Client Alert

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Federal Reserve Board Proposes Guidance on Control Rules

Recently the Board of Governors of the Federal Reserve System (the "Board") proposed new regulations on the Board's standards for determining control for purposes of the Bank Holding Company Act ("BHC Act") and the Home Owners' Loan Act ("HOLA"). The proposed regulations would clarify, streamline and memorialize in regulation the Board's control standards under these statutes by introducing a series of presumptions of control based on particular relationships between one company and another.

Under the BHC Act and HOLA, a company that controls a bank or savings association is a bank holding company or savings and loan holding company, respectively, and thus subject to restrictions on its activities and the Board's supervision and regulation. For purposes of the BHC Act, a company has control over another company if the first company (1) 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 other company; (2) controls in any manner the election of a majority of the directors of the other company; or (3) directly or indirectly exercises a controlling influence over the management or policies of the other company. The definition of control in HOLA is similar.

In both the BHC Act and HOLA, the first two prongs of control involve relatively straightforward tests. The third prong of control, however, involves a fact-based determination by the Board of whether one company controls another. This controlling influence test has been the most vexing over the years since it is heavily dependent upon the facts and circumstances.

Over the years the Board has developed a number of ad hoc determinations, through policy statements and individual decisions, as to when a "controlling influence" exists. The proposed regulations are intended to provide definitive rules in this space in order to provide greater transparency to prospective investors and acquirers. The proposal would also provide more flexibility to prospective investors regarding levels of investment, representative directors, management interlocks and business relationships. In light of today's environment where Fintech companies and banks are joining forces, the guidance provided in these rules could prove very useful.

There are proposed changes that should provide more flexibility and guidance to investors and existing bank and thrift holding companies. First, the Board proposes a tiered system of non-control presumptions based upon the percentage of voting shares held by the investor and the presence of other indicia of control. Second, there is greater flexibility afforded in the number of permissible directors and the roles they can play on the board of directors. Third, there is clarification provided on the amount of business relationships that would be permissible. Finally, the Board has proposed specific rules regarding the divestiture of control. (The proposal continues the Board's view that an acquirer limit its non-voting investments to one-third of the total equity of a company in order to avoid control. The Board has historically been concerned with non-voting equity investments as a means of exercising a controlling influence.)

To provide guidance to companies the Board proposes four categories of tiered presumptions on non-control based upon the percentage ownership of voting shares by the company or investor. The four tiers are (i) less than 5%, (ii) 5% to 9.9%, (iii) 10% to 14.9% and (iv) 15% to 24.9%. Fewer indicia of ownership is permitted as the percentage of voting shares increases.

Under the proposal there would be greater ability to increase materially the number of directors that an investor may place in a company or bank without being deemed to have a controlling influence. An investor would fall within the presumption of non-control if the investor has (i) less than 5% of the voting shares of the company and less than one-half of the directors serving on the board or (ii) between 5% and 24.9% of the voting shares of the company and less than a quarter of the directors serving on the board. Under current policy, a minority investor would not be deemed to have a controlling influence if the investor only had one director representative on the board of directors. Current policy would also permit a second director if the two directors would represent a share of the company's board that is proportional to the investor's ownership in the company and if there is another larger shareholder that controls the company.

Control would be found, however, if a 5% or more shareholder has director representatives that are able to make or block major operational or policy decisions. This standard is intended to account for supermajority voting requirements, veto power or any similar unusual provision that would allow a minority of the board to effectively control major operational or policy decisions of the company. The Board noted that it continues to believe that director representatives are a significant conduit through which an investor can exercise a controlling influence.

Control would also be found if a 5% or more shareholder has any limiting contractual rights that would significantly restrict the discretion of the company, including its senior officers and directors, over operation and policy decisions of the company. The Board listed a number of examples, including restrictions on (i) activities in which the company may engage, (ii) hiring, firing or compensating senior management, (iii) ability to merge or consolidate, (iv) the ability to make significant investment or expenditures, or (v) dividends or distributions or requirements that the company achieve certain financial targets. The contractual rights limitation would not apply in the context of a merger agreement which is expected to close within one year and the limitation is designed to ensure that the target company continues to operate in the ordinary course.

The proposal would also allow director representatives to have broader roles than has previously been permitted. A director representative would be able to serve as chairman of the board or of key committees if the investor controls 14.9% or less of the voting shares of the company. In addition, there would be no limits on committee membership if the investor controls less than 10% of the voting shares of the company. Currently, director representatives of a non-controlling investor cannot make up more than 25% of the members of a committee and may not participate on committees that can bind the company.

The Board also addressed the permissible business relationships. The Board's view is that a major supplier, customer or lender to a company can exercise considerable influence over management and policies, especially combined with a sizable investment, by threatening to change or terminate its business relationships.

Under the proposal, control will not be found if the investment in voting shares is between 5% and 9.9% and the business relationships are limited to 10% of the revenue and expenses of the company. If the investment in voting shares climbs between 10% and 14.9% and the business relationships are limited to 5% of the revenues and expenses of the company and all relationships are on market terms, control would not be found. If the investment is between 15% and 24.9% of the voting shares of the company and the business relationships are limited to 2% of the revenue and expenses of the company and all relationships are on market terms, control would not be found. If the investment is below 5% there are no restrictions proposed (but control could be found in individual cases depending upon the facts and circumstances).

The proposed rule also would establish a new presumption providing guidance for companies seeking to divest control. Under the proposal a company would no longer be deemed to control the other company if (i) the first company holds less than 15% of the voting shares and would not trigger any presumption of control (directorate, business relationships, etc.), (ii) the first company holds more than 15% of the voting shares (but less than 25%) and would not have triggered a presumption of control at any time over the previous two years or (iii) more than 50% of the voting shares are controlled by an unrelated party.

In sum, the Board's proposal should provide guidance for structuring relationships in order to avoid a controlling influence determination. The Board has posed over 50 questions soliciting input from the public for the final rule, including whether a company should be permitted to own more than one-third of the total equity of the target company and whether a higher level of business relationships should be permitted. The comment period closes on July 15, 2019. Stay tuned for further developments as the rule is finalized.

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