provisions include the following:

- Requirements that a company direct the proceeds of the investment to effect any action, including to redeem the company's outstanding voting shares
- Restrictions on hiring, firing, or compensating senior management officials of a company, or restrictions on significantly modifying a company's policies concerning the salary, compensation, employment, or benefits plan for employees of the company
- Restrictions on a 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 major assets
- Restrictions on a company's ability to authorize or issue additional junior equity or debt securities, or amend the terms of any equity or debt securities issued by the company
- Restrictions on a company's ability to amend its articles of incorporation or bylaws, other than limited restrictions that are solely defensive for the investor

Note that for first company holdings of less than 5% of a second company's voting shares, there can be *no* management agreements between the first company and the second company in order to avoid a control presumption. This position is roughly in line with the Board's longstanding view that small holdings of voting shares must be held in a passive rather than an active capacity.

Investment Advisers

The Proposal would establish a presumption of control where a first company serves as investment adviser to a second company that is an investment fund, and where the first company controls 5% or more of any class of voting securities of the second company or 25% or more of the total equity capital of the second company. This presumption, however, would not apply if the first company organized and sponsored the investment fund within the preceding 12 months. Thus, the organization and "seeding" of a new investment fund during an initial 12-month period would not be treated as a control relationship. Further, the Proposal includes a roughly parallel noncontrol test for investment companies that are registered under the Investment Company Act of 1940.

Historical Ownership and Divestitures

The Board provides more concrete guidance on its longstanding presumption that a first company is capable of controlling a second company even after a substantial divestiture where it has long controlled another company. Noting that the passage of time diminishes the likelihood that a formerly controlling company would be able to leverage its past relationship to exert a controlling influence over the management and policies of the second company, the Board provides that a first company that previously controlled a second company during the preceding two years would be presumed to continue to control the second company if the first company owns 15% or more of any class of voting securities of the

second company. There would be an exception to this rule if nonsenior managers of the first company, or unaffiliated investors, control an outright majority of a class of voting securities of a second company.

The other presumptions of control, such as business relationships and interlocks, would continue to apply in evaluating whether a divesting company exercises a controlling influence over a partially divested company. The effect of this application would be that the divesting company would not be presumed to control a former subsidiary; in order to avoid the presumption of control the first company also would be required to remain divested below 15% for two years. This is a departure from past administrative practice, under which some industry participants conservatively divested to below 5% in order to sever a control relationship between a first company and a second company. The Board previously did not consistently take into account the control impact of the passage of time after a partial divestiture of the second company's shares.

In another apparent departure from past administrative practice, the Board is not proposing a presumption of control based on threats to dispose of securities. Further, the Proposal does not differentiate between publicly held companies and closely held businesses in applying a control presumption.

Application to Savings and Loan Control Relationships

In addition to amending the BHC Act, the Proposal would also amend Regulation LL in a substantially similar manner to revise determinations of control under the HOLA with respect to savings and loan holding companies. The HOLA contains substantially similar tests for control as the BHC Act, and the Proposal states that the Board believes that the statutory construct for controlling influence under HOLA is sufficiently similar to the BHC Act in that it is appropriate to apply the same presumptions and related provisions to determinations of controlling influence under both.

Other Noteworthy Points

With respect to the calculation of ownership percentage, the Proposal proposes to create a "look through" approach, under which a person would be deemed to control all securities that the person could control upon exercise of any options or warrants. One proposed exception, however, would exclude any options, warrants, or convertible instruments that would permit an investor to acquire additional voting securities for the sole purpose of allowing the investor to maintain its relative percentage of voting securities in the event the second company increases the number of its outstanding voting securities.

The Proposal would also provide a standard for calculating a company's total equity percentage in a second company that both (1) is a stock corporation and (2) prepares financial statements according to generally accepted accounting principles (GAAP). Under the Proposal, the first company would assess its total equity percentage each time that it either acquires control over additional interests of the second company or ceases to control interests of the second company. Generally, the total percentage equity is the total of each class of stock that the first company controls in the second company, divided by the total of each class of stock outstanding. The Proposal includes certain considerations for debt or other nonequity interests that are "functionally equivalent" to equity for calculating the total percentage. To make the subjective determination of whether debt is "functionally equivalent," the Board will consider whether the debt (1) is treated as equity under accounting, regulatory, or tax standards; (2) is long dated or subordinated; (3) has minimal equity to support it; or (4) is not issued on market terms that may be deemed functionally equivalent to equity. Other interests that provide the first company with an economic interest that is equivalent to an equity interest are treated as equity regardless of whether they are classified as equity or debt (i.e., if the other interests are functionally equivalent to equity). Further, we note that the concept of "passivity commitments," which are written commitments that the Board has traditionally requested in cases where the Board wanted to assure that there was no control by limiting the "controlling influence" activities of a first company, does not seem to appear in the Proposal. Does this mean that the Board will no longer ask for passivity commitments in marginal control or divestiture situations, and rely instead on its proposed control framework? The answer to this question is not clear at this time.

Concluding Thoughts

Reports have appeared in the trade press suggesting that the Proposal, if adopted in its current form, could, among other things, encourage further activism among banking organization investors. While the Proposal appears to provide more flexibility on, among other things, proxy solicitation activities by banking organization investors and director representation matters than historically has been the case under Board administrative practice, how the Proposal would more broadly influence investor behaviors is an issue that will play out over the period following the Proposal's adoption (presuming that adoption in fact occurs).

Putting aside these types of considerations, however, we believe that the Proposal is a step in the right direction. Even if the new control framework, if adopted, cannot address all the heavily fact-specific situations where a control determination needs to be made, in its current form the Proposal would add materially more certainty to the outcomes of these determinations, which, given the historic opacity of the Board's control framework, should facilitate the efforts of banking organizations and investors in structuring their investments and business relationships with BHC Act and HOLA control considerations in mind.

We do caution that because this is in the proposal stage, and the Board has asked a number of questions concerning its specific proposals, final action (if it occurs), depending on comments received and further internal analysis of the Board, may result in changes to the Proposal. Further, while some aspects of the Proposal would liberalize more or less around the margins the Board's historical control framework, by and large the Proposal does not materially alter the criteria or thresholds for determinations of control or noncontrol under the BHC Act or HOLA.

In sum, we continue to welcome the concrete and specific guidance provided in the Proposal, and will further follow with interest the developments at the Board on this initiative.

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