

# The Federal Reserve's Final Rule for Determining Control

## WRITTEN BY

Jacob A. Lutz, III | [Gregory Parisi](#) | [Brad R. Resweber](#) | [James W. Stevens](#) | [Seth A. Winter](#) | [Zayne Ridenhour Tweed](#)

---

On January 30, 2020, the Board of Governors of the Federal Reserve System (the Board) issued its final rule for determining whether a company has control over a bank or other company for purposes of the Bank Holding Company Act (the BHCA) and the Home Owners' Loan Act (the HOLA), and the control presumptions promulgated under Regulation Y and Regulation LL, respectively (collectively, the Control Rule).[1] The Control Rule becomes effective April 1, 2020. The Control Rule provides specific guidance in place of the Board's decades-long, ad hoc approach to control evaluations and creates a useable and easy-to-understand tiered framework. Following up on our client alert from [May 2019](#), this article summarizes the key points from the Board's Control Rule and its implications for financial institution holding companies and their investors.

## The Control Rule and the Tiered Framework

The Control Rule provides increased predictability and simplicity to control determinations by the Board and clarifies how combinations of investment and influence will, and will not, subject investors to Board supervision and regulation. Community banks and other financial institutions that rely on substantial investments from a few significant investors to raise capital will be affected the most by the Board's Control Rule. At the same time, because control determinations can lead to federal supervision of non-bank business relationships, the Control Rule also has the potential to disincentivize certain bank investment in entities such as fintech companies.

The Control Rule is closely aligned with the April 2019 rulemaking proposal, as it retains the initially proposed tiered framework (*see below*), which incorporates a series of presumptions of control based on ownership of a class of voting securities.[2] The framework works as a matrix – a company may be presumed to be in control of a target second company based on five levels of ownership of voting securities in that target second company: less than five percent, five percent, ten percent, 15 percent, and 25 percent, with the presumption triggered at levels below 25 percent, if any of nine types of relationships exists and exceeds the threshold on the table applicable to the ownership level. The matrix is as follows:

By working through the tiered framework, investors and holding companies can determine what level of investment to pursue depending on how comfortable they are with a potential control determination. Of course, triggering a presumption of control does not mean that the investor is deemed to control the company for purposes of the BHCA or HOLA. As with control determinations prior to enactment of the Control Rule, a presumption of control may be rebutted. In connection with the Control Rule, the Board has also raised the prospect that standard-form passivity commitments will no longer be used (discussed in more detail below).

### **Directors and Proxy Contests**

The Board's Control Rule permits an investor holding more than five percent but less than 25 percent of voting securities in a target company may appoint up to a quarter of the directors serving on the board of the target company. More importantly, investors holding less than five percent of the voting securities in a target company may appoint up to half of the directorships on the target board.[3]

The Board's Control Rule also significantly lessens the restrictions on the roles of directors representing noncontrolling interests. For example, an investor holding less than ten percent of the voting securities of a target company is free from restrictions on service as the board chair or on key committees. The Control Rule also expands the ability of noncontrolling investors to propose director nominees and conduct proxy solicitations.[4] However, these abilities are limited as the percentage of voting securities held by the investor in the target company increases.

### **Total Equity of Noncontrolling Investments**

The Board's Control Rule permits a company to own up to one-third of the total equity of a second target company that is a bank holding company (BHC) and have that investment remain noncontrolling. This is reflected in the bottom row of the tiered framework.[5]

With respect to a savings and loan holding company (SLHC), the Board's Control Rule takes into account the differences with respect to the definition of "control" under the BHCA and HOLA. For example, under HOLA, a person controls a SLHC if the person has more than 25 percent of any class of voting securities of the SLHC (as opposed to 25 percent or more of any class of voting securities of a BHC under the BHCA).[6] Based on this and other differences between the BHCA and HOLA, the Board's Control Rule imposes a lower total equity percentage – 25 percent or less – for presumption of noncontrol of a SLHC.

Furthermore, the Control Rule retains the Board's proposed total equity calculation methodology, which is keyed to the amount of the target company's shareholders' equity (calculated according to U.S. GAAP) that is allocated to the stock held by the investor. The Board believes that the U.S. GAAP-based core methodology of the Control Rule is effective, fit for purpose, well-understood, and easy to apply for investors and holding companies. Interestingly, the Control Rule includes (without change) a provision whereby debt or other interests may be treated as equity if the interests are functionally equivalent to equity. However, according to the preamble, the Board expects to reclassify debt as equity under the rule only under unusual circumstances to prevent evasion of the rule.

### **Business Relationships**

In its initial proposal, the Board proposed that where a company's business relationships with a target second company exceed the applicable percentage of either the investor's or the target company's revenues or expenses, a presumption of control would arise. However, as reflected in the tiered framework above, in connection with the Control Rule the Board determined that only the revenues and expenses of the target second company, and not the investor's, are relevant when calculating the triggering revenue percentage threshold.<sup>[7]</sup> This gives welcome breathing room to investors and target holding companies who have established business relationships. Nevertheless, the Board emphasized that a relationship between two companies may raise supervisory or other concerns whether or not the relationship raises controlling influence concerns.<sup>[8]</sup>

## **Passivity Commitments**

In its proposed rulemaking, the Board gave no mention to passivity commitments. However, in the final pages of the preamble to the Control Rule, the Board announced that it does not intend to obtain standard-form passivity commitments going forward in the ordinary course. Moreover, while passivity commitments may be requested in specific contexts (e.g., ESOPs, mutual fund complexes, etc.), the Board has invited companies currently subject to standard passivity commitments to contact the Federal Reserve to seek relief from these commitments. Absent unusual circumstances, the Board expects to be receptive to such requests for relief. Now appears to be the opportune time for investors and holding companies subject to standard passivity commitments to seek relief.

## **No Grandfathering or Transition Period**

While several commenters asked the Board to apply the new control framework only prospectively, others suggested grandfathering for existing investments or a delayed phase-in period. However, because the Board views the Control Rule to be generally consistent with its current practice, the Board determined that it would not grandfather existing structures and would not provide a transition period for firms to conform existing investments.<sup>[9]</sup> Further, the Board does not expect to review investment structures that have already been reviewed by the Federal Reserve unless they were materially altered from the facts and circumstances of the original review. Accordingly, holding companies and investors should be aware that the Control Rule becomes effective as of April 1, 2020.

## **Conclusion**

The Board's Control Rule is a significant development for financial institutions with direct ramifications for investors, investment companies, and holding companies, as well as their respective business relationships and management, operational and policy decisions. The impact of the Board's new framework will likely be felt for many years to come – including years in which banks and their holding companies may need to seek equity investment in times of stress. We recommend that all financial institutions and bank investors review and carefully weigh the implications of the Board's Control Rule – particularly those relying on the Board's 2008 policy statement on equity investments as more favorable terms and conditions may be available from the Board following implementation of the Control Rule.

[1] See Board of Governors of Federal Reserve System, Press Release – Federal Reserve finalizes rule to simplify and increase the transparency of the Board's rules for determining control of a banking organization (Jan. 30, 2020), available [here](#).

[2] *Id.* at Appendix – Summary of Tiered Presumptions (reproduced herein).

[3] See *id.* at section II.B. (pp. 19-23).

[4] See *id.* at section II.B. (p. 38).

[5] See also *id.* at section II.B. (pp.36-37) and section III.D. (pp. 69-73).

[6] For further discussion of the Board's rationale for the distinction between total equity holdings of a BHC and SLHC, please refer to section IV of the preamble to the Board's final rule (pp. 83-85).

[7] *Id.* at section II.B. (pp. 26-27).

[8] *Id.* at section I.B. (p. 8 n.21).

[9] However, the Board did state that, to the extent that a company previously considered an existing relationship between two companies to not constitute control, the relationship was not reviewed by the Federal Reserve, and the relationship would be presumed to be a controlling relationship under the final rule, company may contact the Board or its staff to discuss potential actions. See *id.* at section V. (pp. 86-87).

## RELATED INDUSTRIES + PRACTICES

- [Community Banking](#)
- [Corporate](#)
- [Financial Services](#)
- [Financial Services Securities + Capital Markets](#)
- [Mergers + Acquisitions](#)
- [Payments + Financial Technology](#)
- [Private Equity](#)