

## **FEDERAL RESERVE SYSTEM**

### **12 CFR Parts 225 and 238**

#### **Regulations Y and LL; Docket No. R-1662**

#### **RIN 7100-AF 49**

#### **Control and Divestiture Proceedings**

**AGENCY:** Board of Governors of the Federal Reserve System (Board).

**ACTION:** Final Rule.

**SUMMARY:** The Board is adopting a final rule to revise the Board's regulations related to determinations of whether a company has the ability to exercise a controlling influence over another company for purposes of the Bank Holding Company Act or the Home Owners' Loan Act. The final rule expands the number of presumptions for use in such determinations. By codifying the presumptions in the Board's Regulation Y and Regulation LL, the Board's rules will provide substantial additional transparency on the types of relationships that the Board generally views as supporting a determination that one company controls another company. The final rule is largely consistent with the proposal and includes certain targeted adjustments to the Board's historical practice, as described in detail in the Supplementary Information.

**DATES:** The final rule is effective on April 1, 2020.

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## **I. Background and summary of the proposal**

In May 2019, the Board issued a proposal seeking comment on revisions to its rules regarding the definition of control in the Bank Holding Company Act (“BHC Act”),<sup>1</sup> and the Home Owners’ Loan Act (“HOLA”).<sup>2</sup> The proposal was published in the *Federal Register* on May 14, 2019, and the period for public comment ended on July 15, 2019.<sup>3</sup> The proposal was intended to provide bank holding companies, savings and loan holding companies, depository institutions, investors, and the public with a better understanding of the facts and circumstances that the Board considers most relevant when assessing control and thereby increase transparency around the Board’s views on control under the BHC Act and HOLA.

Under the BHC Act, control is defined by a three-pronged test: 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 percent or more of any class of voting securities of the other company; (ii) controls in any manner the election of a majority of the

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<sup>1</sup> 12 U.S.C. 1841 *et seq.*

<sup>2</sup> 12 U.S.C. 1461 *et seq.*

<sup>3</sup> 84 FR 21634 (May 14, 2019).

directors or trustees of the other company; or (iii) directly or indirectly exercises a controlling influence over the management or policies of the other company.<sup>4</sup> HOLA includes a substantially similar definition of control.<sup>5</sup> While the first two prongs of the definition of control are easily understood bright-line standards, the third prong of the definition of control requires a facts and circumstances determination by the Board. As a result, it is often difficult for an investor that does not meet either of the first two prongs of the definition of control to determine whether it will be considered controlling or noncontrolling by the Board under the third prong.

In practice, large minority investors often seek to protect or enhance their investments through multiple forms of engagement with the target company that provide the investor with an opportunity to monitor and influence the target company. This situation in particular frequently has raised questions regarding whether the investor will be able to exercise a controlling influence over the management or policies of the target company when the investment and all other aspects of the relationship are considered in the aggregate. These issues arise for both companies seeking to invest in banking organizations and banking organizations seeking to make investments in other companies.

Under the statutory framework, the determination of whether a company has the ability to exercise a controlling influence over another company is a factual determination. The Board's experience has shown that the variety of equity investments, negotiated investment terms, and business and other arrangements between companies makes it difficult to prescribe a set of rigid rules that determine whether one company exercises a controlling influence over another company in all situations. As a result, Board determinations regarding the presence or absence

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<sup>4</sup> 12 U.S.C. 1841(a)(2); 12 CFR 225.2(e).

<sup>5</sup> *See* 12 U.S.C. 1467a(a)(2); 12 CFR 238.2(e).

of a controlling influence have taken into account the specific facts and circumstances of each case.<sup>6</sup> Nonetheless, the Board has developed over time a number of factors and thresholds that the Board believes generally are indicative of the ability or inability of a company to exercise a controlling influence over another company.

The Board believes that the final rule, which is largely consistent with the proposal, will increase the transparency and consistency of the Board's control framework. As a result, the final rule should help to facilitate permissible investments in banking organizations and by banking organizations.

The final rule includes certain targeted adjustments relative to historical practice that the Board believes are appropriate based on its experience over the past few decades. The specific provisions of the final rule, including the targeted adjustments, are described in detail in this preamble.

***A. Description of "control" under the Bank Holding Company Act***

Control is a foundational concept under the BHC Act and related statutes.<sup>7</sup> Most notably, control is used to determine the scope of application of the BHC Act because a company is defined to be a bank holding company if the company directly or indirectly controls a bank or bank holding company.<sup>8</sup> Accordingly, a company that controls a bank or bank holding company

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<sup>6</sup> See 12 CFR 225.143; Policy Statement on equity investments in banks and bank holding companies (September 22, 2008), [www.federalreserve.gov/newsevents/press/bcreg/20080922c.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20080922c.htm).

<sup>7</sup> The following discussion is limited to the BHC Act because much of the Board's experience with control has arisen in the context of the BHC Act, rather than HOLA. The final rule generally applies the same standards in the context of the BHC Act and HOLA, though the final rule is different in each context where appropriate to recognize the limited differences between the BHC Act and HOLA with respect to the definition of control.

<sup>8</sup> 12 U.S.C. 1841(a)(1).

is subject to the Board’s regulations and supervisory oversight, which includes examinations,<sup>9</sup> regular financial reporting,<sup>10</sup> capital and liquidity requirements,<sup>11</sup> source of strength obligations,<sup>12</sup> activities restrictions,<sup>13</sup> and restrictions on affiliate transactions.<sup>14</sup>

In assessing control, the Board historically has focused on two key purposes of the BHC Act to guide its understanding of the meaning of control and controlling influence. First, the BHC Act was intended to ensure that companies that acquire control of banks have the financial strength and managerial ability to exercise control in a safe and sound manner. Second, the BHC Act was intended to separate banking from commerce by preventing companies with commercial interests from exercising control over banking organizations and by restricting the nonbanking activities of banking organizations.<sup>15</sup>

Congress enacted the BHC Act in 1956. In the original BHC Act, Congress defined “bank holding company” to mean any company that (1) “directly or indirectly owns, controls, or holds with power to vote, 25 per centum or more of the voting shares of each of two or more banks or of a company which is or becomes a bank holding company by virtue of this Act, or

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<sup>9</sup> 12 U.S.C. 1844(c); 12 CFR 225.5(c).

<sup>10</sup> 12 U.S.C. 1844(c); 12 CFR 225.5(b).

<sup>11</sup> *See, e.g.*, 12 CFR part 217; 12 CFR 225 app. C; 12 CFR part 249.

<sup>12</sup> 12 U.S.C. 1831o-1.

<sup>13</sup> 12 U.S.C. 1843; 12 CFR 225 subpart C.

<sup>14</sup> 12 U.S.C. 371c and 371c-1; 12 CFR part 223.

<sup>15</sup> *Bank Holding Company Act Amendments: Hearing on H.R. 6778 Before H. Comm. on Banking & Currency, 91st Cong. 85 (1969).*

(2) which controls in any manner the election of a majority of the directors of each of two or more banks.”<sup>16</sup>

In 1970, Congress made significant amendments to the BHC Act, including revisions to the definition of control. Specifically, Congress added to the existing two prongs of the definition of control a new third prong. This third prong provided that a company has control over a bank or other company if the “Board determines after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.”<sup>17</sup> Congress added the controlling influence prong to address concerns that a company could structure an investment in a bank below the two bright-line thresholds of control while still having the “power directly or indirectly to direct or cause the direction of the management or policies of any bank.”<sup>18</sup>

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<sup>16</sup> Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (May 9, 1956). The original BHC Act also defined “bank holding company” to include a company that holds 25 percent or more of the voting securities of two or more banks or bank holding companies, if such securities are held by trustees for the benefit of the shareholders or members of the company. This prong of control was repealed in 1966. *See* An Act to Amend the Bank Holding Company Act of 1956, Pub. L. No. 89-485, 80 Stat. 236 (July 1, 1966).

<sup>17</sup> An Act to Amend the Bank Holding Company Act of 1956, Pub. L. No. 91-607, 84 Stat. 1760, 1761 (December 31, 1970). HOLA, originally enacted in 1933, contains substantially similar language for its definition of control. As a corollary to the third prong in the BHC Act, HOLA’s definition of control of a savings association or other company includes “if the Board determines after reasonable notice and opportunity for hearing, that such person directly or indirectly exercises a controlling influence over the management or policies of such association or other company.” 12 U.S.C. 1467a(a)(2)(D).

<sup>18</sup> *Bank Holding Company Act Amendments: Hearing on H.R. 6778 Before H. Comm. on Banking & Currency*, 91st Cong. 87 (1969).

***B. Summary of the Board’s historical interpretation of “control” under the Bank Holding Company Act***

Since the 1970 amendments to the BHC Act, the Board has had numerous occasions to interpret and apply the controlling influence prong of the BHC Act. The Board historically has interpreted controlling influence not to require that an investor is able to exercise complete domination or absolute control over all aspects of the management and policies of a company. Instead, the Board has found that a controlling influence is possible at lower levels of influence, including where a company is not able to determine the outcome of a significant matter under consideration.<sup>19</sup> In other words, control requires only “the mere potential for manipulation of a bank.”<sup>20</sup>

In assessing the controlling influence prong, the Board has considered a number of factors, including the size of a company’s voting and total equity investment in the other company; the presence of countervailing shareholders of the other company; a company’s representation on the board of directors or board committees of the other company; covenants or other agreements that allow a company to influence or restrict the management decisions of the other company; and the nature and scope of the business relationships between the companies.<sup>21</sup>

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<sup>19</sup> *Patagonia Corp.*, 63 *Federal Reserve Bulletin* 288 (1977) (citing *Detroit Edison Co. v. S.E.C.*, 119 F.2d 738, 739 (6th Cir. 1941) (interpreting “controlling influence” in the Public Utility Holding Company Act, which has a nearly identical definition of control as in the BHC Act, to not “necessarily [require] those exercising a controlling influence [to] be able to carry their point.” Rather a controlling influence can be effective “without accomplishing the purpose fully”)).

<sup>20</sup> *Interamericas Investments, Ltd. v. Bd. of Governors of the Fed. Reserve Sys.*, 111 F.3d 376, 383 (5th Cir. 1997).

<sup>21</sup> A relationship between two companies may raise supervisory or other concerns whether or not the relationship raises controlling influence concerns.



The Board's regulations include procedures for determining controlling influence, as well as certain standards for identifying controlling influence. The Board also has issued guidance documents related to control on several occasions. For example, the Board issued a limited set of regulatory presumptions of control for use in control proceedings in 1971 and updated these presumptions in 1984.<sup>22</sup> In addition, the Board issued policy statements regarding the controlling influence prong of the BHC Act in 1982 and 2008.<sup>23</sup>

### *C. Summary of the proposal*

The proposal established tiered presumptions of control in the Board's regulations. The proposal also provided several additional presumptions of control and noncontrol, along with various ancillary provisions such as definitions of terms used in the proposed presumptions.

As noted, the BHC Act and HOLA provide that control due to controlling influence arises once the Board determines, based on the facts presented and after notice and opportunity for a hearing, that a company controls another company. The proposal established presumptions intended to assist the Board in conducting such a hearing or other proceeding and to provide additional information to the public regarding the circumstances in which the Board believes that controlling influence is likely to exist.<sup>24</sup>

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<sup>22</sup> 36 FR 18945 (Sept. 24, 1971); 49 FR 794, 817, 828–29 (Jan. 5, 1984).

<sup>23</sup> See 68 Federal Reserve Bulletin 413 (July 1982) (codified at 12 CFR 225.143); Policy Statement on equity investments in banks and bank holding companies (September 22, 2008). The Board has issued two additional policy statements that are also relevant to the meaning of control and controlling influence: “Statement of policy concerning divestitures by bank holding companies” (12 CFR 225.138) and “Presumption of continued control under section 2(g)(3) of the Bank Holding Company Act” (12 CFR 225.139). These policy statements remain in effect to the extent not superseded by the final rule.

<sup>24</sup> Under the final rule, the Board retains the ability to find a controlling influence based on the facts and circumstances presented by a particular case. However, the Board generally does not expect to find that a company controls another company unless the first company triggers a regulatory presumption of control with respect to the second company.

The proposal—like this final rule—related solely to the issue of whether an investment, alone or in combination with other relationships, raises control concerns. The Board may have safety and soundness or other concerns arising out of either controlling or noncontrolling relationships of a banking organization. Thus, that an investment is not presumed to be controlling does not mean that the investment and all other aspects of a relationship are necessarily consistent with safe and sound banking practices or other expectations or requirements of the Board.<sup>25</sup> The Board retains the right to review investments involving banking organizations under its jurisdiction for potential safety and soundness or other concerns.

#### ***D. Summary of comments received on the proposal***

##### *General Comments*

Many commenters were supportive of the Board’s overall efforts to bring increased transparency, clarity, and consistency to the Board’s views regarding controlling influence. Some commenters noted that the additional clarity provided by the proposal would improve the speed with which banking institutions can raise capital.

Certain commenters argued that the Board’s presumptions of control presumed control at levels too low to be supported by the underlying statutes.<sup>26</sup> Several of these commenters contended that Congress intended the controlling influence prong of the BHC Act to cover only situations with higher levels of influence than the Board has traditionally considered controlling,

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<sup>25</sup> For example, contractual covenants and business relationships between a banking organization and a company may raise safety and soundness or other concerns whether or not the relationship raises control concerns. In particular, a contractual provision may not allow a company to restrict substantially the discretion of a banking organization, but may impose financial obligations on the banking organization that are inconsistent with safe and sound operation of the banking organization.

<sup>26</sup> Specific suggestions from commenters are described in the appropriate sections of this preamble on specific presumptions.

which some commenters referred to as situations of “actual control.” Many commenters who supported higher thresholds for the presumptions of control argued that unduly low thresholds would inhibit investments into and by banking organizations and, in particular, would inhibit investments by banking organizations into start-up technology companies. These commenters generally argued that there was no public benefit to limiting such investments and that there could be a negative impact on the economy. At least one commenter also suggested that a higher threshold for control would be appropriate in order to mitigate the extraterritorial application of the BHC Act on the foreign operations of foreign firms.

In support of a higher threshold for control, several commenters suggested that the Board look to its treatment of merchant banking investments, as well as the definition of banking entity under the Volcker Rule. These commenters argued that the Board had established looser definitions of control in these areas that should be applied to control more generally. Other commenters argued that the Board should separate control in general under the BHC Act from the definition of banking entity under the Volcker Rule. In addition, certain commenters provided suggestions for revising the Board’s rules related to merchant banking to separate merchant banking from questions of control.

A few commenters objected to the proposal on the basis that the Board’s current standards and processes around controlling influence have functioned well. Such commenters asserted that the proposal may have various negative effects by weakening the existing framework. Several commenters objected to the elements of the proposal that they viewed as raising the threshold for control for several reasons, including concern that the proposal could lead to greater concentration in the banking industry or to greater concentration in the shareholder base of the banking industry. At least one commenter expressed concern that the

proposal might allow companies to have greater influence over banking organizations without being subject to the bank regulatory framework and noted that retaining discretion to review each case on the facts and circumstances presented was necessary to address the wide variety of potential relationships among companies. At least one commenter stated that the Board should consider the economic and competitive impact of these types of increased consolidation and should update its analysis of competitive issues more generally. At least one commenter also stated that the Board should carefully consider the impact of the control proposal on smaller banking organizations and the ability of banking organizations to sponsor and advise investment funds.

The Board believes that the proposal reflected an appropriate interpretation of the controlling influence prong of the BHC Act and generally conformed to historical Board practice implementing and interpreting the statute. The Board's historical practice is consistent with the underlying statutes, the legislative history, and relevant case law. The Board has made several changes in the final rule compared to the proposal, as described in more detail in the applicable sections of this preamble, but the Board is issuing the final rule in a form substantially consistent with the proposal. As indicated in the proposal, the final rule contains certain targeted adjustments from current practice in light of the Board's experience administering the statute. These changes are generally technical in nature rather than fundamental changes to the Board's substantive standards for controlling influence. As the final rule is generally consistent with current practice, significant changes in outcomes are not anticipated and, therefore, no major impact on the banking industry is expected. Importantly, the final rule significantly improves the transparency and predictability around questions of controlling influence.

Some commenters expressed concern that certain of the presumptions could have extraterritorial reach by attributing control over companies outside the United States, especially by foreign banking organization. Commenters recommended that the Board clarify that lawful home country activities and relationships currently in existence should not be upset by the proposal. A few commenters argued for different control standards for qualifying foreign banking organizations, or for foreign companies more generally. At least one commenter argued that the Board's rules should take foreign control standards into account when considering relationships involving foreign entities or that the Board should revise its control standards to not apply to relationships that are wholly outside the United States.

The statutory framework for control does not contemplate different definitions of control for companies in different jurisdictions. For this reason, neither the proposal nor the Board's historical practice contains such distinctions. The final rule is consistent with the proposal in this regard. As noted, the final rule is generally consistent with the Board's current practice and, as a result, the final rule is not expected to result in substantially different outcomes for questions of controlling influence involving foreign companies.

*Comments on scope of application*

Some commenters suggested that the final rule should make it clear that an investment that does not trigger a presumption of control and is less than 5 percent of any class of voting securities should be considered passive for purposes of section 4(c)(6) of the BHC Act. The final rule is intended to apply to questions of control under the BHC Act and HOLA. As a result, the control framework in the final rule applies for purposes of section 4(c)(6) and, in particular,

the Board’s interpretation of section 4(c)(6) located in section 225.137 of the Board’s Regulation Y.<sup>27</sup>

*Comments on interaction with other regulations*

Several commenters suggested that the Board apply the proposed control standards to control under the Change in Bank Control Act (“CIBCA”).<sup>28</sup> Several commenters also recommended that the Board apply the proposed control standards to the Board’s Regulation O and Regulation W.<sup>29</sup> Commenters suggested that applying the control standards in the proposal to these other contexts would improve the simplicity and efficiency of the Board’s regulations by establishing a uniform, trans-regulatory concept of control. Some commenters noted that, in certain cases, this could result in a more permissive control standard than currently applies under CIBCA, Regulation O, and Regulation W.

A few commenters also argued that the threshold for filing a notice under CIBCA was too low and that the Board should streamline the CIBCA notice process—in coordination with the FDIC and OCC—to reduce the burden of CIBCA filings. These commenters asserted that the existing CIBCA regulations restricted investment into banking organizations and therefore recommended that the Board revise its regulations to reduce the number of filings and the information required in a filing. Specific recommendations for reduced burden included creating a process for investors to rebut the 10 percent presumption of control under the CIBCA regulations, reducing the required content of a CIBCA notice, and increasing reliance on public information such as public filings with the Securities and Exchange Commission (“SEC”). At

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<sup>27</sup> 12 CFR 225.137.

<sup>28</sup> 12 U.S.C. 1817(j).

<sup>29</sup> 12 CFR part 215; 12 CFR part 223.

least one commenter stated that the Board should reduce the scope of CIBCA filing requirements to remove or limit, for example, CIBCA filing requirements for investments in predominantly non-financial grandfathered savings and loan holding companies.

Other commenters argued against applying the proposed control framework to contexts other than control under the BHC Act and HOLA. These commenters noted that the control concept under the BHC Act and HOLA serves a different purpose than under CIBCA, Regulation O, and Regulation W. For example, control under CIBCA requires filing a one-time notice, while control under the BHC Act results in a permanent regulatory status that comes with activity restrictions, prudential regulation, approval requirements for major transactions, periodic examinations, and reporting requirements. Some commenters also encouraged the Board to provide additional clarity about the operation of the presumptions of control under the regulations implementing CIBCA.

The final rule applies to questions of control under the BHC Act and HOLA; it does not extend to CIBCA, Regulation O, and Regulation W. The Board may in the future consider conforming revisions to other elements of its regulatory framework, including CIBCA, Regulation O, and Regulation W. While common control standards across the Board's regulatory framework may provide efficiency benefits, each of the regulations identified by commenters arises out of different provisions of law and is intended to address different concerns in specific contexts.

Some commenters suggested that the Board provide additional guidance for investments in non-corporate entities, such as partnerships and limited liability companies. In certain sections, the proposal provided for the special characteristics of non-corporate entities. The final rule retains these provisions but does not contain further information regarding the treatment of

non-corporate entities because of the wide variety of forms such entities can take. The Board generally expects to apply equivalent control standards to all types of legal entities while taking into account the unique features of different entity types.

## **II. Final rule – presumptions of control and noncontrol**

### ***A. Control hearings and the role of presumptions of control and noncontrol***

The BHC Act provides that control due to controlling influence arises following a Board determination that a company controls another company. The presumptions of control in the final rule are intended to assist the Board in the context of such a determination and to provide additional public information regarding the Board's views on controlling influence.

Under the final rule, the Board, in its discretion, may issue a preliminary determination of control if it appears that a company has the power to exercise a controlling influence over a bank or other company. A company that receives a preliminary determination of control must respond within 30 days with (i) a plan to terminate the control relationship; (ii) an application for the Board's approval of the control relationship; or (iii) a response contesting the preliminary determination, setting forth supporting facts and circumstances, and, if desired, requesting a hearing or other proceeding. If a company contests a preliminary determination of control and requests a hearing or other proceeding, then the Board shall order a hearing or other appropriate proceeding if material facts are in dispute. The presumptions in the final rule would apply at such a hearing or other proceeding in accordance with the Federal Rules of Evidence and the Board's Rules of Practice for Formal Hearings. After considering all relevant facts and circumstances, including information gathered during any hearing or other proceeding, the Board would issue a final order stating its determination on controlling influence. Under the final rule, as under the proposal, the procedures differ from the existing procedures in the Board's



regulations in only two modest ways. First, the final rule clarifies that failure to respond to a preliminary determination of control from the Board would constitute waiver of the right to present additional information to the Board and waiver of the opportunity to request a hearing or other proceeding. Second, the final rule contains an express requirement to submit additional information in writing in response to a preliminary determination of control.

Some commenters recommended that the Board grant additional time to respond to preliminary determinations of control. The final rule maintains the existing 30-day timeframe because 30 days should generally be sufficient time to respond to a preliminary determination of control. Thirty days is consistent with, or, in some cases, longer than, the procedural timeframes provided by the Board for similar administrative processes.<sup>30</sup> In addition, the final rule provides that the Board may allow for additional time in its discretion, so firms that need additional time may request additional time. The procedures for control proceedings in the final rule are consistent with the proposal.

### ***B. Description of the tiered presumptions***

As discussed, a core consideration for control established by Congress in the BHC Act is the percentage of voting securities that one company controls of a second company. Under the statute, a company that controls 25 percent or more of any class of voting securities of a second company controls the second company.<sup>31</sup> Similarly, under the statute, a company that controls less than 5 percent of any class of voting securities of a company is presumed not to control the second company.<sup>32</sup> This statutory framework leaves a space between 5 percent and 25 percent of

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<sup>30</sup> See, e.g., 12 CFR part 263.

<sup>31</sup> 12 U.S.C. 1841(a)(2)(A).

<sup>32</sup> 12 U.S.C. 1841(a)(3).

a class of voting securities where a company does not have clear statutory control and is not presumed not to control. For companies within this range of voting securities of 5 percent to less than 25 percent voting, the Board considers the full facts and circumstances of the relationship between the two companies when determining whether the first company controls the second company, consistent with the controlling influence prong of the BHC Act.<sup>33</sup>

The framework established by Congress implies that a company with a level of voting securities at the higher end of the range—closer to 25 percent—is more likely to control the second company, while a company at the lower end of the range—closer to 5 percent—is less likely to control the second company. The Board’s experience supports these implications. As a result, where a company’s voting securities percentage falls within this range is one of the most salient considerations for determining whether the first company controls the second company.

The final rule, like the proposed rule, establishes a series of tiered presumptions of control. These presumptions are arranged in tiers based on the level of voting securities of the first company in the second company. Each of these presumptions applies where the first company has at least a specified level of voting securities in a second company, and another specified relationship with the second company. The presumptions use three thresholds for voting securities: 5 percent, 10 percent, and 15 percent.

Consistent with the proposal, many of the other control factors referenced in the final rule also vary in magnitude. For instance, business relationships between two companies can range from minimal to very significant, and more significant business relationships provides a greater means of exercising (and a greater incentive to exercise) a controlling influence than less significant business relationships. In recognition of this, the presumptions in the final rule

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<sup>33</sup> 12 U.S.C. 1841(a)(2)(C).

effectively assume that higher levels of business relationships, combined with higher levels of voting securities, increase the likelihood of the ability to exercise a controlling influence.

*Director representation*

The Board has long considered a company's level of representation on the board of directors of a second company as an important factor for controlling influence. The importance of director representation to controlling influence is supported by the second prong of the definition of control in the BHC Act, which provides that control over the election of a majority of the board of directors of a company constitutes control of the company. Traditionally, the board of directors of a company is the body that makes strategic decisions and establishes major policies for the company. One of the most important issues that holders of voting securities can vote on is the selection of the members of the board of directors of a company.

For a company that controls 5 percent or more of any class of voting securities of a second company, the proposal presumed control if the first company controlled a quarter or more of the board of directors of the second company. This presumption reflected the view that the combination of a material level of voting power combined with control over a quarter or more of the board of directors is generally enough to constitute a controlling influence. This element of the proposal reflected a modest liberalization of practice. Under the Board's precedents, a noncontrolling company that controlled more than 10 percent of a class of voting securities of another company often was limited to one or two director representatives at the second company (regardless of the size of the board of directors at the second company).<sup>34</sup>

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<sup>34</sup> Policy Statement on equity investments in banks and bank holding companies (September 22, 2008).

In addition, the proposal presumed that a company that controls 5 percent or more of any class of voting securities of a second company controls the second company if the first company has director representatives that are able to make or block the making of major operational or policy decisions of the second company. This presumption was intended to address supermajority voting requirements, individual veto rights, or any similar unusual provision that would allow a minority of the board of directors of the second company to control effectively major operational or policy decisions of the second company.

Commenters generally supported the proposal to allow a company to have up to a quarter of the representatives on the board of directors of another company without triggering a presumption of control. Commenters generally also confirmed that they preferred the proposal to a standard where companies with higher levels of voting securities must have reduced levels of director representation to avoid triggering a presumption of control. The final rule is consistent with the proposal with respect to the total share of director representatives that a company may have on the board of directors of another company before triggering a presumption of control.

In addition to the share of director representatives that one company has on the board of directors of a second company, the proposed presumptions considered particular director representatives to have outsized ability to affect the decisions of the second company. For instance, the chair of the board of directors of a company is generally recognized as a leader of the company and its board of directors, and the chair may have additional powers, such as the ability to set the agenda for meetings of the board of directors. Similarly, certain committees of the board of directors may have the power to take actions that bind the company without the need for approval by the full board of directors. In these circumstances, such a committee is

nearly equivalent to the full board of directors with respect to those decisions that it is empowered to make unilaterally.

To recognize the enhanced power wielded by directors in the positions described in the paragraph above, the proposal included a presumption of control if a company controls 15 percent or more of any class of voting securities of a second company and if any director representative of the first company also serves as the chair of the board of directors of the second company. In addition, the proposal included a presumption of control if a company controls 10 percent or more of any class of voting securities of a second company and the director representatives of the first company occupy more than a quarter of the positions on any board committee of the second company that has the power to bind the company without the need for additional action by the full board of directors.

With respect to the presumption of control for a director representative serving as chair of the board, commenters suggested that different standards should apply depending on whether the company was publically traded, on the basis that public companies are subject to heightened governance standards compared to private companies. Commenters also suggested that the Board take the presence of independent directors into account because independent directors could limit the influence of the chair of the board.

With respect to the presumption of control for director representatives serving on certain committees, commenters generally supported the distinction drawn in the proposal between committees with power to act independently and committees with only advisory powers. Some commenters suggested that the presumption of control should apply only if the director representatives occupied 50 percent or more of an independent committee. At least one commenter suggested clearly excluding advisory committees from the committee presumption.

The final rule is consistent with the proposal with respect to the presumptions of control for director representatives serving as chair of the board or serving on certain committees. Distinguishing between public and private companies, or between companies that have a high versus low proportion of independent directors, would add substantial complexity to the framework. In addition, incorporating such distinctions may increase uncertainty with respect to control because the proportion of independent directors or the public status of a company may change without action by an investor. Moreover, as noted above, the presumption of control related to director representatives occupying more than 25 percent of a committee that has the power to take action to bind the company is premised on the concern that such a committee is nearly equivalent to the full board of directors with respect to those items that the committee can act on unilaterally. As a result, the final rule retains the 25 percent committee standard contained in the proposal to correspond to the 25 percent entire-board standard for director representatives. With respect to the questions on advisory committees, the standard under the final rule is whether a committee has the ability to take action that binds the company or its subsidiaries. If an advisory committee does not have that ability, it is not a committee covered by the presumption.

The proposal also included a presumption regarding the solicitation of proxies for the election of directors, consistent with Board precedent. Under the proposal, the Board would have presumed control if a company that controls 10 percent or more of any class of voting securities of a second company solicits proxies to appoint a number of directors that equals or exceeds a quarter of the total directors on the board of directors of the second company. This 25 percent standard aligned the presumption for proxy solicitations to elect directors with the proposed presumption for having director representatives.

The Board did not receive comments specifically on the presumption of control related to the solicitation of proxies to elect directors. The final rule is consistent with the proposal with respect to this presumption of control, though the final rule has been revised slightly to describe the standard more clearly.

*Business relationships*

The Board has long believed that a company's business relationships with another company provides a mechanism through which the first company could exercise a controlling influence over the second company. For example, a business relationship between an investor and another company that accounts for a substantial portion of the revenues or expenses of the investor may create a financial incentive for the investor to attempt to influence the second company. Similarly, a business relationship between an investor and another company that accounts for a substantial portion of the revenues or expenses of the second company may create a powerful lever of influence for the investor over the second company.

Under the proposal, the Board presumed control in the following circumstances:

- i. If a company controls 5 percent or more of any class of voting securities of a second company and has business relationships with the second company that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the first company or the second company;
- ii. If a company controls 10 percent or more of any class of voting securities of a second company and has business relationships with the second company that generate in the aggregate 5 percent or more of the total annual revenues or expenses of the first company or the second company; or

- iii. If a company controls 15 percent or more of any class of voting securities of a second company and has business relationships with the second company that generate in the aggregate 2 percent or more of the total annual revenues or expenses of the first company or the second company.

In addition, the Board has long believed that if a company is able to enter into a business relationship with a second company on terms that are not market terms, it is likely that the first company has a significant level of influence over the second company. Thus, under the proposal, the Board presumed control if a company controls 10 percent or more of any class of voting securities of a second company and has business relationships with the second company that are not on market terms.

Many commenters suggested that the Board's proposed presumptions related to business relationships used revenue and expense thresholds that were too low. These commenters suggested that, as a consequence, the presumptions would capture business relationships that generally would be too small to provide a controlling influence and that the rule could therefore unnecessarily inhibit beneficial business relationships. Similarly, some commenters argued that the business relationship presumptions had the effect of conflating influence over a business relationship with influence over the management and policies of a company. A few commenters suggested that the thresholds established in the proposal for business relationships would create particular issues for banking organizations seeking to make minority investments in smaller companies, such as recently formed financial technology firms.

Various commenters recommended different thresholds for the control presumptions based on business relationships. For example, some commenters recommended that the Board revise the business relationship presumptions such that an investor with less than 15 percent of



any class of voting securities in a second company would not be presumed to have control regardless of the size of business relationships between the companies. Similarly, a few commenters recommended that the business relationship thresholds for a presumption of control be raised substantially at different levels of voting securities. For example, at least one commenter stated that the presumptions of control should be set at 50 percent of revenues and expenses for an investor with between 5 and 10 percent of voting securities, at 33 percent of revenues and expenses for an investor between 10 and 15 percent of voting securities, and at 25 percent of revenues and expenses for an investor between 15 and 25 percent of voting securities. Some commenters also suggested applying higher thresholds in certain circumstances, such as if there were a larger shareholder or a party with a larger business relationship.

A few commenters suggested that the Board abandon quantitative metrics for business relationships and instead presume control only if a company threatens to terminate or alter business relationships with another company for the purpose of exercising a controlling influence over the second company's management or policies.

As noted, the Board historically has viewed business relationships as an important mechanism through which one company can exercise control over the management or policies of another company. The Board's longstanding view has required business relationships to be quantitatively limited and qualitatively immaterial to avoid raising control concerns. Consistent with this principle, the proposal provided several presumptions based on voting securities and business relationships. The Board views the thresholds at which the proposed business relationship presumptions of control were set to be reasonable and generally consistent with its past practice. The final rule, therefore, retains the threshold levels that were included in the

proposal. Further, the final rule includes the presumption related to business relationships that are not on market terms without change from the proposal, for the reasons described above.

Some commenters argued that the Board should modify the business relationships thresholds to focus only on the revenues (not expenses) of the two companies. These commenters contended that a business relationship that is a substantial expense to one party generally does not provide that party with any additional ability to exercise control over the counterparty. While commenters acknowledged uncommon exceptions to this general standard—such as a relationship that cannot be easily replaced—commenters asked that the rule not consider expenses or only consider expenses under circumstances likely to be relevant to control. A number of commenters further argued that the presumptions should only take into account the scale of business relationships from the perspective of the second company and not the first company. Specifically, these commenters contended that the fact that a relationship was significant to a first company did not mean that it was significant to a second company and only relationships that were significant from the perspective of the second company would provide the first company with an ability to exert influence over the second company.

In response to these comments, the final rule differs from the proposal in that the final presumptions of control related to business relationships only include thresholds based on the revenues and expenses of the second company. As commenters noted, the significance of business relationships from the perspective of a first company is not necessarily indicative of the first company's ability to control a second company, even though it may provide an incentive for the first company to attempt to exercise control over the second company. A business

relationship that is significant to a second company as a source of revenue or expense, however, may be leveraged by the first company to exercise influence over the second company.<sup>35</sup>

As a result, under the final rule, a company would be presumed to control another company when:

- i. The first company controls 5 percent or more of any class of voting securities of the second company and has business relationships with the second company that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the second company;
- ii. The first company controls 10 percent or more of any class of voting securities of the second company and has business relationships with the second company that generate in the aggregate 5 percent or more of the total annual revenues or expenses of the second company; or
- iii. The first company controls 15 percent or more of any class of voting securities of the second company and has business relationships with the second company that generate in the aggregate 2 percent or more of the total annual revenues or expenses of the second company.

Some commenters sought clarification of concepts used in the business relationship presumptions, such as total annual revenues and total annual expenses, and encouraged the Board to rely on well-understood and widely-available definitions of these concepts.

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<sup>35</sup> Though the final rule is expected to cover most controlling influence concerns arising out of business relationships, the Board may raise controlling influence concerns under specific facts and circumstances consistent with historical precedent, such as relationships with special qualitative significance (for example, relationships that are difficult to replace and are necessary for core functions). In addition, the revised business relationship presumptions of control do not in any way limit the ability of the Board to take action to address business relationships that raise safety and soundness or other concerns.

Commenters suggested that the Board provide clear standards for measurement and attribution of revenues and expenses, and that the Board clarify what accounting standards could be relied upon for such measurements. Some commenters argued for a longer period of time over which to measure the companies' business relationships, such as two years or three years. A number of commenters argued that the thresholds for business relationships should only apply with respect to a company and its consolidated subsidiaries and should not include business relationships from unconsolidated subsidiaries.

A few commenters argued for an exception to the business relationship presumptions for a company that could not calculate both sides of the business relationship but had a good faith basis for believing that the relationships were within the limits of the presumptions. At least one commenter recommended that business relationships be measured based only on the financial statements of a company at the time of an investment in order to make it easier to comply with the business relationship thresholds.

Consistent with the proposal, the business relationship presumptions in the final rule include thresholds based on total consolidated annual revenues and expenses. Revenues and expenses are meant to be understood as these terms are commonly understood in the context of U.S. generally accepted accounting principles ("GAAP").<sup>36</sup> Principles of consolidation are also meant to be applied as generally implemented in the context of GAAP. Thus, the general expectation is that a company's consolidated income statement for the preceding fiscal year should contain the necessary information to determine revenues and expenses for purposes of the

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<sup>36</sup> For purposes of the final rule, revenue is understood to mean gross income, not income net of expenses. If a company does not prepare financial statements according to GAAP, the Board expects to rely on the non-GAAP financial statements of the company, while taking differences in accounting standards into account as appropriate.

presumptions. Further, the final rule maintains annual measurement of revenues and expenses for purposes of the presumptions as annual financials provide an existing and widely-relied upon means to understand the significance of business relationships.

Many commenters sought specific exclusions from the business relationship presumptions. At least one commenter recommended that the final rule exclude certain types of business relationships, such as arm's-length lending and deposit relationships, or non-exclusive business relationships where alternative service providers are available. Some commenters sought clarification regarding specific contexts, such as whether management fees paid by limited partners to general partners should be included as business relationships. Similarly, commenters argued that readily marketable debt securities of a company owned by another company should not be included in business relationships if the terms were not negotiated by the two companies.

At least one commenter argued that the presumptions should not take into account business relationships between an investment fund and any company in which the fund makes an investment, to the extent such relationships are at arm's length and non-exclusive. Some commenters suggested that the business relationship presumption should take account of the special circumstances of start-up companies by measuring revenues over a longer period or not considering business relationships during the first several years of a company's existence. Several commenters argued that business relationships involving referrals should not be included for revenue purposes because the amount of referral fees can be volatile.

The final rule contains no specific exclusions from the presumptions for particular types of business relationships. The final rule establishes clear and generally applicable standards that rely on well-understood accounting principles that aim to capture the economic significance of

business relationships between two companies. The introduction of exclusions for particular types of relationships or counterparties would add substantial complexity to the rule.

Some commenters argued that there should be a temporary transition or grace period, during which business relationships could exceed applicable thresholds without triggering a presumption of control. As discussed, the business relationship presumptions in the final rule are based on annual consolidated revenues and expenses. The use of annual measurement allows for some, but not excessive, day-to-day volatility in business relationships that should be sufficient for companies to manage. As a result, the final rule includes no additional transition or grace period.

In addition, consistent with the proposal, the final rule does not include a presumption of control based on threats to alter or terminate business relationships. Although such actions may be relevant to determinations of control, adding such a presumption would increase the complexity of the final rule.

#### *Senior management interlocks*

The officers of a company wield significant power over the company because they implement the major policies set by the board of directors, make all the ancillary policy decisions necessary for implementation, and operate the company on a day-to-day basis. In addition, officers often make influential recommendations to the board of directors regarding major policy decisions. As a result of this substantial degree of influence, the Board historically has viewed situations where an agent of a significant investor company serves as a management official of another company as providing a significant avenue for the first company to exercise a controlling influence over the second company.

The proposal included a presumption of control where a company that controls 5 percent or more of any class of voting securities of a second company has more than one senior management interlock with the second company. In addition, the proposal included a presumption of control where a company that controls 15 percent or more of any class of voting securities of a second company has any senior management interlock with the second company. In order to trigger either of these presumptions, the individual must serve as an employee or director at the first company and as a senior management official at the second company. The proposal defined a senior management official of a company as any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of the company.

In addition, the proposal included a presumption of control where a company that controls 5 percent or more of any class of voting securities of a second company has an employee or director who serves as the chief executive officer (or an equivalent role) of the second company. The chief executive officer of a company is generally the most powerful senior management official of the company.

Some commenters criticized the proposed presumption based on senior management interlocks on the basis that the scope of individuals treated as senior management officials was unclear. These commenters generally encouraged the Board to limit the scope of covered senior management officials to a clearly identifiable group, rather than using the qualitative standard included in the proposal. A few commenters also argued that larger companies should be permitted to have more senior management interlocks.

The final rule includes the proposed presumptions of control for senior management interlocks without revision. The Board has long recognized the potential for senior management

interlocks to be a conduit by which one company can influence another company, and the final rule is consistent with this understanding. Consistent with the proposal, the presumptions related to senior management interlocks in the final rule include targeted adjustments to historical practice to refine the scope of relevant interlocks to focus on senior officers and, in particular, the chief executive officer. The focus on senior management officials leans against the types of interlocks most likely to raise controlling influence concerns, but also permits an investor to have multiple junior employee interlocks that would not increase the investor's ability to influence operations and policies at the investee company.

Also consistent with the proposal, the final rule defines "senior management official" to be any person with authority to participate (other than as a director) in major policy making functions of a company. This definition is based on the function that a person serves rather than a person's official title. The Board recognizes that this definition is not precise and will consider providing additional clarity around this definition after acquiring more experience with the senior management interlocks presumptions.

*Contractual limits on major operational or policy decisions*

A company that controls a material amount of voting securities of a second company also may have contractual arrangements with the second company, such as investment agreements, debt relationships, service agreements, or agreements related to other business relationships. Often, these contractual rights do not raise controlling influence concerns because the rights, for example, are limited in scope or reinforce the protections provided to the investor under the law. However, the Board has viewed many other contractual provisions as raising controlling



influence concerns when the agreement has the effect of substantially enhancing one company's influence over the discretion of another company.<sup>37</sup>

Contractual rights often raise controlling influence concerns when they provide an investor with the ability to direct or block major operational or policy decisions of another company, whether such decisions are made by management or by the board of directors of the other company. The ability of an investor effectively to veto an important business decision of a company generally provides the investor with the ability to exercise a significant influence over a major operational or policy decision of the company.

The Board also has long recognized that contracts governing business relationships, including many loan agreements, contain restrictive covenants and that the existence of these covenants has not been sufficient, in itself, to constitute a controlling influence. Thus, the Board generally has not viewed restrictive covenants in the context of loan transactions or commercial services to raise controlling influence concerns. However, when a company has both control over a material percentage of the voting securities of another company and covenants that significantly restrict the discretion of the second company, the covenants have raised controlling influence concerns. These concerns have been raised whether the covenants arise directly from the terms of the equity investment or from separate agreements between the companies.

Under the proposal, a company generally was presumed to control a second company if the first company (i) owns 5 percent or more of any class of voting securities of the second company; and (ii) has any contractual right that significantly restricts the discretion of the second

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<sup>37</sup> Contractual covenants also may raise safety and soundness concerns, such as a covenant that impairs the ability of a banking organization to raise additional capital, or a covenant that imposes substantial financial obligations on a banking organization. Safety and soundness concerns may arise in the absence of, or in addition to, controlling influence concerns.

company over major operational or policy decisions.<sup>38</sup> A company with less than 5 percent of each class of voting securities of a second company would not have triggered this presumption of control even if the first company had covenants that significantly restricted the discretion of the second company over major operational and policy decisions. Thus, the proposal both recognized the potentially significant influence that covenants can provide and recognized the normal use of restrictive covenants in loan agreements and other market-terms business relationships.

The presumption of control under the proposal introduced a new defined term, “limiting contractual right,” defined as a contractual right that allows a company to restrict significantly the discretion of a second company, including its senior management officials and directors, over major operational or policy decisions. The proposal also included a nonexclusive list of examples of contractual rights that are generally considered to be limiting contractual rights, as well as a nonexclusive list of examples of contractual rights that are generally not considered to be limiting contractual rights.

Commenters argued that the Board should either raise the voting securities threshold at which the presumption of control based on limiting contractual rights would apply or remove the presumption entirely. At least one commenter argued that the presumption related to limiting contractual rights should not apply to an investor that controls less than 10 percent of each class of voting securities. In addition, commenters raised concerns with some of the specific rights listed in the proposal as examples of limiting contractual rights. These comments are discussed later in this preamble in the section related to the definition of limiting contractual rights.

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<sup>38</sup> The proposal provided an exclusion for limiting contractual rights in the context of a pending merger that are designed to ensure that the target company operates in the ordinary course while the merger is pending. The final rule includes this exclusion consistent with the proposal.

Consistent with the proposal, under the final rule, a company is presumed to control another company if the first company controls 5 percent or more of any class of voting securities of the second company and the first company has a limiting contractual right with respect to the second company. As discussed, limiting contractual rights can allow a company to exercise significant influence over another company, such as by providing the first company with an effective veto over decisions of the second company, overriding the discretion of the board of directors of the second company or the choices of its shareholders. However, limiting contractual rights are often important provisions in commercial agreements, including many loan agreements, and the Board has long recognized the importance of such contractual provisions in the context of commercial relationships. Thus, consistent with the proposal, under the final rule, a company must also control a material percentage of the voting securities of another company—specifically, at least 5 percent of any class of voting securities—in order to be presumed to control the other company due to a limiting contractual right. In other words, the final rule reflects that the Board’s concern with limiting contractual rights generally arises from the combination of a limiting contractual right and control over a material share of voting securities.<sup>39</sup> This approach is intended to balance the normal use of restrictive covenants in standard lending and other commercial relationships, while also recognizing the power of limiting contractual rights to enhance the influence of a company that is a material equity investor in another company.

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<sup>39</sup> This is different from management agreements, which raise control concerns regardless of the share of voting securities controlled.

### *Total equity*

The Board has long subscribed to the view that the overall size of an equity investment, including both voting and nonvoting equity, is an important indicator of the degree of influence an investor may have. A company is likely to pay heed to its large shareholders in order to maintain stability in its capital base, enhance its ability to raise additional equity capital in the future, and to prevent the negative market signal that may be created by the sale of a large block of equity by an unhappy shareholder. All of these concerns are present independent of the ability of an investor to exercise the voting powers of equity to attempt to influence the investee company. Further, an investor with a large equity investment also has a powerful incentive to wield influence over the company in which it has invested due to the investor's substantial economic interest in the investee company. However, the Board also has recognized that nonvoting equity does not provide the same ability to exercise a controlling influence as voting equity.

Accordingly, under the proposal, a company was presumed to control another company if the first company controls less than 15 percent of the voting securities of the second company but one-third or more of the total equity of the second company. In addition, a company was presumed to control another company if the first company controls 15 percent or more of the voting securities of the second company and 25 percent or more of the second company's total equity. This element of the proposal was consistent with the total equity standard described in the Board's 2008 Policy Statement.

Some commenters argued that total equity on its own does not provide a company with a substantial ability to exercise a controlling influence and therefore recommended that the Board increase the amount of total equity the first company could control in the second company before

triggering a presumption of control. A few commenters suggested that the Board permit all investors to own up to one-third of the total equity of a company (regardless of voting equity position) without triggering a presumption of control. Other commenters advocated for alternative tiered presumptions related to total equity, such as presumptions of control where a company (i) has 15 percent or more of the voting securities of the second company and one-third or more of the total equity; (ii) has between 10 percent and 15 percent voting and more than 40 percent total equity; and (iii) has under 10 percent voting and more than 50 percent total equity. Some commenters suggested that the Board have an exception to the total equity presumption if another shareholder has a significant block of voting securities in the second company that could prevent the first company from using total equity to exercise a controlling influence over the second company.

In the final rule, the Board is simplifying its total equity presumption so that a company will be presumed to control a second company when the first company controls one-third or more of the total equity of the second company. The threshold of one-third or more of total equity would apply without regard to the first company's voting securities percentage. In addition to simplifying, this adjustment to the proposal reflects that nonvoting equity, while a significant mechanism through which control may be exercised, should not be capped at the same 25 percent voting securities level that the statute identifies as control.

Commenters also raised a variety of issues around the Board's proposed methodology for calculating a company's total equity position in another company. These comments are discussed below in section III.D. of the preamble.

*Proxies on issues*

The Board historically has raised controlling influence concerns if a company with control over 10 percent or more of a class of voting securities of a second company solicits proxies from the shareholders of the second company on any issue. The Board did not propose a presumption of control for a company that controls 10 percent or more of a class of voting securities of a second company and solicits proxies from the shareholders of the second company on any issue. Many commenters supported the Board's decision to not include a presumption of control based on soliciting proxies on issues presented to the shareholders.

Consistent with the proposal, the Board is not adopting a general presumption of control for a company that solicits proxies from the shareholders of another company.<sup>40</sup> Accordingly, under the final rule, a noncontrolling investor generally may act as a shareholder and engage with the target company and other shareholders on issues through proxy solicitations.

*Threats to dispose of securities*

Historically, the Board has viewed threats to dispose of large blocks of voting or nonvoting securities in an effort to try to affect the policy and management decisions of another company as presenting potential controlling influence concerns. As a result, the Board traditionally has raised controlling influence concerns if a company with control over 10 percent or more of a class of voting securities of a second company threatens to dispose of its investment if the second company refuses to take some action desired by the first company. However, the Board also has recognized that an investor that is unhappy or disagrees with the business decisions of the company in which it has invested should be able to exit its investment and that

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<sup>40</sup> The final rule includes a presumption of control related to soliciting proxies for the election of directors, which is discussed in the section of this preamble related to the presumptions of control based on director representation.

the possibility of investor exit imposes important discipline on management. The Board did not propose a presumption of control based on threats to dispose of securities.

Many commenters expressed support for the Board's decision to not include a presumption of control based on attempts to exercise control by threatening to dispose of securities.

Consistent with the proposal, the Board is not adopting a presumption of control based on one company attempting to exercise control over another company by threatening to dispose of its securities in the second company. By not adopting a presumption, the Board recognizes that investors generally should be able to exit investments without raising control concerns.

### *C. Description of additional presumptions and exclusions*

In addition to the tiered presumption framework described previously, the proposal included several additional presumptions of control. Several of these presumptions clarified presumptions already in Regulation Y and Regulation LL, and others of these presumptions related to standards that the Board historically has used to make control decisions but has not before included in regulation. This section of the preamble discusses these additional presumptions and how they are reflected in the final rule.

#### *Management agreements*

The Board has long believed that management agreements under which a company can direct or exercise significant influence over the management or operations of another company raise significant controlling influence concerns.<sup>41</sup> The proposal expanded slightly the existing regulatory presumption to expressly identify additional types of agreements or understandings

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<sup>41</sup> See 12 CFR 225.31(d)(2)(i); 12 CFR 238.21(d)(2)(i) (citations are to the Code of Federal Regulations prior to the amendments made by this final rule).

that allow a company to direct or exercise significant influence over the core business or policy decisions of another company. The proposal also clarified that a management agreement includes an agreement where a company is a managing member, trustee, or general partner of another company, or exercises similar functions.

The Board did not receive comment specifically on the presumption of control arising from a management agreement. Accordingly, the Board is finalizing the presumption as proposed, including with the clarifications to expressly include agreements where a company is a managing member, trustee, or general partner of another company.

*Investment advice and investment funds*

The proposal included a presumption of control where a company serves as investment adviser to an investment fund and controls 5 percent or more of any class of voting securities of the fund or 25 percent or more of the total equity of the fund. For purposes of this presumption, the proposal defined “investment adviser” to include any person registered as an investment adviser under the Investment Advisers Act of 1940 (“Advisers Act”), any person registered as a commodity trading adviser under the Commodity Exchange Act, or a foreign equivalent of such a registered adviser.<sup>42</sup> Similarly, “investment fund” included a wide range of investment vehicles, including investment companies registered under the Investment Company Act of 1940, investment companies that are exempt from registration under the Investment Company Act, and foreign equivalents of either registered investment companies or exempt investment companies.<sup>43</sup> Other investment vehicles, such as commodity funds and real estate investment trusts, generally also were included as investment funds.

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<sup>42</sup> 15 U.S.C. 80b-1 *et seq.*; 7 U.S.C. 1 *et seq.*

<sup>43</sup> 15 U.S.C. 80a *et seq.*



However, the proposed presumption of control would not have applied if the investment adviser organized and sponsored the investment fund within the preceding twelve months. This provision allowed the investment adviser to avoid triggering the presumption of control over the investment fund during the initial seeding period of the fund.<sup>44</sup>

In addition, the proposal provided a limited exception from the presumptions of control where the investment fund was an investment company registered with the SEC under the Investment Company Act of 1940 and certain other criteria were satisfied.<sup>45</sup> In order to qualify for this exception:

- The only permitted business relationships between the investment adviser and the investment company were investment advisory, custodian, transfer agent, registrar, administrative, distributor, and securities brokerage services provided by the investment adviser to the investment company;
- Representatives of the investment adviser must occupy 25 percent or less of the board of directors or trustees of the investment company; and
- The investment adviser must control less than 5 percent of each class of voting securities of the investment company and less than 25 percent of the total equity of the investment company.

Corresponding to the seeding period in the investment adviser presumption, the last criteria in the registered investment company exception did not apply if the investment adviser had

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<sup>44</sup> The proposed presumption of control for service as an investment adviser to an investment fund was intended to be consistent with the Board's precedents regarding when an investment adviser controls an advised investment fund under the BHC.

<sup>45</sup> 15 U.S.C. 80a *et seq.*

organized and sponsored the investment company within the preceding twelve months. This provision allowed the investment adviser to control greater percentages of securities of the investment company during the initial seeding period of the investment company.<sup>46</sup>

Commenters argued that the proposals with respect to investment funds and registered investment companies were inconsistent with prior Board precedent, most notably a single case where the Board allowed a bank holding company to retain up to 25 percent of the voting securities of an investment company under certain conditions.<sup>47</sup> Many commenters argued that the rule should follow this precedent and allow investment advisers to control up to 25 percent of the voting securities of an advised investment fund without triggering a presumption of control, rather than 5 percent as proposed.

Many commenters also suggested a one-year seeding period was too short and should be extended to three years to be consistent with the Volcker Rule. In addition, commenters suggested that the seeding periods should be available to authorized participants, not just organizers and sponsors. Some commenters advocated for an approach where no seeding period was specified in the rule and instead the seeding period would be a reasonable period determined by fund managers.

A few commenters recommended that the investment company exception apply to foreign equivalents of U.S. registered investment companies and certain other types of investment funds, such as exempt investment companies and business development companies. Some commenters also requested that registered investment companies be excluded from the

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<sup>46</sup> See, e.g., *Mellon Bank Corporation*, 79 Federal Reserve Bulletin 626 (1993); *The Chase Manhattan Corporation*, 81 Federal Reserve Bulletin 883 (1995); *Commerzbank AG*, 83 Federal Reserve Bulletin 678 (1997).

<sup>47</sup> See Letter to H. Rodgin Cohen, Esq., dated June 24, 1999, [https://www.federalreserve.gov/boarddocs/legalint/BHC\\_ChangeInControl/1999/19990624/](https://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/1999/19990624/).

presumptions of control without having to satisfy any conditions. Several commenters further argued that the Board should apply the standards of the SEC for independent directors rather than the Board's standards for director representatives for purposes of determining how many director representatives a company has on the board of directors of a registered investment company. At least one commenter suggested that the Board exclude any ordinary-course business relationships between investment companies and their advisers from consideration in the context of control.

The final rule retains the presumption of control for investment advisers of investment funds as proposed. The exception for registered investment companies is not included in the final rule. Both the control presumption and the exception were designed to align with Board precedent regarding control over investment funds and thus were intended to be complementary in scope. The registered investment company exception had minimal incremental information value beyond the general investment fund presumption, and the details of the exception raised many questions regarding how it would function. Thus, it has been removed from the final rule to simplify the rule.

The final rule retains the threshold of 5 percent of a class of voting securities for purposes of the investment adviser presumption of control. The single precedent identified by commenters that permitted ownership of up to 25 percent of the voting securities of a fund was an unusual case based in part on statutory provisions that are no longer in effect. In addition, in that precedent, the Board relied on additional constraints to mitigate control concerns and these additional constraints were not included in the proposal. The threshold of 5 percent of any class of voting securities is consistent with the preponderance of Board precedent in this area.

The final rule retains the one-year seeding period, consistent with the proposal. The one-year seeding period is consistent with the bulk of Board precedent related to organizing and sponsoring investment funds and provides a reasonable amount of time for the seeding of most investment funds. The one-year seeding period is only available to the company that organizes and sponsors an investment fund and not to other early investors in an investment fund, because only the sponsor/organizer necessarily controls all the equity securities of the company when the fund is formed.<sup>48</sup>

At least one commenter recommended that the Board confirm the ongoing applicability of control letters from the General Counsel of the Board to mutual fund families, and investments made in accordance with those letters. The application of the final rule to existing structures is discussed in more detail elsewhere in this preamble. The Board does not intend to revisit existing structures that were previously reviewed by the Federal Reserve System and have not changed materially.

#### *Accounting consolidation*

Under the proposal, the Board presumed that a company that consolidates a second company under GAAP controls the second company. The presumption was based on an understanding that GAAP generally calls for consolidation under circumstances where the consolidating entity has a controlling financial interest over the consolidated entity. Consolidation is typically required under GAAP due to ownership of a majority of the voting securities of a company, which would significantly exceed the voting security threshold for control under the BHC Act and HOLA. In addition, GAAP requires consolidation of companies

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<sup>48</sup> The one-year seeding period in the final rule does not alter the rules applicable to hedge fund and private equity fund investments under the Volcker Rule, including the rules addressing permissible seeding periods for such funds.

under the variable interest entity standard (i) where a company has significant economic exposure to a variable interest entity and has the power to direct the activities of the entity that most significantly impact the entity's economic performance or (ii) where a company controls a variable interest entity by contract.<sup>49</sup>

Many commenters urged the Board to abandon the proposed presumption of control where a first company consolidates a second company for purposes of GAAP. Commenters also urged the Board not to expand the proposed consolidation presumption based on GAAP to consolidation under other accounting standards. These commenters argued that the standards for consolidation for variable interest entities did not conform to the Board's standards for controlling influence. Commenters also stated that presuming that consolidated variable interest entities are controlled could have unintended consequences for foreign banking organizations subject to the Board's U.S. intermediate holding company requirements.<sup>50</sup> In addition, commenters expressed concern that the accounting consolidation rules were promulgated by a different authority with different purposes and that the consolidation standards were subject to change outside of the control of the Board. Some commenters requested exclusions for variable interest entities in certain contexts, such as an exclusion for asset-backed commercial paper conduits or particular types of ownership or management relationships between a company and a variable interest entity.

The final rule establishes a presumption of control when one company consolidates a second company for purposes of GAAP. This presumption is consistent with the proposal. A company that consolidates another company due to control over a majority of the voting

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<sup>49</sup> See, e.g., ASC 810-10.

<sup>50</sup> See 12 CFR 252.153.

securities of the second company should control the second company under the voting securities control prong of the BHC Act and HOLA. A company that consolidates another company under the variable interest entity standard must have substantial ability to direct the activities of the second company (in addition to having a potentially significant economic exposure). A company that is consolidated under the variable interest entity standard often would be controlled under one of the other presumptions of control in the final rule such as the management agreement presumption. The inclusion of the GAAP consolidation presumption should reduce burden and uncertainty by allowing companies to identify presumptive control relationships based on existing accounting standards.

The presumption of control where one company consolidates a second company for purposes of GAAP covers, by its terms, only those companies that prepare financial statements under GAAP. The Board notes, however, that the Board is likely to have control concerns where a company consolidates another company on its financial statements under another accounting standard, particularly if the other accounting standard has consolidation standards that are similar to the consolidation standards under GAAP.

Regarding the interaction of the final rule and the intermediate holding company requirements of the Board's Regulation YY, a foreign banking organization that is required to form a U.S. intermediate holding company must hold all ownership interests in U.S. subsidiaries through its U.S. intermediate holding company.<sup>51</sup> In general, ownership interest under the intermediate holding company requirements does not include contractual relationships, including contractual relationships that result in consolidation of a company under the variable interest entity standard. Thus, for example, where a U.S. branch of a foreign bank has a contract with an

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<sup>51</sup> 12 CFR 252.153.

asset-backed commercial paper conduit that causes the conduit to be consolidated by the branch under the variable interest entity standard, the contract is not an ownership interest and therefore may remain between the branch and the conduit.

The proposal sought comment on whether the Board should presume that a company controls a second company if the first company applies the equity method of accounting with respect to its investment in the second company. Many commenters opposed the introduction of this presumption. These commenters argued that the standards for the equity method of accounting were different than control under the BHC Act and HOLA and that the practical effect of such a presumption would be to presume control over a company due to control over 20 percent of a company's voting securities, substantially below the statutory threshold of 25 percent. Similar to comments regarding accounting consolidation, commenters also objected to the Board's control-based reliance on accounting standards designed for different purposes.

The final rule does not include a presumption of control when one company applies the equity method of accounting with respect to its investment in a second company. Although equity method accounting treatment indicates a substantial relationship between two companies, unlike consolidation, equity method accounting is not as closely linked to the Board's views on what constitutes a controlling influence.

#### *Divestiture*

The proposal substantially revised the Board's standards regarding divestiture of control. The Board historically has taken the position that a company that has controlled another company may be able to exert a controlling influence over that company even after a substantial

divestiture.<sup>52</sup> As a result, the Board typically has applied a stricter standard for terminating control than for establishing new noncontrolling investments.<sup>53</sup>

The proposal provided that a 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 owned 15 percent or more of any class of voting securities of the second company. The divestiture presumption did not apply if a majority of each class of voting securities of the second company would be controlled by a single unaffiliated individual or company after the divestiture by the first company. Further, the divestiture presumption generally did not apply in cases where a company sold a subsidiary to a third company and received stock of the third company as consideration for the sale.<sup>54</sup>

Many commenters supported the proposed divestiture presumption. Other commenters argued that the threshold for the divestiture presumption should be raised higher than 15 percent

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<sup>52</sup> See, e.g., “Statement of policy concerning divestitures by bank holding companies” (divestiture policy statement). 12 CFR 225.138. The divestiture policy statement indicates that divestiture is a special consideration for purposes of control and that the Board’s normal rules and presumptions regarding control may not always be appropriate in the context of divestiture. See also *Am. Gas & Elec. Co. v. SEC*, 134 F.2d 633, 643 (D.C. Cir. 1943) (holding that “controls and influences exercised for so long and so extensively [under the Public Utilities Holding Company Act] are not severed instantaneously, sharply and completely, especially when powers of voting, consultation and influence such as have been retained remain”).

<sup>53</sup> See, e.g., 12 CFR 225.139 (“2(g)(3) policy statement”). The 2(g)(3) policy statement describes the implementation of section 2(g)(3) of the BHC Act (Congress removed section 2(g)(3) from the BHC Act in 1996). Section 2(g)(3) created a rebuttable presumption that a transferor continued to control securities of a company transferred to a transferee if the transferee was indebted to the transferor or if there were certain director or officer interlocks between the transferor and transferee. The 2(g)(3) policy statement remains relevant because it reflects the Board’s longstanding position that terminating control requires reducing relationships to lower levels than would be consistent with a new noncontrolling relationship.

<sup>54</sup> See, e.g., Letter to Mark Menting, Esq., dated February 14, 2012, [https://www.federalreserve.gov/bankinfo/legal/LegalInterpretations/bhc\\_changeincontrol20120214.pdf](https://www.federalreserve.gov/bankinfo/legal/LegalInterpretations/bhc_changeincontrol20120214.pdf).



or that the divestiture presumption should be entirely removed from the rule. At least one commenter requested clarification as to the conditions required for the exception to the divestiture presumption to apply, specifically whether the other shareholder must control a majority of every class of voting securities of the second company, or only a majority of the securities of the class of voting securities that the divesting shareholder is selling. In addition, commenters asked the Board to clarify how the divestiture presumption interacts with the seeding period in the investment fund context.

The final rule includes the divestiture presumption substantially as proposed. As noted, the possibility of continued control in the context of a partial divestiture has been identified as a concern in Board precedent and case law. The final rule balances these concerns with the goal of providing greater transparency and certainty to the Board's consideration of controlling influence issues.

The final rule does not provide an exception to the presumption to facilitate the organization and sponsorship of investment funds. Such an exception is not necessary because an investment adviser must have less than 5 percent of each class of voting securities of an investment fund after the initial one-year seeding period in order to not trigger the investment fund presumption of control, and the divestiture presumption only applies where a company retains at least 15 percent of any class of voting securities.

Regarding the commenter requests for clarification of the exception to the divestiture presumption, the Board clarifies that the exception only applies when an unaffiliated person controls 50 percent or more of the outstanding securities of each class of voting securities of the company being divested.

*Presumption of control for the combined ownership of a company and its senior management officials and directors*

The proposal included a presumption that a company controls a second company when (i) the first company controls at least 5 percent of any class of voting securities of the second company and (ii) the senior management officials and directors of the first company, together with their immediate family members and the first company, own 25 percent or more of a class of voting securities of the second company (5-25 presumption). The proposed presumption reflected the Board's historical position that it is often appropriate to attribute securities held by management officials of a company to the company itself for purposes of measuring control by a company under the BHC Act. The management officials of a company are well positioned to coordinate their actions with each other and the company to act as a single voting bloc to advance the interests of the company.

The proposal differed from current practice, however, by providing an exception to this general presumption. Specifically, the presumption did not apply if (i) the first company controls less than 15 percent of each class of voting securities of the second company and (ii) the senior management officials and directors of the first company, together with their immediate family members, control 50 percent or more of each class of voting securities of the second company.

The proposed exclusion to the presumption reflected the Board's traditional understanding that, when individuals control an outright majority of a class of voting securities of a second company, it is likely the individuals who are truly exercising control over the second company, rather than any company that employs the individuals. Under these circumstances, the first company is generally not a significant conduit for control over the second company.<sup>55</sup>

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<sup>55</sup> See *Vickars-Henry Corp. v. Fed. Reserve Sys.*, 629 F.2d 629 (9th Cir. 1980).

At least one commenter requested that the Board clarify how the rule attributing ownership of securities held by senior management officials, directors, or controlling shareholders of a company to that company (proposed sections 12 CFR 225.9(c), 238.10(c)) would operate in conjunction with the 5-25 presumption (proposed sections 12 CFR 225.32(d)(6), 238.22(d)(6)).

The final rule does not include the 5-25 presumption of control of a company. Instead, this presumption of control of a company has been integrated into the standard for control by a company over voting securities. Specifically, the final rule provides that a company that controls 5 percent or more of any class of voting securities of another company also controls any securities issued by the second company that are controlled by the senior management officials, directors, or controlling shareholders of the first company, or immediate family members of such individuals. In addition, the final rule incorporates into this standard for control over securities the exclusion contained in the proposed 5-25 presumption, as described further in section III.B of this preamble.

*Closely-held companies and widely-held companies*

In developing the proposal, the Board considered whether there should be different presumptions for (i) companies that are widely held relative to companies that are closely held or (ii) companies that are majority owned by a third party. The Board considered these factors because it could be reasonable to assume that a major investor in a company that is otherwise widely-held has outsized influence compared to a context where the major investor is one of several major investors in a closely-held company. Similarly, in many cases, it could be reasonable to assume that a major investor has reduced influence over a company where another investor has an outright majority of the voting securities of the company. The proposal,

however, did not include different presumptions for widely-held companies versus closely-held companies or for companies under the majority control of a third party because such distinctions increased the complexity of the proposal and could have made the presumptions more difficult to apply in practice.

Some commenters argued that the presence of a larger, third-party shareholder should create a presumption of non-control for any company with a lesser interest. Commenters provided several different proposals for how this might be implemented, ranging from an exemption from the presumptions of control where a third party controls a majority of the securities of a company to an exemption from the presumptions of control where a third party controls a sufficiently large plurality of the securities of a company. Some commenters suggested that the presence of a larger, third-party shareholder should raise the level of other relationships, particularly business relationships, that two companies could have before triggering a presumption of control. Commenters also argued that a majority shareholder should give rise to a presumption of noncontrol for all other shareholders.

Other commenters supported the Board's proposal not to create different presumptions depending on the shareholder composition of the second company because of the complexity this would add to the rule.

The presumptions in the final rule do not differentiate between closely held and widely held companies and generally do not turn on the presence of a majority third-party shareholder. Although a company's influence over another company may vary based on the shareholder structure of the second company, adding exceptions to certain presumptions of control because the second company is closely held or majority-controlled by a third party would significantly increase the complexity of the rule. Moreover, the Board notes that the statutory framework

contemplates that multiple companies could control a single company even if there is one company that has predominant, or even majority, control over the voting securities of the company. Finally, having control determinations turn on the shareholder structure of the target company may create practical difficulties for investors. For example, a first company could establish a relationship that does not trigger a presumption of control over a second company, but the second company could subsequently become more widely held, leading the first company to trigger a presumption of control without any action of its own.

*Fiduciary exception*

Under the proposal, the presumptions of control did 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. This exception for holding securities in a fiduciary capacity is currently in the control provisions of Regulation Y and was retained in full.<sup>56</sup>

Many commenters argued that the Board's proposed exclusion for securities held in a fiduciary capacity was overly restrictive because it included a requirement that the fiduciary not have sole discretionary voting authority over the securities. Commenters noted that, although not having sole discretionary voting authority was required for the fiduciary exemption in section 3 of the BHC Act, section 4 of the BHC Act excluded securities held in a fiduciary capacity without this additional requirement.

Commenters also sought clarification of when a company would be considered to have sole discretionary authority to exercise voting rights. At least one commenter asked that the

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<sup>56</sup> See 12 CFR 225.31(d)(2)(iv); see also 12 U.S.C. 1841(a)(5)(A).

Board provide that an investment adviser lacks sole discretionary voting authority where an investment fund has the right to revoke the adviser's voting authority.

In response to the issues raised by commenters, the fiduciary exception in the final rule only requires that the securities of a depository institution or a depository institution holding company be held without sole discretionary voting authority. Accordingly, the final rule's fiduciary exception would parallel the different fiduciary exceptions in section 3 and section 4 of the BHC Act. The same exception would apply for purposes of Regulation LL, to provide parallel treatment under the BHC Act and HOLA. The final rule also includes additional clarifying edits to the fiduciary exception.

The final rule does not provide broader clarity around the scope of the fiduciary exception. The Board notes, however, that the fiduciary exception in the final rule is intended to align with the Board's traditional understanding of the scope of the fiduciary exceptions in the BHC Act and Regulation Y. The primary example of the role covered by the fiduciary exception is that of the trust department of a depository institution that is authorized to engage in fiduciary activities. Companies may contact the Board or its staff to seek clarification as to whether any particular holding of securities would qualify for the fiduciary exception.

*Rebuttable presumption of noncontrol*

Under the proposal, a company was presumed not to control a second company if the first company (i) controls less than 10 percent of every class of voting securities of the second company and (ii) is not presumed to control the second company under any of the proposed presumptions of control. This provision of the proposal modestly expanded the statutory and

pre-existing regulatory rebuttable presumption of noncontrol that applies where a first company controls less than 5 percent of any class of voting securities of a second company.<sup>57</sup>

Many commenters supported the proposed presumption of noncontrol, arguing that controlling influence would be especially unusual for companies with less than 10 percent of each class of voting securities of another company. Some commenters argued that the Board should expand the presumption of noncontrol further to cover any company that did not trigger a presumption of control. At least one commenter argued that a presumption of noncontrol should at least apply to foreign entities that do not trigger a presumption of control in order to mitigate extraterritorial application of the BHC Act. Commenters also raised concerns with the proposed exclusion from the presumption of noncontrol for any company that triggered a presumption of control, at least as applied to companies with less than 5 percent of any class of voting securities of another company.

The final rule adopts the rebuttable presumption of noncontrol as proposed.<sup>58</sup> Thus, a company is presumed not to control a second company if the first company (i) controls less than 10 percent of every class of voting securities of the second company and (ii) is not presumed to control the second company under any of the presumptions of control. This approach and calibration of the noncontrol presumption reflects the Board's experience that a company with less than 10 percent of any class of voting securities of another company is unlikely to have a controlling influence over the second company, absent the indicia of control specified in the control presumptions. The additional changes supported by some commenters would increase

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<sup>57</sup> 12 U.S.C. 1841(a)(3); 12 CFR 225.31(e) and 238.21(e).

<sup>58</sup> As under the proposal, the filing requirements applicable to bank holding companies and savings and loan holding companies for investments in 5 percent or more of any class of voting securities of a company are not impacted as a result of the presumption of noncontrol.

the scope of the presumption of noncontrol significantly, well beyond both the presumption of noncontrol in the BHC Act and the Board's experience.

### **III. Final rule – control-related definitions**

The proposal proposed to amend Regulation Y and Regulation LL to update and clarify the definitions of various control-related terms. This section discusses in detail how the final rule addresses each of these definitions.

Some commenters indicated that the Board should define additional terms to further clarify the application of the presumptions of control. For example, a commenter suggested that the Board clarify how the presumptions of control would apply to an agreement among shareholders that is designed to preserve a company's tax status under the Internal Revenue Code. In addition, a commenter stated that the Board should clarify whether a testamentary trust qualified as a "company" under the proposal.

The final rule does not introduce new defined terms compared to the proposal, though certain changes have been made to the proposed defined terms as described in detail in this section. Consistent with the proposal, the final rule includes defined terms to the extent appropriate to clarify the application of the rule, while avoiding over-prescription that could limit the Board's ability to respond appropriately to unusual facts and circumstances or to prevent evasion of the framework. Specifically with respect to agreements to preserve tax status under the Internal Revenue Code, the final rule, consistent with the proposal, clarifies that covenants to take reasonable steps to maintain a specific tax status generally are not limiting contractual rights and that agreements among shareholders to preserve a certain tax status generally do not constitute restrictions on securities that provide control over the covered securities. On the status



of testamentary trusts as companies under the BHC Act, neither the proposal nor the final rule alters the Board's standards related to testamentary trusts.

***A. First company and second company***

The core of the proposal was the addition of a series of presumptions of control that apply in the context of the Board making a determination that one company has the ability to exercise a controlling influence over another company. To clarify the application of these presumptions, the proposal provided definitions of "first company" and "second company."

The proposal defined "first company" as the company whose control over a second company was the subject of a determination of control by the Board. The proposal defined "second company" as the company the control of which by a first company was the subject of a determination of control by the Board. For many of the proposed presumptions, the first company was presumed to control the second company if the first company, together with its subsidiaries, had particular relationships with the second company, together with its subsidiaries.

In addition, the proposal provided that, for purposes of the proposed presumptions, any company that was both a subsidiary of the first company and the second company should be treated as a subsidiary of the first company but not as a subsidiary of the second company. This provision prevented the second company's relationships with a joint venture subsidiary with the first company from being considered relationships with the first company for purposes of the presumptions of control.

Some commenters contended that it would be more appropriate to consider only relationships between top-tier parent companies. Relatedly, a few commenters stated that first company and second company should not be defined to include their subsidiaries. With respect to joint ventures, some commenters argued that the language of the proposal was difficult to

apply and that it would be better to not consider any relationships with joint ventures when reviewing for control between joint venture partners.

The final rule adopts the definitions of first company and second company as proposed.<sup>59</sup> For purposes of controlling influence, the Board historically has considered the relationships between one company and its subsidiaries, on the one hand, and another company and its subsidiaries, on the other hand. Grouping a parent company with its subsidiaries reflects an understanding that a subsidiary generally will comply with directions from its parent company. Considering only direct relationships between two companies would ignore this dynamic and thus the economic realities of corporate structures. For example, an investing company may own securities in a top-tier bank holding company while having substantial business relationships with the bank holding company's subsidiary bank. Considering the investing company's relationships with the bank holding company alone and with the bank alone would exclude important aspects of the combined relationship between the investing company, on the one hand, and the bank holding company and the bank, on the other hand.

Regarding joint ventures, the Board historically has recognized that relationships with joint ventures can be significant for purposes of controlling influence analysis because such relationships can represent a significant connection between the joint venture partners. For this reason, the final rule does not completely exclude relationships with joint ventures. Instead, consistent with the proposal, the final rule provides that a company that is a subsidiary of both the first company and the second company is treated as a subsidiary of the first company and not of the second company for purposes of applying the presumptions of control. The Board

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<sup>59</sup> First company and second company could take a variety of legal entity forms, including a stock corporation, limited liability company, partnership, business trust, or foreign equivalents of such legal entities. *See* 12 U.S.C. 1467a(a)(1)(C) and 1841(b).

believes that this is a reasonable standard for recognizing the potential importance of joint ventures without overstating such importance.

***B. Voting securities and nonvoting securities***

The BHC Act defines control to include the ownership, control, or power to vote 25 percent or more of any class of voting securities of a company.<sup>60</sup> In addition, several of the proposed presumptions required identifying the percentage of a class of voting securities controlled by a company in another company.

Regulation Y and Regulation LL previously included definitions of “voting securities” and “nonvoting shares.”<sup>61</sup> The proposal changed the defined term “nonvoting shares” to “nonvoting securities” and added to the definition of “nonvoting securities” equity instruments issued by companies other than stock corporations, such as limited liability companies and partnerships. In addition, the proposal revised the definition of “nonvoting securities” to clarify that common stock can be nonvoting securities.<sup>62</sup>

Regulation Y and Regulation LL also provide a nonexclusive list of examples of the types of voting rights that the Board has considered to be within the scope of the defensive voting rights that nonvoting securities may contain.<sup>63</sup> The proposal revised the definition of nonvoting securities to expressly permit certain additional defensive voting rights that are commonly found in investment funds that are organized as limited liability companies and limited partnerships. Specifically, the proposal provided that defensive voting rights that do not

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<sup>60</sup> 12 U.S.C. 1841(a)(2)(A).

<sup>61</sup> 12 CFR 225.2(q).

<sup>62</sup> For safety and soundness reasons, the Board generally believes that voting common stockholders’ equity should be the dominant form of equity for a banking organization. *See, e.g.*, 78 FR 62018, 62044 (Oct. 11, 2013).

<sup>63</sup> 12 CFR 225.2(q)(2)(i); 12 CFR 238.2(r)(2)(i).

cause a security to be a voting security include the right to vote to remove a general partner or managing member for cause, the right to vote to replace a general partner or managing member that has been removed for cause or has become incapacitated, and the right to vote to dissolve the company or to continue operations following the removal of a general partner or managing member. Some commenters asked that the Board provide that certain securities—including limited partnership interests, REIT investment units, and trust beneficiary rights—are nonvoting securities.

The final rule is largely consistent with the proposal on the definitions of voting securities and nonvoting securities. To prevent evasion, the final rule does not categorically exclude any specific types of securities issued by certain legal entities from the definition of voting securities. Although there is substantial variability in the terms and structures of securities in the financial markets, the definitions of voting securities and nonvoting securities in the final rule have been drafted broadly to apply effectively to all forms of legal entities.

### *C. Control of securities*

The proposed rule reflected the Board’s current practice for determining whether a company’s securities are owned, controlled, or held with power to vote by an investor and provided rules for determining the percentage of a class of a company’s voting securities attributed to a person.

#### *Ownership, Control, and Holding with Power to Vote*

The proposal provided rules for determining whether a person “controls” a security.<sup>64</sup> Specifically, the proposal provided that a person controls a security if the person owns the

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<sup>64</sup> These proposed standards effectively replaced the presumptions for control over voting securities currently in 12 CFR 225.31(d)(1). In this discussion, “person” has the meaning provided in 12 CFR 225.2(l) and 12 CFR 238.2(j).

security or has the power to sell, transfer, pledge, or otherwise dispose of the security. In addition, a person controls a security if the person had the power to vote the security, other than due to holding a short-term, revocable proxy. This proposed definition of control over securities is consistent with Board precedent and with the language of the BHC Act.<sup>65</sup>

Some commenters suggested that power to dispose of securities in certain circumstances should not provide control over the securities, such as securities held in a fiduciary capacity or as collateral that may be rehypothecated. A few commenters argued that securities held in a small business investment company or in a merchant banking portfolio company should not be considered controlled. Commenters also argued that securities held in an underwriting, dealing, or market making capacity should not be considered controlled for purposes of the presumptions of control.

The final rule makes minor revisions to the proposal's provisions on control over securities. The final rule is consistent with Board precedent and the statutory framework. However, the Board does recognize that securities held by an underwriter for a very limited period of time for purposes of conducting a bona fide underwriting generally do not raise control concerns. An underwriter generally would hold the securities only for a few days and only for the purpose of prompt resale to the market.<sup>66</sup>

The Board does not believe that the final control rule should make exceptions for small business investment company investments, merchant banking portfolio company investments, or any specific investment types. The Board's general regulatory framework addresses the permissibility of these investments, and there are no compelling reasons to treat these

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<sup>65</sup> See, e.g., 12 U.S.C. 1841(a)(2)-(3) and 1842(a).

<sup>66</sup> For example, the Board's capital rule provides a 5-day holding period for underwriting securities. 12 CFR 217.2.

investments differently than other investments under the Board’s control framework. For example, if a financial holding company owns 100 percent of the securities of a merchant banking portfolio company, the financial holding company controls the portfolio company for purposes of the BHC Act under the first prong of the definition of control. The financial holding company is able to have this ownership interest under its merchant banking authority, but must treat the portfolio company as a controlled subsidiary under Regulation Y.<sup>67</sup>

*Options, warrants, and convertible instruments*

The proposal provided standards for 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. Under the proposal’s “look-through” approach, a person would control all securities that the person could control upon exercise of any options or warrants. In addition, a person would control all securities that the person could control as a result of the conversion or exchange of a convertible instrument controlled by the person. This approach was consistent with the Board’s longstanding precedent of generally considering a person to control any securities (i) that the person has a contractual right to acquire now or in the future; or (ii) that the person would automatically acquire upon occurrence of a future event.<sup>68</sup>

In addition, the proposal provided that a person controls the maximum number of securities that could be obtained under the terms of the option, warrant, or convertible instrument. Thus, for example, if the number of securities that could be acquired upon exercise of an option varied based on some metric, such as the market price or book value of the

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<sup>67</sup> 12 CFR part 225, Subpart J.

<sup>68</sup> See, e.g., 2008 Policy Statement.

securities, the person with the option was considered to control the highest percentage of the class of securities that could possibly be acquired under the terms of the option.

Moreover, for purposes of calculating a person's percentage of a class of voting securities or total equity, the proposal generally deemed a person to control the percentage resulting from the exercise of the person's options, warrants, or conversion features, assuming that no other parties exercised their options, warrants, or conversion features. However, if, for example, a person is only able to exercise an option when all outstanding options in a class are simultaneously exercised by all holders, the percentage controlled by the person should reflect the exercise of all the outstanding options in the class, not just those options held by the person.

The proposal included several limited exceptions to this general look-through approach. Consistent with the 2008 Policy Statement, the proposal incorporated a limited exception for financial instruments that may convert into voting securities but by their terms may not become voting securities in the hands of the current holder or any affiliate of the current holder and may only convert to voting securities upon transfer to (i) the issuer or an affiliate of the transferor, (ii) in a widespread public distribution, (iii) in transfers where no transferee or group of associated transferees would receive 2 percent or more of any class of voting securities of the issuer, or (iv) to a transferee that controls 50 percent or more of every class of voting securities before the transfer.

The proposal also exempted from the general look-through approach a purchase agreement to acquire securities that had not yet closed. This exemption allowed parties to enter into securities purchase agreements pending regulatory approval, due diligence, and satisfaction of other conditions to closing.

In addition, the proposal exempted from the general look-through approach any options, warrants, or convertible instruments that permitted an investor to acquire additional voting securities only to maintain the investor's percentage of voting securities in the event the issuing company increased the number of its outstanding voting securities.

Many commenters suggested that the Board should apply the look-through approach only to narrow classes of options, warrants, and convertible instruments, or that the Board should not look through options, warrants, or convertible instruments at all. Some commenters suggested that the Board only look through options or convertible instruments if they could be freely exercised within 60 days, are in the money, or are not subject to a remote contingency trigger or condition outside of the holder's control. Some commenters argued that the look-through approach should not apply to options if the investor does not have control over the exercise of the option. A few commenters asked the Board to clarify the application of the standards from the 2008 Policy Statement under the proposal. A few commenters suggested that the Board clarify that nonvoting securities will remain nonvoting even if they have the right to elect directors after six quarterly dividend payments are missed, consistent with Board precedent.

The final rule is generally consistent with the proposal with respect to these provisions. However, the final rule includes an additional exception to the look-through approach that preferred securities that have no voting rights unless the issuer fails to pay dividends for six or more quarters are only considered to be voting securities if a sufficient number of dividends are missed and the voting rights are active. As noted by commenters, this additional narrow exception to the look-through approach is consistent with Board precedent and helps to address a fairly common feature of preferred securities. Securities with springing voting rights that do not



fit into this exception generally will be considered to be voting securities under the look-through approach.

The final rule does not include any of the other limitations on the look-through approach supported by commenters. The look-through approach appropriately recognizes that options, warrants, and convertible instruments provide the holder of such instruments with the ability to control the underlying securities by exercising the option, warrant, or convertible instrument, or transferring the option, warrant, or convertible instrument. In addition, many of the suggested limitations on the look-through approach are not practicable. For example, looking through in-the-money options while not looking through out-of-the-money options could result in unpredictable moves from non-control to control of a bank without the ability of the investor to apply or receive prior approval under section 3 of the BHC Act. Moreover, excluding from the look-through approach options, warrants, and convertible instruments with remote contingency triggers would require the Board to adopt an impracticable measure of remoteness. The Board notes that the final rule's exception to the look-through approach based on transfer restrictions has been slightly revised to conform more precisely to the 2008 Policy Statement.

*Control over securities through restrictions on rights*

Consistent with current regulations, the proposal provided that a person controls securities if the person is a party to an agreement or understanding under which the rights of the owner or holder of securities are restricted in any manner, unless the restriction falls under one of the exceptions specified in the rule.<sup>69</sup>

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<sup>69</sup> This standard could result in multiple persons being considered to have control over the same securities. This remains possible under the final rule.

The proposal provided six exceptions to this general rule, each designed to accommodate certain common restrictions on securities that do not provide the type of control over securities relevant to this rulemaking. The first exception was for rights of first refusal, rights of last refusal, tag-along rights, drag-along rights, or similar rights that are on market terms and that do not impose significant restrictions on the transfer of the securities. Second, the proposal provided an exception for arrangements that restrict the rights of an owner or holder of securities when the restrictions are incidental to a bona fide loan transaction. Third, the proposal provided that an arrangement that restricts the ability of a shareholder to transfer securities pending the consummation of an acquisition of the securities does not provide the restricting party control over the securities of the restricted party. Fourth, the proposal generally provided that an arrangement that requires a current shareholder of a company to vote in favor of a proposed acquisition of the company would not result in the proposed acquirer controlling the securities of the current shareholder. Fifth, the proposal exempted arrangements among the shareholders of a company designed to preserve the tax status or tax benefits of a company, such as qualifying as a Subchapter S Corporation<sup>70</sup> or to preserve tax assets (such as net operating losses) against impairment.<sup>71</sup> Sixth, the proposal provided that a short-term revocable proxy would not provide the holder of the proxy with control over the securities governed by the proxy.<sup>72</sup>

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<sup>70</sup> See 26 U.S.C. 1361.

<sup>71</sup> See 26 U.S.C. 382. In order to qualify for this exemption, the arrangement was required to not impose restrictions on securities beyond those reasonably necessary to achieve the goal of preserving tax status, tax benefits, or tax assets. Agreements of this type may raise significant safety and soundness concerns under certain circumstances, independent of whether control concerns are raised.

<sup>72</sup> The proposed treatment of short-term revocable proxies was consistent with the Board's current regulations regarding notices under the Change in Bank Control Act. See 12 CFR 225.41(d)(4); 12 CFR 225.42(a)(5).

The Board received very few comments on this framework and is adopting the framework as proposed.

*Control of securities through associated individuals and subsidiaries*

The proposal provided that a company that owns, controls, or holds with power to vote 5 percent or more of any class of voting securities of a second company controls any securities issued by the second company that are owned, controlled, or held with power to vote by the senior management officials, directors, or controlling shareholders of the first company, or by the immediate family members of such individuals.<sup>73</sup> In addition, the proposal provided that a person controls all voting securities controlled by any subsidiaries of the person, and that a person generally does not control any voting securities controlled by any non-subsidiary of the person.

At least one commenter argued that the Board should not consider securities held in separate accounts by an insurance company to be controlled by the insurance company, or that the Board should clarify how separate accounts may be structured so that securities in such accounts are not treated as controlled by the insurance company. One commenter requested clarification regarding the attribution of voting securities held in a voting trust.

The final rule defines control over securities through associated individuals and subsidiaries in a manner substantially consistent with the proposal. The final rule has been revised, however, to integrate the standards for control over voting securities through associated individuals with the proposed 5-25 presumption. Specifically, the proposed 5-25 presumption substantially overlapped with the provision providing that a company should be attributed the securities of its senior management officials, directors, and controlling shareholders, as well as

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<sup>73</sup> See 12 CFR 225.31(d)(2)(ii).

immediate family members of such individuals. As a result, as discussed above, the proposed 5-25 presumption is not necessary and is not included in the final rule. However, the Board is revising the provisions related to control over voting securities through associated individuals to incorporate the exception to the proposed 5-25 presumption when the company controls less than 15 percent of each class of voting securities of the other company and a majority of each class of voting securities of the other company are controlled by the first company's senior management officials, directors, and controlling shareholders, as well as immediate family members of such individuals.

The final rule does not include the express statement from the proposal that a company does not control securities that are controlled by a non-subsiary of the company. Although the Board continues to believe that a company generally should not be deemed to control securities held by a non-subsiary of the company, the Board has removed this provision from the final rule so as not to create an expectation that a company would never be deemed to control securities held by a non-subsiary. For example, a company generally would be deemed to control securities held by a non-subsiary if the company had an option to acquire those securities.

#### *Reservation of authority*

The proposal included a reservation of authority to allow the Board to determine that securities that would otherwise be considered controlled by a person under the proposal are not controlled by the person. Similarly, the proposed reservation of authority allowed the Board to determine that securities that are not considered controlled by a person under the proposal are controlled by the person. The Board received no comments specifically on this reservation of authority provision and the final rule includes the reservation of authority consistent with the

proposal. The reservation of authority is meant to allow the Board to deal with rare circumstances that do not align with the intent of the rule.

*Percentage of a class of voting securities*

The proposal provided a rule for calculating the percentage of a class of voting securities controlled by a person. The proposed rule considered both the number of securities and the voting power of those securities. Specifically, the percentage of a class of voting securities controlled by a person was the greater of (i) the number of voting securities of the class controlled by the person divided by the number of issued and outstanding voting securities of the class (expressed as a percentage) and (ii) the number of votes that the person could cast divided by the total number of votes that may be cast under the terms of all the voting securities of the class that are issued and outstanding (expressed as a percentage).

Commenters argued that the Board should not include two voting ownership tests and should only calculate voting ownership based on voting power not on number of voting securities owned.

The final rule is generally consistent with the proposal. Considering both voting power and number of voting securities is consistent with the text of the BHC Act, the legislative history, and Board precedents. This method of calculation also prevents evasion through the use of securities with different voting power.

***D. Calculation of total equity percentage***

The proposal provided a methodology for calculating a company's total equity percentage in a second company that was a stock corporation that prepared financial statements according to GAAP. The first step to calculate a company's total equity in a second company was to determine the percentage of each class of voting and nonvoting common or preferred

stock issued by the second company that the first company controlled.<sup>74</sup> The second step was to multiply 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 third and final step was to divide the first company's dollars of shareholders' equity by the total shareholders' equity of the second company, as determined under GAAP.

The proposal also provided adjustments to this general standard for more complex structures. For example, a first company was considered to control all equity securities controlled by its subsidiaries. The proposal also provided that a first company controls a pro rata share of equity securities controlled by a non-subsidiary of the first company.

Under the proposal, the total equity calculation methodology applied by its terms only to stock corporations that prepare financials under GAAP. However, the proposed rule indicated that the Board generally would apply the methodology in other circumstances as well, to the extent appropriate.

The proposal also included several anti-evasion provisions. Specifically, where a company controlled debt of a second company that was functionally equivalent to equity of the second company, the debt was counted as equity for purposes of the total equity calculation. The proposal provided a nonexclusive list of factors that the Board would examine in deciding whether to treat debt instruments as functionally equivalent to equity. These factors included treatment of the debt as equity under accounting, regulatory, or tax standards; subordination of

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<sup>74</sup> For this purpose, all classes of common stock—whether voting or nonvoting—were treated as a single class. If certain classes of common stock had different economic interests per share in the issuing company, the number of shares of common stock was adjusted to equalize the economic interest per share.

the debt; or long maturity of the debt. Similarly, the proposal provided that other interests in a company beyond debt that were functionally equivalent to equity may be treated as equity.

In addition to a methodology for calculating total equity, the proposal provided a standard for the frequency of measurement of total equity. Under the proposal, an investing company was required to calculate its total equity in a second company each time the investing company acquired control over additional equity interests of the second company or divested control of equity interests of the second company.

Many commenters criticized the proposed total equity calculation methodology. In particular, commenters argued that it would lead to a first company being presumed to control a second company where the second company had negative retained earnings and the first company controlled preferred securities of the second company that included a liquidation preference. Several commenters recommended that retained earnings from start-up companies be excluded from the total equity calculation to avoid this problem. Some commenters alternatively recommended that the final rule include an exception for start-up companies where the total equity presumption would not apply for the first several years of a company's existence.

Certain commenters suggested that the Board calculate total equity using a common stock equivalent method as an alternative to the proposed methodology. Some commenters argued that the Board should establish more flexible rules for investments by and in investment funds.

Many commenters recommended that the Board not include debt instruments or other interests in the total equity calculation under the proposal's functional equivalence standard. Commenters argued that the standard was vague and could inhibit the use of certain common types of debt and other economic interests. At least one commenter suggested that the Board

also provide that equity may be treated as functionally equivalent to debt under appropriate circumstances and thus excluded from total equity.

Various commenters urged the Board to eliminate or restrict the scope of the provisions of the total equity methodology that required a company to include a pro rata share of equity securities held by a non-subsiary.

One commenter suggested that the Board revise the frequency of recalculation of total equity to require recalculation only if a company acquires control over additional voting equity, or only if a company controls five percent or more of a class of voting securities. Some commenters recommended that the final rule require recalculation of total equity only when a company acquires equity, never in the case of divestiture of equity.

The final rule's methodology for determining a company's total equity percentage in another company is largely consistent with the proposal. The Board believes that the GAAP-based core methodology of the final rule is effective, fit for purpose, well-understood, and easy to apply. The final rule includes a technical correction to the formula for total equity so that *pari passu* classes of preferred stock (i.e., classes of preferred securities of the same seniority in liquidation) are treated as a single class.

The final rule includes without change the provision whereby debt or other interests may be treated as equity if the interests are functionally equivalent to equity. The Board expects to reclassify debt as equity under the rule only under unusual circumstances to prevent evasion of the rule. The list of debt features that support a reclassification as equity should not be understood to indicate that a debt instrument having any one of such features automatically would be treated as equity.



In response to concerns raised by commenters, the final rule provides flexibility for excluding nominally equity instruments from total equity if the equity instruments are determined to be functionally equivalent to debt. The final rule also includes a non-exclusive list of characteristics that could indicate that an equity instrument may be functionally equivalent to debt, such as protections generally provided to creditors, a limited term, a fixed rate of return or a variable rate of return linked to a reference interest rate, classification as debt for tax purposes, or classification as debt for accounting purposes.<sup>75</sup> This provision is intended to provide flexibility for unusual structures and is expected to be used rarely. Companies should consult with the Board or its staff in order to determine whether equity instruments would be excluded from total equity.

The final rule does not include the proposed provision that required a company to include a pro rata share of equity securities held by a non-subsidiary. Accordingly, a company must include in the total equity calculation only equity securities it controls directly or indirectly through its subsidiaries.

Also in response to concerns raised by commenters, the final rule requires calculation of total equity only when a first company acquires control over additional equity of a second company. The first company is not required to recalculate its total equity when it sells or otherwise disposes of equity of the second company. This change will prevent a divestiture from causing an increase in total equity due to balance sheet changes at the second company.

#### ***E. Limiting contractual rights***

Under the proposal, a company was presumed to control a second company if the first company had a contractual right that significantly restricts, or allows the first company to

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<sup>75</sup> See, e.g., ASC 480-10.

significantly restrict, the discretion of the second company over major operational or policy decisions.<sup>76</sup> Such contractual provisions was defined as a limiting contractual right.

The proposal provided examples of provisions that generally were considered limiting contractual rights and examples of provisions that generally were not considered limiting contractual rights. The examples included in the proposal were not intended to be a complete list of provisions that would or would not be considered limiting contractual rights. Rather, the provisions were meant as non-exclusive examples to provide transparency. The examples of limiting contractual rights listed in the proposal were:

- Restrictions on activities in which a company may engage, including a prohibition on (i) entering into new lines of business, (ii) making substantial changes to or discontinuing existing lines of business, (iii) entering into a contractual arrangement with a third party that imposes significant financial obligations on the company, or (iv) materially altering the policies or procedures of the company;
- Requirements that a company direct the proceeds of the investment to effect any action, including to redeem the company's outstanding voting securities;
- 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;

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<sup>76</sup> For purposes of this restriction, a contractual arrangement between the first company and a subsidiary of the second company, or between a subsidiary of the first company and the second company, could constitute a limiting contractual right of the first company over the second 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 make significant investments or expenditures;
- Requirements that a 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;
- Requirements that a company not exceed a specified percentage of classified assets or non-performing loans;
- Restrictions on a company's ability to pay or not pay dividends, change its dividend payment rate on any class of securities, redeem senior instruments, or make voluntary prepayment of indebtedness;
- 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 engage in a public offering or to list or de-list securities on an exchange;
- Restrictions on a company's ability to amend its articles of incorporation or by-laws, 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; or
- Restrictions on a 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's examples of contractual provisions that generally would not be limiting contractual rights were:

- A restriction on a company's ability to issue securities senior to the securities owned by the investor;
- A requirement that a company provide the investor with financial reports of the type ordinarily available to common stockholders;
- A requirement that a company maintain its corporate existence;
- A requirement that a company consult with the investor on a reasonable periodic basis;
- A requirement that a company comply with applicable statutory and regulatory requirements;
- A requirement that a company provide the investor with notice of the occurrence of material events affecting the company or its significant assets;
- A market standard "most-favored nation" requirement that the investor receive similar contractual rights as those held by other investors in a company; or
- Drag-along rights, tag-along rights, rights of first or last refusal, or stock transfer restrictions related to preservation of tax benefits of a company, such as S-corporation status and tax carry forwards, or other similar rights.

Commenters suggested that the scope of the definition of limiting contractual rights might be inconsistent with past precedent. Many commenters argued that the list of limiting contractual rights was overly broad and encompassed many standard investor protection rights. In addition, many commenters argued that the open-ended definition of limiting contractual right to include any right that restricts or allows one company to exert significant influence over another was overly vague.

In addition, commenters objected to including within the scope of limiting contractual rights various of the examples provided, including limits on: the second company's ability to enter into new lines of business; how the second company directs the proceeds of investments; the second company's ability to incur additional debt or raise additional equity; requirements that the second company maintain a particular financial ratio; the second company's ability to amend the terms of its debt or equity securities; the second company's ability to engage in a public offering, or to list or de-list securities on an exchange; the second company's ability to merge or consolidate with another company; the second company's ability to dispose of material subsidiaries or assets; and the second company's ability to alter its accounting methods or policies or its regulatory, tax, or liability status.

The final rule's definition of a limiting contractual right is generally consistent with the proposal. Limiting contractual rights are important indicia of controlling influence. In particular, limiting contractual rights provide a means for a company to cause or prevent otherwise permissible actions by another company, independent of the first company's exercise of its voting rights as a shareholder in the second company. Using such contractual rights, a company that has relatively low voting power may effectively control another company's decisions over important actions, or at least have influence over such decisions well beyond what the first company's voting power would provide.<sup>77</sup>

The variety of forms that limiting contractual rights may take makes the functional definition included in the final rule preferable to a prescriptive definition. The final rule, consistent with the proposal, includes lists of contractual rights that generally would or would

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<sup>77</sup> Such limiting contractual rights also may raise safety and soundness concerns by restricting the ability of a company to take appropriate actions to address supervisory issues.

not be considered limiting contractual rights in order to provide additional clarity around the specific application of the definition. The lists of contractual rights reflect a distillation of the Board's past practice and current understanding of the types of contractual restrictions that likely would or would not raise controlling influence concerns. The lists of contractual rights have not been changed from the proposal, though the introductory text of each list has been revised to make it clear that the listed provisions are examples of what generally would or would not be considered a limiting contractual right. Whether or not a particular contractual right is a limiting contractual right depends on whether the contractual right meets the functional regulatory definition of a limiting contractual right.

Commenters argued that a restriction on new lines of business should not be considered a limiting contractual right because such a restriction would help a bank holding company comply with the activity limitations in the BHC Act. Similarly, commenters argued that covenants to comply with the activities restrictions under the BHC Act or HOLA should not be treated as limiting contractual rights. Under the final rule, a contractual prohibition on engaging in particular activities is generally a limiting contractual right. However, the Board notes that a contractual provision that provides a reasonable and non-punitive mechanism for an investing company to reduce its investment to comply with the activities restrictions of the BHC Act or HOLA generally would not be a limiting contractual right.

One commenter asked the Board to clarify whether a contractual right restricting "materially altering policies or procedures" would qualify as a limiting contractual right. A restriction of this type generally would be considered a limiting contractual right. It is similar to the example of a limiting contractual right provided in the final rule related to amendments to the articles or bylaws of a company.

Commenters suggested that the right to information available to shareholders should be expanded to include access to information that is necessary or appropriate to allow the first company to monitor its investment and to monitor regulatory, legal, or other requirements or standards, including the presumptions of control in the final rule. In the Board's view, an investor's right to access information regarding the relationship between the investor and the investee company, such as the information necessary to determine the application of the presumptions of control, generally would not be considered a limiting contractual right. In addition, the final rule has been revised to clarify that a contractual right to information ordinarily available to common shareholders, whether or not the information is financial in nature, is generally not a limiting contractual right.

Commenters also argued that the presumption of control based on limiting contractual rights should be revised so that the presumption does not apply if the first company cannot exercise the right unilaterally or if the first company is not the largest single decider of the exercise of the right. One commenter sought clarification as to whether, and in what circumstances, voting rights exercised by a group of investors (such as a voting right that can only be exercised by certain preferred shareholders) would be treated as a limiting contractual right. To avoid undue complexity, the final rule does not specifically address contractual provisions that incorporate elements of voting by requiring agreement of a certain percentage of certain parties. Companies with questions on a particular limiting contractual right may contact the Board or its staff to address the specific situation.

In addition, commenters expressed concern that the proposal would treat standard loan or bond covenants as limiting contractual rights. Commenters argued that treating loan covenants as limiting contractual rights would make it impossible for a bank to make a loan to another

company if its affiliate had also made an equity investment in that company. Some commenters argued that standard loan covenants should not trigger a presumption of control when they are on market terms, there are multiple lenders, and the first company has less than 15 percent voting power in the second company. The final rule does not include any revisions in response to these comments. In the Board's view, a contractual provision that significantly restricts a company's discretion over operational and policy decisions ought to be treated as a limiting contractual right in the final rule. Whether or not the limiting contractual right is embedded in a market-standard loan agreement does not affect the influence the limiting contractual right provides the holder of the right. The Board generally has controlling influence concerns when a company, directly or indirectly, both controls a material amount of voting securities of another company and has the ability to significantly restrict the discretion of the other company over operational or policy decisions by contract.

***F. Director representatives***

As discussed, the Board has long taken the position that director representatives of a company serving on the board of directors of a second company are an avenue through which the first company may exercise a controlling influence over the second company. To provide more clarity on when the Board deems an individual to be a director representative of a company, the proposal defined director representative to be any director who (i) is a current director, employee, or agent of the company; (ii) was a director, employee, or agent of the company within the preceding two years; or (iii) is an immediate family member of an individual who is a current director, employee, or agent of the company, or was a director, employee, or agent of the company within the preceding two years. In addition, the proposal provided that a director is a director representative of a first company if the director was proposed to serve as a director by



the first company, whether by exercise of a contractual right or otherwise. The proposal also specified that a nonvoting observer is not a director representative.

Some commenters suggested that the definition of a director representative was too broad and could include directors over which the first company did not have substantial influence. In particular, some commenters contended that director representatives should not include individuals elected to the board of directors of a mutual fund by a first company if the director representatives are independent of the first company.

A few commenters expressed concern that the proposed definition might mean that the Board would attribute a director to a company if the company merely suggested the name of the director to a nominating committee. Some commenters also expressed concern about the ambiguity of treating “agents” of a company as director representatives and requested that the Board define the term agent in this context.

Several commenters argued that the definition of director representative should include only former directors of the first company and should not include former employees. Similarly, some commenters suggested that a company should only be attributed a former officer, director, or employee if the individual became a director of the second company while still an officer, director, or employee of the first company.

Some commenters argued that the inclusion of immediate family members of directors, employees, and agents of the first company was too broad and would create compliance difficulties, especially with respect to employees of large companies. These commenters argued that the immediate family member prong ought to be removed from the definition of director representative.

In response to the comments received, the Board is substantially amending the definition of a director representative to be more functional and more narrow. Specifically, under the final rule, “director representative” is defined as an individual that represents the interests of a first company through service on the board of directors of a second company. The final rule then provides a non-exclusive list of examples of persons who generally would be considered to be director representatives for purposes of the final rule: (i) individuals who are officers, employees, or directors of the first company, (ii) individuals who were officers, employees, or directors of the first company within the preceding two years, and (iii) individuals who were nominated or proposed by the first company to be directors of the second company. Companies may contact the Board or its staff for guidance in determining whether or not a particular individual would be considered to be a director representative for purposes of the final rule.

#### ***G. Investment advisers***

The proposal defined investment adviser for purposes of the proposed presumptions to mean a company that is registered as an investment adviser with the SEC under the Investment Advisers Act,<sup>78</sup> a company registered with the Commodity Futures Trading Commission (“CFTC”) as a commodity trading adviser under the Commodity Exchange Act,<sup>79</sup> a company that is a foreign equivalent of an investment adviser or commodity trading adviser registered with the SEC or CFTC, respectively, or a company that engages in any of the activities set forth in section 225.28(b)(6)(i) through (iv) of the Board’s Regulation Y.

The Board did not receive comments specifically on the definition of investment adviser, although the Board did receive comments on the presumption of control based on investment

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<sup>78</sup> 15 U.S.C. 80b-1 *et seq.*

<sup>79</sup> 7 U.S.C. 1 *et seq.*

advisory relationships. The comments on the presumption of control based on investment advisory relationships are discussed earlier in this preamble. The final rule adopts the definition of investment adviser as proposed.

#### **IV. Application to savings and loan holding companies**

As noted, the proposal applied equally to bank holding companies and savings and loan holding companies to the maximum extent permitted by law. HOLA defines control in a substantially similar manner as the BHC Act.<sup>80</sup> The Board previously recognized that the statutory control framework under the BHC Act and HOLA are nearly identical and determined to apply matching procedures for reviewing controlling influence cases involving savings and loan holding companies under Regulation LL as apply to bank holding companies under Regulation Y.<sup>81</sup> Consistent with this principle, the proposal incorporated the proposed control presumptions and related revisions into the Board's Regulation LL for savings and loan holding companies in essentially the same manner as into the Board's Regulation Y for bank holding companies.

##### ***A. Control under HOLA compared to the BHC Act***

Although controlling influence is defined similarly under HOLA and the BHC Act, there are several differences between the definitions of "control" in each statute. Under HOLA, the definition of control applies to both individuals and companies controlling other companies, while control is limited to companies controlling other companies under the BHC Act.<sup>82</sup> Under HOLA, a person controls a company if the person has more than 25 percent of any class of

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<sup>80</sup> Compare 12 U.S.C. 1467a(a)(2) (HOLA) with 12 U.S.C. 1841(a)(2) (BHC Act).

<sup>81</sup> 76 Fed. Reg. 56508, 56509 (Sept. 13, 2011).

<sup>82</sup> 12 U.S.C. 1467a(a)(2).

voting securities of the company, rather than 25 percent or more of any class of voting securities under the BHC Act.<sup>83</sup> Unlike the BHC Act, HOLA specifies that a general partner of a partnership controls the partnership, a trustee of a trust controls the trust, and a person that has contributed more than 25 percent of the capital of a company controls the company.<sup>84</sup> Further, HOLA does not include the BHC Act's presumption of noncontrol for a company with a less than 5 percent voting interest in another company.<sup>85</sup>

At least one commenter stated that the Board should confirm past decisions of the Office of Thrift Supervision indicating that contributed capital for purposes of HOLA was the same as total equity, or that the Board should otherwise clarify its interpretation of contributed capital for purposes of HOLA. One commenter suggested that the Board should seek additional public comment on its interpretation of contributed capital.

In response to comments received on the proposal, the final rule has been revised to reflect that contributed capital for purposes of HOLA generally has the same meaning as total equity as used by the Board in the context of control under the BHC Act. As a result, the final rule differs from the proposal in several respects. Specifically, the final rule omits the concept of total equity from subpart C of Regulation LL because subpart C relates to questions of controlling influence and contributed capital is a separate part of the statutory definition of control under HOLA. The rules for calculating total equity under subpart D of Regulation Y reflect how the Board generally expects to measure contributed capital for purposes of HOLA and Regulation LL.

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<sup>83</sup> 12 U.S.C. 1467a(2)(A)–(B) and 1841(a)(2)(A).

<sup>84</sup> 12 U.S.C. 1467a(2)(B)–(C).

<sup>85</sup> 12 U.S.C. 1841(a)(3).

## ***B. Revisions to Regulation LL***

Under the proposal, the Board included in Regulation LL the same presumptions and related amendments made to Regulation Y, with limited changes to reflect the relevant differences between control under the BHC Act and HOLA. The proposed defined terms were located in section 238.2 of Regulation LL. The proposed provisions relating to the calculation of the percentage of a class of securities controlled by a person were located in section 238.10 of Regulation LL. The proposed provisions related to control proceedings, including the proposed presumptions of control and noncontrol, were located in subpart C of Regulation LL.

The Board did not receive any comments specifically on how the rule amended Regulation LL, other than the contributed capital issue described previously. Accordingly, other than the provisions related to total equity, the final rule creates an essentially consistent control framework between Regulation Y and Regulation LL.

## **V. Additional implementation matters**

### *Use of passivity commitments*

Some commenters suggested that the Board abandon its use of passivity commitments and clarify that such commitments are not needed going forward. Other commenters requested that the Board clarify whether it intends to continue to seek either the general passivity commitments or any of the specialized types of similar commitments. A few commenters also requested that the Board provide a process under which companies that have provided passivity commitments may obtain relief from the commitments to align to the control framework. Some commenters suggested that investors that had previously submitted passivity commitments to the Board should be allowed to increase their relationships with the target company without seeking

relief from commitments so long as the increased relationships would not trigger a presumption of control under the final rule.

The Board does not intend to obtain the standard-form passivity commitments going forward in the ordinary course. The Board will continue to obtain control-related commitments in specific contexts, such as commitments from employee stock ownership plans and mutual fund complexes, and in special situations.

In the wake of the final rule, companies that have provided the standard form of passivity commitments to the Board may contact the Board or the appropriate Federal Reserve Bank to seek relief from these commitments. Absent unusual circumstances, the Board expects to be receptive to such requests for relief.<sup>86</sup>

#### *Application of the final rule*

Several commenters suggested that the Board's new control framework should only apply prospectively. Similarly, some commenters suggested that the Board grandfather all existing investments or more narrowly grandfather existing investments that had been reviewed by the Board or its staff. Some commenters advocated for a three-year phase-in period for foreign banking organizations so that these firms could make adjustments to their business practices to account for the final rule.

The final rule provides additional information regarding the Board's views on questions of controlling influence, but it is generally consistent with the Board's current practice. As it is not a fundamental change to current practice, the final rule does not grandfather existing structures and does not provide a transition period to allow firms to conform existing

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<sup>86</sup> Companies that have provided commitments in connection with TARP securities may also seek relief.

investments. The Board does not expect to revisit structures that have already been reviewed by the Federal Reserve System unless such structures are materially altered from the facts and circumstances of the original review. 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 System, and the relationship would be presumed to be a controlling relationship under the final rule, the company may contact the Board or its staff to discuss potential actions.

## **VI. Administrative law matters**

### ***A. Paperwork Reduction Act***

In accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3521) (PRA), the Board may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The Board reviewed the final rule and determined that it does not create any new or revise any existing collection of information under section 3504(h) of title 44.

### ***B. Regulatory Flexibility Act***

An initial regulatory flexibility analysis (IRFA) was included in the proposal in accordance with section 603(a) of the Regulatory Flexibility Act (RFA), 5 U.S.C. 601 *et seq.* (RFA). In the IRFA, the Board requested comment on the effect of the proposed rule on small entities and on any significant alternatives that would reduce the regulatory burden on small entities. The Board did not receive any comments on the IRFA. The RFA requires an agency to prepare a final regulatory flexibility analysis unless the agency certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities.

Based on its analysis, and for the reasons stated below, the Board certifies that the rule will not have a significant economic impact on a substantial number of small entities.<sup>87</sup>

Under regulations issued by the Small Business Administration, a small entity includes a bank, bank holding company, or savings and loan holding company with assets of \$600 million or less and trust companies with total assets of \$41.5 million or less (small banking organization).<sup>88</sup> As of June 30, 2019, there were approximately 2,976 small bank holding companies, 133 small savings and loan holding companies, and 537 small SMBs. The final rule may also have implications for additional entities that have material relationships with banking organizations; however, the scope of potentially affected entities and thus the extent to which affected entities are small entities under the regulations of the Small Business Administration, is not known.

As discussed in the Supplementary Information section, the final rule establishes a more detailed framework for the Board to determine whether a company has control over another company for purposes of the BHC Act and HOLA. The final rule consists of a series of rebuttable presumptions of control, a rebuttable presumption of noncontrol, and various ancillary items such as definitions of terms used in the presumptions. The presumptions of control generally would be consistent with the Board's current practice with respect to controlling influence, with certain targeted adjustments.

A main impact of the final rule will be to enhance transparency to the public on the Board's views on controlling influence. The final rule most directly affects bank holding

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<sup>87</sup> 5 U.S.C. 605(b).

<sup>88</sup> See 13 CFR 121.201. Effective August 19, 2019, the SBA revised the size standards for banking organizations to \$600 million in assets from \$550 million in assets.

84 FR 34261 (July 18, 2019).



companies and savings and loan holding companies, though it also could impact state member banks and other companies with relationships with depository institutions and depository institution holding companies. However, the final rule generally will not impact banking organizations in the ordinary course; there are no regular compliance, recordkeeping, or reporting requirements associated with the final rule. Rather, the impact of the final rule will generally be in the context of certain types of significant transactions that companies may decide to engage in. In addition, any material impact would be concentrated in companies engaged in the particular types of investments where controlling influence is a concern for the parties involved, which is a narrow subset of all transactions banking organizations may be party to. For the reasons discussed above, the Board anticipates that any economic impact of the final rule, including on small banking organizations, will be a reduction of burden associated with structuring transactions to address control issues. Therefore, the Board does not expect the rule to have a significant economic impact on a substantial number of small entities.

### ***C. Plain Language***

Section 722 of the Gramm-Leach-Bliley Act<sup>89</sup> requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Board have sought to present the final rule in a simple and straightforward manner, did not receive any comments on the use of plain language.

### **List of Subjects**

#### **12 CFR Part 225**

Administrative practice and procedure, Banks, banking, Capital planning, Holding companies, Reporting and recordkeeping requirements Securities, Stress testing.

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<sup>89</sup> Pub. L. 106-102, section 722, 113 Stat. 1338, 1471 (1999).

## **12 CFR Part 238**

Administrative practice and procedure, Banks, Banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Holding companies, Securities.

### **Authority and Issuance**

For the reasons stated in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to amend 12 CFR chapter II as follows:

### **PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)**

1. The authority citation for part 225 continues to read as follows:

AUTHORITY: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3906, 3907, and 3909; 15 U.S.C. 1681s, 1681w, 6801 and 6805.

#### **Subpart A—General Provisions**

2. In § 225.2:

a. Revise section 225.2(e)(1) by replacing “bank or other company” with “company” wherever it appears;

b. Revise paragraphs (e)(2) and (q)(2); and

c. Add paragraph (u).

The revisions and additions read as follows:

#### **§ 225.2 Definitions.**

\* \* \* \* \*

(e) \* \* \*

(2) A company is deemed to control voting securities or assets owned, controlled, or held, directly or indirectly:

(i) By the company, or by any subsidiary of the company;

(ii) That the company has power to vote or to dispose of;

(iii) In a fiduciary capacity for the benefit of the company or any of its subsidiaries;

(iv) In a fiduciary capacity (including by pension and profit-sharing trusts) for the benefit of the shareholders, members, or employees (or individuals serving in similar capacities) of the company or any of its subsidiaries; or

(v) According to the standards under section 225.9 of this part.

\* \* \* \* \*

(q) \* \* \*

(2) *Nonvoting securities*. Common shares, preferred shares, limited partnership interests, limited liability company interests, or similar interests are not *voting securities* if:

(i) Any voting rights associated with the securities are limited solely to the type customarily provided by statute with regard to matters that would significantly and adversely affect the rights or preference of the security, such as the issuance of additional amounts or classes of senior securities, the modification of the terms of the security, the dissolution of the issuing company, or the payment of dividends by the issuing company when preferred dividends are in arrears;

(ii) The securities represent an essentially passive investment or financing device and do not otherwise provide the holder with control over the issuing company; and

(iii) The securities do not entitle the holder, by statute, charter, or in any manner, to select or to vote for the selection of directors, trustees, or partners (or persons exercising similar functions) of the issuing company; except that limited partnership interests or membership interests in limited liability companies are not voting securities due to 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).

\* \* \* \* \*

(u) *Voting percentage.* For purposes of this part, the percentage of a class of a company's voting securities controlled by a person is the greater of:

(1) The quotient, expressed as a percentage, of the number of shares of the class of voting securities controlled by the person, divided by the number of shares of the class of voting securities that are issued and outstanding, both as determined under section 225.9 of this part; and

(2) The quotient, expressed as a percentage, of the number of votes that may be cast by the person on the voting securities controlled by the person, divided by the total votes that are legally entitled to be cast by the issued and outstanding shares of the class of voting securities, both as determined under section 225.9 of this part.

\* \* \* \* \*

3. Section 225.9 is added to read as follows:

**§ 225.9 Control over securities.**

(a) *Contingent rights, convertible securities, options, and warrants.* (1) A person that controls a security, option, warrant, or other financial instrument that is convertible into, exercisable for, exchangeable for, or otherwise may become a security controls each security that could be acquired as a result of such conversion, exercise, exchange, or similar occurrence.

(2) If a financial instrument of the type described in paragraph (a)(1) of this section is convertible into, exercisable for, exchangeable for, or otherwise may become a number of securities that varies according to a formula, rate, or other variable metric, the number of securities controlled under paragraph (a)(1) of this section is the maximum number of securities that the financial instrument could be converted into, be exercised for, be exchanged for, or otherwise become under the formula, rate, or other variable metric.

(3) Notwithstanding paragraph (a)(1) of this section, a person does not control voting securities due to controlling a financial instrument if the financial instrument:

(i) By its terms is not convertible into, is not exercisable for, is not exchangeable for, and may not otherwise become voting securities in the hands of the person or an affiliate of the person; and

(ii) By its terms the financial instrument is only convertible into, exercisable for, exchangeable for, or may otherwise become voting securities in the hands of a transferee after a transfer:

(A) In a widespread public distribution;

(B) To the issuing company;

(C) In transfers in which no transferee (or group of associated transferees) would receive 2 percent or more of the outstanding securities of any class of voting securities of the issuing company; or

(D) To a transferee that would control more than 50 percent of every class of voting securities of the issuing company without any transfer from the person.

(4) Notwithstanding paragraph (a)(1) of this section, a person that has agreed to acquire securities or other financial instruments pursuant to a securities purchase agreement does not control such securities or financial instruments until the person acquires the securities or financial instruments.

(5) Notwithstanding paragraph (a)(1) of this section, a right that provides a person the ability to acquire securities in future issuances or to convert nonvoting securities into voting securities does not cause the person to control the securities that could be acquired under the right, so long as the right does not allow the person to acquire a higher percentage of the class of securities than the person controlled immediately prior to the future acquisition.

(6) Notwithstanding paragraph (a)(1) of this section, a preferred security that would be a nonvoting security but for a right to vote on directors that activates only after six or more quarters of unpaid dividends is not considered to be a voting security until the securityholder is entitled to exercise the voting right.

(7) For purposes of determining the percentage of a class of voting securities or the total equity percentage of a company controlled by a person that controls a financial instrument of the type described in paragraph (a)(1) of this section:

(A) The securities controlled by the person under paragraphs (a)(1) through (6) of this section are deemed to be issued and outstanding; and

(B) Any securities controlled by anyone other than the person under paragraph (a)(1) through (6) of this section are not deemed to be issued and outstanding, unless by the terms of the financial instruments the securities controlled by the other persons must be issued and outstanding in order for the securities of the person to be issued and outstanding.

(b) *Restriction on securities.* A person that enters into an agreement or understanding with a second person under which the rights of the second person are restricted in any manner with respect to securities that are controlled by the second person, controls the securities of the second person, unless the restriction is:

(1) A requirement that the second person offer the securities for sale to the first person for a reasonable period of time prior to transferring the securities to a third party;

(2) A requirement that, if the second person agrees to sell the securities, the second person provide the first person with the opportunity to participate in the sale of the securities by the second person;

(3) A requirement under which the second person agrees to sell its securities to a third party if a majority of securityholders agree to sell their securities to the third party;

(4) Incident to a bona fide loan transaction in which the securities serve as collateral;

(5) A short-term and revocable proxy;

(6) A restriction on transferability that continues only for a reasonable amount of time necessary to complete an acquisition by the first person of the securities from the second person, including the time necessary to obtain required approval from an appropriate government authority with respect to the acquisition;

(7) A requirement that the second person vote the securities in favor of a specific acquisition of control of the issuing company, or against competing transactions, if the restriction

continues only for a reasonable amount of time necessary to complete the transaction, including the time necessary to obtain required approval from an appropriate government authority with respect to an acquisition or merger; or

(8) An agreement among securityholders of the issuing company intended to preserve the tax status or tax benefits of the company, such as qualification of the issuing company as a Subchapter S corporation, as defined in 26 U.S.C. 1361(a)(1) or any successor statute, or prevention of events that could impair deferred tax assets, such as net operating loss carryforwards, as described in 26 U.S.C. 382 or any successor statute.

(c) *Securities held by senior management officials or controlling equity holders of a company.* A company that controls 5 percent or more of any class of voting securities of another company controls all securities issued by the second company that are controlled by senior management officials, directors, or controlling shareholders of the first company, or by immediate family members of such persons, unless the first company controls less than 15 percent of each class of voting securities of the second company and the senior management officials, directors, and controlling shareholders of the first company, and immediate family members of such persons, control 50 percent or more of each class of voting securities of the second company.

(d) *Reservation of authority.* Notwithstanding paragraphs (a) through (c) of this section, the Board may determine that securities are or are not controlled by a company based on the facts and circumstances presented.

4. Section 225.31 is revised to read as follows:

**§ 225.31 Control proceedings.**



(a) *Preliminary determination of control.* (1) The Board in its sole discretion may issue a preliminary determination of control under the procedures set forth in this section in any case in which the Board determines, based on consideration of the facts and circumstances presented, that a first company has the power to exercise a controlling influence over the management or policies of a second company.

(2) If the Board makes a preliminary determination of control under this section, the Board shall send notice to the first company containing a statement of the facts upon which the preliminary determination is based.

(b) *Response to preliminary determination of control.* (1) Within 30 calendar days after issuance by the Board of a preliminary determination of control or such longer period permitted by the Board in its discretion, the first company against whom the preliminary determination has been made shall:

(i) Consent to the preliminary determination of control and either:

(A) Submit for the Board's approval a specific plan for the prompt termination of the control relationship; or

(B) File an application or notice under this part, as applicable; or

(ii) Contest the preliminary determination by filing a response, setting forth the facts and circumstances in support of its position that no control exists, and, if desired, requesting a hearing or other proceeding.

(2) If the first company fails to respond to the preliminary determination of control within 30 days, the first company will be deemed to have waived its right to present additional information to the Board or to request a hearing or other proceeding regarding the preliminary determination of control.

(c) *Hearing and final determination.* (1) The Board shall order a hearing or other appropriate proceeding upon the petition of a first company that contests a preliminary determination of control if the Board finds that material facts are in dispute. The Board may, in its discretion, order a hearing or other appropriate proceeding without a petition for such a proceeding by the first company.

(2) At a hearing or other proceeding, any applicable presumptions established under this subpart shall be considered in accordance with the Federal Rules of Evidence and the Board's Rules of Practice for Formal Hearings (12 CFR part 263).

(3) After considering the submissions of the first company and other evidence, including the record of any hearing or other proceeding, the Board will issue a final order determining whether the first company has the power to exercise a controlling influence over the management or policies of the second company. If a controlling influence is found, the Board may direct the first company to terminate the control relationship or to file an application or notice for the Board's approval to retain the control relationship.

(d) *Submission of evidence.* (1) In connection with contesting a preliminary determination of control under paragraph (b)(1)(ii) of this section, a first company may submit to the Board evidence or any other relevant information related to its control of a second company.

(2) Evidence or other relevant information submitted to the Board pursuant to paragraph (d)(1) must be in writing and may include a description of all current and proposed relationships between the first company and the second company, including relationships of the type that are identified under any of the rebuttable presumptions in sections 225.32 and 225.33 of this part, copies of any formal agreements related to such relationships, and a discussion regarding why the Board should not determine the first company to control the second company.

(e) *Definitions.* For purposes of this subpart:

(1) *Board of directors* means the board of directors of a company or a set of individuals exercising similar functions at a company.

(2) *Director representative* means any individual that represents the interests of a first company through service on the board of directors of a second company. For purposes of this paragraph (e)(2), examples of persons who are directors of a second company and generally would be considered director representatives of a first company include:

(i) A current officer, employee, or director of the first company;

(ii) An individual who was an officer, employee, or director of the first company within the prior two years; and

(iii) An individual who was nominated or proposed to be a director of the second company by the first company.

(D) A director representative does not include a nonvoting observer.

(3) *First company* means the company whose potential control of a second company is the subject of determination by the Board under this subpart.

(4) *Investment adviser* means a company that:

(i) Is registered as an investment adviser with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 *et seq.*);

(ii) Is registered as a commodity trading advisor with the Commodity Futures Trading Commission under the Commodity Exchange Act (7 U.S.C. 1 *et seq.*);

(iii) Is a foreign equivalent of an investment adviser or commodity trading advisor, as described in paragraph (e)(4)(i) or (ii) above; or

(iv) Engages in any of the activities set forth in section 225.28(b)(6)(i) through (iv) of this part.

(5) *Limiting contractual right* means a contractual right of the first company that would allow the first company to restrict significantly, directly or indirectly, the discretion of the second company, including its senior management officials and directors, over operational and policy decisions of the second company.

(i) Examples of limiting contractual rights may include, but are not limited to, a right that allows the first company to restrict or to exert significant influence over decisions related to:

(A) Activities in which the second company may engage, including a prohibition on entering into new lines of business, making substantial changes to or discontinuing existing lines of business, or entering into a contractual arrangement with a third party that imposes significant financial obligations on the second company;

(B) How the second company directs the proceeds of the first company's investment;

(C) Hiring, firing, or compensating one or more senior management officials of the second company, or modifying the second company's policies or budget concerning the salary, compensation, employment, or benefits plan for its employees;

(D) 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;

(E) The second company's ability to make investments or expenditures;

(F) The second company achieving or maintaining a financial target or limit, including, for example, a debt-to-equity ratio, a fixed charges ratio, a net worth requirement, a liquidity target, a working capital target, or a classified assets or nonperforming loans limit;

(G) The second company's payment of dividends on any class of securities, redemption of senior instruments, or voluntary prepayment of indebtedness;

(H) The second 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 second company;

(I) 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;

(J) The second company's ability to amend its articles of incorporation or by-laws, other than in a way that is solely defensive for the first company;

(K) The removal or selection of any independent accountant, auditor, investment adviser, or investment banker employed by the second company;

(L) The second company's ability to significantly alter accounting methods and policies, or its regulatory, tax, or liability status (e.g., converting from a stock corporation to a limited liability company); and

(ii) A limiting contractual right does not include a contractual right that would not allow the first company to significantly restrict, directly or indirectly, the discretion of the second company over operational and policy decisions of the second company. Examples of contractual rights that are not limiting contractual rights may include:

(A) A right that allows the first company to restrict or to exert significant influence over decisions relating to the second company's ability to issue securities senior to securities owned by the first company;

(B) A requirement that the first company receive financial reports or other information of the type ordinarily available to common stockholders;

(C) A requirement that the second company maintain its corporate existence;

(D) A requirement that the second company consult with the first company on a reasonable periodic basis;

(E) A requirement that the second company provide notices of the occurrence of material events affecting the second company;

(F) A requirement that the second company comply with applicable statutory and regulatory requirements;

(G) A market standard requirement that the first company receive similar contractual rights as those held by other investors in the second company;

(H) A requirement that the first company be able to purchase additional securities issued by the second company in order to maintain the first company's percentage ownership in the second company;

(I) A requirement that the second company ensure that any securityholder who intends to sell its securities of the second company provide other securityholders of the second company or the second company itself the opportunity to purchase the securities before the securities can be sold to a third party; or

(J) A requirement that the second company take reasonable steps to ensure the preservation of tax status or tax benefits, such as status of the second company as a Subchapter S corporation or the protection of the value of net operating loss carry-forwards.

(6) *Second company* means the company whose potential control by a first company is the subject of determination by the Board under this subpart.

(7) *Senior management official* means any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of a company.

(f) *Reservation of authority*. Nothing in this subpart shall limit the authority of the Board to take any supervisory or enforcement action otherwise permitted by law, including an action to address unsafe or unsound practices or conditions, or violations of law.

5. Section 225.32 is added to read as follows:

**§ 225.32 Rebuttable presumptions of control of a company.**

(a) *General*. (1) In any proceeding under section 225.31(b)(2) or (c) of this part, a first company is presumed to control a second company in the situations described in subsections (b) through (i) of this section. The Board also may find that a first company controls a second company based on other facts and circumstances.

(2) For purposes of the presumptions in this section, any company that is a subsidiary of the first company and also a subsidiary of the second company is considered to be a subsidiary of the first company and not a subsidiary of the second company.

(b) *Management contract or similar agreement*. The first company enters into any agreement, understanding, or management contract (other than to serve as investment adviser) with the second company, under which the first company directs or exercises significant influence or discretion over the general management, overall operations, or core business or policy decisions of the second company. Examples of such agreements include where the first company is a managing member, trustee, or general partner of the second company, or exercises similar powers and functions.

(c) *Total equity.* The first company controls one third or more of the total equity of the second company.

(d) *Ownership or control of 5 percent or more of voting securities.* The first company controls 5 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) (i) Director representatives of the first company or any of its subsidiaries comprise 25 percent or more of the board of directors of the second company or any of its subsidiaries; or

(ii) Director representatives of the first company or any of its subsidiaries are able to make or block the making of major operational or policy decisions of the second company or any of its subsidiaries;

(2) Two or more employees or directors of the first company or any of its subsidiaries serve as senior management officials of the second company or any of its subsidiaries;

(3) An employee or director of the first company or any of its subsidiaries serves as the chief executive officer, or serves in a similar capacity, of the second company or any of its subsidiaries;

(4) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the second company, each on a consolidated basis; or

(5) The first company or any of its subsidiaries has any limiting contractual right with respect to the second company or any of its subsidiaries, unless such limiting contractual right is part of an agreement to merge with or make a controlling investment in the second company that is reasonably expected to close within one year and such limiting contractual right is designed to



ensure that the second company continues to operate in the ordinary course until the merger or investment is consummated or such limiting contractual right requires the second company to take an action necessary for the merger or investment to be consummated.

(e) *Ownership or control of 10 percent or more of voting securities.* The first company controls 10 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) The first company or any of its subsidiaries propose a number of director representatives to the board of directors of the second company or any of its subsidiaries in opposition to nominees proposed by the management or board of directors of the second company or any of its subsidiaries that, together with any director representatives of the first company or any of its subsidiaries on the board of directors of the second company or any of its subsidiaries, would comprise 25 percent or more of the board of directors of the second company or any of its subsidiaries;

(2) Director representatives of the first company and its subsidiaries comprise more than 25 percent of any committee of the board of directors of the second company or any of its subsidiaries that can take action that binds the second company or any of its subsidiaries; or

(3) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that:

(i) Are not on market terms; or

(ii) Generate in the aggregate 5 percent or more of the total annual revenues or expenses of the second company, each on a consolidated basis.

(f) *Ownership or control of 15 percent or more of voting securities.* The first company controls 15 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) A director representative of the first company or of any of its subsidiaries serves as the chair of the board of directors of the second company or any of its subsidiaries;

(2) One or more employees or directors of the first company or any of its subsidiaries serves as a senior management official of the second company or any of its subsidiaries; or

(3) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that generate in the aggregate 2 percent or more of the total annual revenues or expenses of the second company, each on a consolidated basis.

(g) *Accounting consolidation.* The first company consolidates the second company on its financial statements prepared under U.S. generally accepted accounting principles.

(h) *Control of an investment fund.* (1) The first company serves as an investment adviser to the second company, the second company is an investment fund, and the first company, directly or indirectly, or acting through one or more other persons:

(i) Controls 5 percent or more of the outstanding securities of any class of voting securities of the second company; or

(ii) Controls 25 percent or more of the total equity of the second company.

(2) The presumption of control in paragraph (h)(1) of this section does not apply if the first company organized and sponsored the second company within the preceding 12 months.

(i) *Divestiture of control.* (1) The first company controlled the second company under paragraph (e)(1)(i) or (ii) of section 225.2 of this part at any time during the prior two years and

the first company controls 15 percent or more of any class of voting securities of the second company.

(2) Notwithstanding paragraph (i)(1) of this section, a first company will not be presumed to control a second company under this paragraph if 50 percent or more of the outstanding securities of each class of voting securities of the second company is controlled by a person that is not a senior management official or director of the first company, or by a company that is not an affiliate of the first company.

(j) *Securities held in a fiduciary capacity.* For purposes of the presumptions of control in this section, the first company does not control securities of the second company that the first company holds in a fiduciary capacity, except that if the second company is a depository institution or a depository institution holding company, this paragraph (j) only applies to securities held in a fiduciary capacity without sole discretionary authority to exercise the voting rights of the securities.

6. Section 225.33 is added to read as follows:

**§ 225.33 Rebuttable presumption of noncontrol of a company.**

(a) In any proceeding under section 225.31(b)(2) or (c) of this part, a first company is presumed not to control a second company if:

(1) The first company controls less than 10 percent of the outstanding securities of each class of voting securities of the second company; and

(2) The first company is not presumed to control the second company under section 225.32 of this part.

(b) In any proceeding under this subpart, or judicial proceeding under the Bank Holding Company Act, other than a proceeding in which the Board has made a preliminary determination that a first company has the power to exercise a controlling influence over the management or policies of a second company, a first company may not be held to have had control over a second company at any given time, unless the first company, at the time in question, controlled 5 percent or more of the outstanding securities of any class of voting securities of the second company, or had already been found to have control on the basis of the existence of a controlling influence relationship.

7. Section 225.34 is added to read as follows:

**§ 225.34 Total Equity.**

(a) *General.* For purposes of this subpart, the total equity controlled by a first company in a second company that is organized as a stock corporation and prepares financial statements pursuant to U.S. generally accepted accounting principles will be calculated as described in paragraph (b) of this section. With respect to a second company that is not organized as a stock corporation or that does not prepare financial statements pursuant to U.S. generally accepted accounting principles, the first company's total equity in the second company will be calculated so as to be reasonably consistent with the methodology described in paragraph (b) of this section, while taking into account the legal form of the second company and the accounting system used by the second company to prepare financial statements.

(b) *Calculation of total equity.* (1) *Total Equity.* The first company's total equity in the second company, expressed as a percentage, is equal to:

(i) The sum of Investor Common Equity and, for each class of preferred stock issued by the second company, Investor Preferred Equity, divided by

(ii) Issuer Shareholders' Equity.

(2) *Investor Common Equity* equals the greater of:

(i) Zero, and

(ii) The quotient of the number of shares of common stock of the second company that are controlled by the first company divided by the total number of shares of common stock of the second company that are issued and outstanding, multiplied by the amount of shareholders' equity of the second company not allocated to preferred stock under U.S. generally accepted accounting principles.<sup>90</sup>

(3) *Investor Preferred Equity* equals, for each class of preferred stock issued by the second company, the greater of:

(i) Zero, and

(ii) The quotient of the number of shares of the class of preferred stock of the second company that are controlled by the first company divided by the total number of shares of the class of preferred stock that are issued and outstanding, multiplied by the amount of shareholders' equity of the second company allocated to the class of preferred stock under U.S. generally accepted accounting principles.<sup>91</sup>

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<sup>90</sup> If the second company has multiple classes of common stock outstanding and different classes of common stock have different economic interests in the second company on a per share basis, the number of shares of common stock must be adjusted for purposes of this calculation so that each share of common stock has the same economic interest in the second company.

<sup>91</sup> If there are different classes of preferred stock with equal seniority (i.e., *pari passu* classes of preferred stock), the *pari passu* shares are treated as a single class. If *pari passu* classes of preferred stock have different economic interests in the second company on a per share basis, the number of shares of preferred stock must be adjusted for purposes of this calculation so that each share of preferred stock has the same economic interest in the second company.

(c) *Consideration of debt instruments and other interests in total equity.* (1) For purposes of the total equity calculation in paragraph (b) of this section, a debt instrument or other interest issued by the second company that is controlled by the first company may be treated as an equity instrument if that debt instrument or other interest is functionally equivalent to equity.

(2) For purposes of paragraph (b)(1) of this section, the principal amount of all debt instruments and the market value of all other interests that are functionally equivalent to equity that are controlled by the first company are added to the sum under paragraph (b)(1)(i) of this section, and the principal amount of all debt instruments and the market value of all other interests that are functionally equivalent to equity that are outstanding are added to Issuer Shareholders' Equity.

(3) For purposes of paragraph (c)(1) of this section, a debt instrument issued by the second company may be considered functionally equivalent to equity if it has equity-like characteristics, such as:

- (i) Extremely long-dated maturity;
- (ii) Subordination to other debt instruments issued by the second company;
- (ii) Qualification as regulatory capital under any regulatory capital rules applicable to the second company;
- (iii) Qualification as equity under applicable tax law;
- (iv) Qualification as equity under U.S. generally accepted accounting principles or other applicable accounting standards;
- (v) Inadequacy of the equity capital underlying the debt at the time of the issuance of the debt; or
- (vi) Issuance not on market terms.

(4) For purposes of paragraph (c)(1) of this section, an interest that is not a debt instrument issued by the second company may be considered functionally equivalent to equity if it has equity-like characteristics, such as entitling its owner to a share of the profits of the second company.

(d) *Exclusion of certain equity instruments from total equity.* (1) For purposes of the total equity calculation in paragraph (b) of this section, an equity instrument issued by the second company that is controlled by the first company may be treated as not an equity instrument if that equity instrument is functionally equivalent to debt.

(2) For purposes of paragraph (d)(1) of this section, an equity instrument issued by the second company may be considered functionally equivalent to debt if it has debt-like characteristics, such as protections generally provided to creditors, a limited term, a fixed rate of return or a variable rate of return linked to a reference interest rate, classification as debt for tax purposes, or classification as debt for accounting purposes.

(e) *Frequency of total equity calculation.* The total equity of a first company in a second company is calculated each time the first company acquires control over equity instruments of the second company, including any debt instruments or other interests that are functionally equivalent to equity in accordance with paragraph (c) of this section.

\* \* \* \* \*

## **PART 238—SAVINGS AND LOAN HOLDING COMPANIES (REGULATION LL)**

8. The authority citation for part 238 continues to read as follows:

AUTHORITY: 5 U.S.C. 552, 559; 12 U.S.C. 1462, 1462a, 1463, 1464, 1467, 1467a, 1468, 1813, 1817, 1829e, 1831i, 1972; 15 U.S.C. 78l.

9. Amend § 238.2 by:

- a. Revising paragraphs (e) and (r)(2), and
- b. Adding paragraph (v).

The revisions and additions read as follows:

**§ 238.2 Definitions.**

\* \* \* \* \*

(e) A person shall be deemed to have *control* of:

(1) A savings association if the person directly or indirectly or acting in concert with one or more other persons, or through one or more subsidiaries, owns, controls, or holds with power to vote, or holds proxies representing, more than 25 percent of the voting shares of such savings association, or controls in any manner the election of a majority of the directors of such association;

(2) Any other company if the person directly or indirectly or acting in concert with one or more other persons, or through one or more subsidiaries, owns, controls, or holds with power to vote, or holds proxies representing, more than 25 percent of the voting shares or rights of such other company, or controls in any manner the election or appointment of a majority of the directors or trustees of such other company, or is a general partner in or has contributed more than 25 percent of the capital of such other company;

(3) A trust if the person is a trustee thereof;



(4) A company if the Board determines, after reasonable notice and opportunity for hearing, that such person directly or indirectly exercises a controlling influence over the management or policies of such association or other company; or

(5) Voting securities or assets owned, controlled, or held, directly or indirectly:

(i) By the company, or by any subsidiary of the company;

(ii) That the company has power to vote or to dispose of;

(iii) In a fiduciary capacity for the benefit of the company or any of its subsidiaries;

(iv) In a fiduciary capacity (including by pension and profit-sharing trusts) for the benefit of the shareholders, members, or employees (or individuals serving in similar capacities) of the company or any of its subsidiaries; or

(v) According to the standards under section 238.10 of this part.

\* \* \* \* \*

(r) \* \* \*

(2) *Nonvoting securities.* Common shares, preferred shares, limited partnership interests, limited liability company interests, or similar interests are not *voting securities* if:

(i) Any voting rights associated with the securities are limited solely to the type customarily provided by statute with regard to matters that would significantly and adversely affect the rights or preference of the security, such as the issuance of additional amounts or classes of senior securities, the modification of the terms of the security, the dissolution of the issuing company, or the payment of dividends by the issuing company when preferred dividends are in arrears;

(ii) The securities represent an essentially passive investment or financing device and do not otherwise provide the holder with control over the issuing company; and

(iii) The securities do not entitle the holder, by statute, charter, or in any manner, to select or to vote for the selection of directors, trustees, or partners (or persons exercising similar functions) of the issuing company; except that limited partnership interests or membership interests in limited liability companies are not voting securities due to 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).

\* \* \* \* \*

(v) *Voting percentage.* For purposes of this part, the percentage of a class of a company's voting securities controlled by a person is the greater of:

(1) The quotient, expressed as a percentage, of the number of shares of the class of voting securities controlled by the person, divided by the number of shares of the class of voting securities that are issued and outstanding, both as determined under section 238.10 of this part; and

(2) The quotient, expressed as a percentage, of the number of votes that may be cast by the person on the voting securities controlled by the person, divided by the total votes that are legally entitled to be cast by the issued and outstanding shares of the class of voting securities, both as determined under section 238.10 of this part.

\* \* \* \* \*

10. Section 238.10 is added to read as follows:

**Subpart A—General Provisions**

**§ 238.10 Control over securities.**

(a) *Contingent rights, convertible securities, options, and warrants.* (1) A person that controls a security, option, warrant, or other financial instrument that is convertible into, exercisable for, exchangeable for, or otherwise may become a security controls each security that could be acquired as a result of such conversion, exercise, exchange, or similar occurrence.

(2) If a financial instrument of the type described in paragraph (a)(1) of this section is convertible into, exercisable for, exchangeable for, or otherwise may become a number of securities that varies according to a formula, rate, or other variable metric, the number of securities controlled under paragraph (a)(1) of this section is the maximum number of securities that the financial instrument could be converted into, be exercised for, be exchanged for, or otherwise become under the formula, rate, or other variable metric.

(3) Notwithstanding paragraph (a)(1) of this section, a person does not control voting securities due to controlling a financial instrument if the financial instrument:

(i) By its terms is not convertible into, is not exercisable for, is not exchangeable for, and may not otherwise become voting securities in the hands of the person or an affiliate of the person; and

(ii) By its terms the financial instrument is only convertible into, exercisable for, exchangeable for, or may otherwise become voting securities in the hands of a transferee after a transfer:

(A) In a widespread public distribution;

(B) To the issuing company;

(C) In transfers in which no transferee (or group of associated transferees) would receive 2 percent or more of the outstanding securities of any class of voting securities of the issuing company; or

(D) To a transferee that would control more than 50 percent of every class of voting securities of the issuing company without any transfer from the person.

(4) Notwithstanding paragraph (a)(1) of this section, a person that has agreed to acquire securities or other financial instruments pursuant to a securities purchase agreement does not control such securities or financial instruments until the person acquires the securities or financial instruments.

(5) Notwithstanding paragraph (a)(1) of this section, a right that provides a person the ability to acquire securities in future issuances or to convert nonvoting securities into voting securities does not cause the person to control the securities that could be acquired under the right, so long as the right does not allow the person to acquire a higher percentage of the class of securities than the person controlled immediately prior to the future acquisition.

(6) Notwithstanding paragraph (a)(1) of this section, a preferred security that would be a nonvoting security but for a right to vote on directors that activates only after six or more quarters of unpaid dividends is not considered to be a voting security until the securityholder is entitled to exercise the voting right.

(7) For purposes of determining the percentage of a class of voting securities or the total equity percentage of a company controlled by a person that controls a financial instrument of the type described in paragraph (a)(1) of this section:

(A) The securities controlled by the person under paragraphs (a)(1) through (6) of this section are deemed to be issued and outstanding; and

(B) Any securities controlled by anyone other than the person under paragraph (a)(1) through (6) of this section are not deemed to be issued and outstanding, unless by the terms of the financial instruments the securities controlled by the other persons must be issued and outstanding in order for the securities of the person to be issued and outstanding.

(b) *Restriction on securities.* A person that enters into an agreement or understanding with a second person under which the rights of the second person are restricted in any manner with respect to securities that are controlled by the second person, controls the securities of the second person, unless the restriction is:

(1) A requirement that the second person offer the securities for sale to the first person for a reasonable period of time prior to transferring the securities to a third party;

(2) A requirement that, if the second person agrees to sell the securities, the second person provide the first person with the opportunity to participate in the sale of the securities by the second person;

(3) A requirement under which the second person agrees to sell its securities to a third party if a majority of securityholders agree to sell their securities to the third party;

(4) Incident to a bona fide loan transaction in which the securities serve as collateral;

(5) A short-term and revocable proxy;

(6) A restriction on transferability that continues only for a reasonable amount of time necessary to complete an acquisition by the first person of the securities from the second person, including the time necessary to obtain required approval from an appropriate government authority with respect to the acquisition;

(7) A requirement that the second person vote the securities in favor of a specific acquisition of control of the issuing company, or against competing transactions, if the restriction

continues only for a reasonable amount of time necessary to complete the transaction, including the time necessary to obtain required approval from an appropriate government authority with respect to an acquisition or merger; or

(8) An agreement among securityholders of the issuing company intended to preserve the tax status or tax benefits of the company, such as qualification of the issuing company as a Subchapter S corporation, as defined in 26 U.S.C. 1361(a)(1) or any successor statute, or prevention of events that could impair deferred tax assets, such as net operating loss carryforwards, as described in 26 U.S.C. 382 or any successor statute.

(c) *Securities held by senior management officials or controlling equity holders of a company.* A company that controls 5 percent or more of any class of voting securities of another company controls all securities issued by the second company that are controlled by senior management officials, directors, or controlling shareholders of the first company, or by immediate family members of such persons, unless the first company controls less than 15 percent of each class of voting securities of the second company and the senior management officials, directors, and controlling shareholders of the first company, and immediate family members of such persons, control 50 percent or more of each class of voting securities of the second company.

(d) *Reservation of authority.* Notwithstanding paragraphs (a) through (c) of this section, the Board may determine that securities are or are not controlled by a company based on the facts and circumstances presented.

\* \* \* \* \*

11. Section 238.21 is revised to read as follows:

**§ 238.21 Control proceedings.**

(a) *Preliminary determination of control.* (1) The Board in its sole discretion may issue a preliminary determination of control under the procedures set forth in this section in any case in which the Board determines, based on consideration of the facts and circumstances presented, that a first company has the power to exercise a controlling influence over the management or policies of a second company.

(2) If the Board makes a preliminary determination of control under this section, the Board shall send notice to the first company containing a statement of the facts upon which the preliminary determination is based.

(b) *Response to preliminary determination of control.* (1) Within 30 calendar days after issuance by the Board of a preliminary determination of control or such longer period permitted by the Board in its discretion, the first company against whom the preliminary determination has been made shall:

(i) Consent to the preliminary determination of control and either:

(A) Submit for the Board's approval a specific plan for the prompt termination of the control relationship; or

(B) File an application or notice under this part, as applicable; or

(ii) Contest the preliminary determination by filing a response, setting forth the facts and circumstances in support of its position that no control exists, and, if desired, requesting a hearing or other proceeding.

(2) If the first company fails to respond to the preliminary determination of control within 30 days, the first company will be deemed to have waived its right to present additional

information to the Board or to request a hearing or other proceeding regarding the preliminary determination of control.

(c) *Hearing and final determination.* (1) The Board shall order a hearing or other appropriate proceeding upon the petition of a first company that contests a preliminary determination of control if the Board finds that material facts are in dispute. The Board may, in its discretion, order a hearing or other appropriate proceeding without a petition for such a proceeding by the first company.

(2) At a hearing or other proceeding, any applicable presumptions established under this subpart shall be considered in accordance with the Federal Rules of Evidence and the Board's Rules of Practice for Formal Hearings (12 CFR part 263).

(3) After considering the submissions of the first company and other evidence, including the record of any hearing or other proceeding, the Board will issue a final order determining whether the first company has the power to exercise a controlling influence over the management or policies of the second company. If a controlling influence is found, the Board may direct the first company to terminate the control relationship or to file an application or notice for the Board's approval to retain the control relationship.

(d) *Submission of evidence.* (1) In connection with contesting a preliminary determination of control under paragraph (b)(1)(ii) of this section, a first company may submit to the Board evidence or any other relevant information related to its control of a second company.

(2) Evidence or other relevant information submitted to the Board pursuant to paragraph (d)(1) must be in writing and may include a description of all current and proposed relationships between the first company and the second company, including relationships of the type that are identified under any of the rebuttable presumptions in sections 238.22 and 238.23 of this part,



copies of any formal agreements related to such relationships, and a discussion regarding why the Board should not determine the first company to control the second company.

(e) *Definitions.* For purposes of this subpart:

(1) *Board of directors* means the board of directors of a company or a set of individuals exercising similar functions at a company.

(2) *Director representative* means any individual that represents the interests of a first company through service on the board of directors of a second company. For purposes of this paragraph (e)(2), examples of persons who are directors of a second company and generally would be considered director representatives of a first company include:

(i) A current officer, employee, or director of the first company;

(ii) An individual who was an officer, employee, or director of the first company within the prior two years; and

(iii) An individual who was nominated or proposed to be a director of the second company by the first company.

(D) A director representative does not include a nonvoting observer.

(3) *First company* means the company whose potential control of a second company is the subject of determination by the Board under this subpart.

(4) *Investment adviser* means a company that:

(i) Is registered as an investment adviser with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 *et seq.*);

(ii) Is registered as a commodity trading advisor with the Commodity Futures Trading Commission under the Commodity Exchange Act (7 U.S.C. 1 *et seq.*);

(iii) Is a foreign equivalent of an investment adviser or commodity trading advisor, as described in paragraph (e)(4)(i) or (ii) above; or

(iv) Engages in any of the activities set forth in 12 CFR 225.28(b)(6)(i) through (iv).

(5) *Limiting contractual right* means a contractual right of the first company that would allow the first company to restrict significantly, directly or indirectly, the discretion of the second company, including its senior management officials and directors, over operational and policy decisions of the second company.

(i) Examples of limiting contractual rights may include, but are not limited to, a right that allows the first company to restrict or to exert significant influence over decisions related to:

(A) Activities in which the second company may engage, including a prohibition on entering into new lines of business, making substantial changes to or discontinuing existing lines of business, or entering into a contractual arrangement with a third party that imposes significant financial obligations on the second company;

(B) How the second company directs the proceeds of the first company's investment;

(C) Hiring, firing, or compensating one or more senior management officials of the second company, or modifying the second company's policies or budget concerning the salary, compensation, employment, or benefits plan for its employees;

(D) 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;

(E) The second company's ability to make investments or expenditures;

(F) The second company achieving or maintaining a financial target or limit, including, for example, a debt-to-equity ratio, a fixed charges ratio, a net worth requirement, a liquidity target, a working capital target, or a classified assets or nonperforming loans limit;

(G) The second company's payment of dividends on any class of securities, redemption of senior instruments, or voluntary prepayment of indebtedness;

(H) The second 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 second company;

(I) 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;

(J) The second company's ability to amend its articles of incorporation or by-laws, other than in a way that is solely defensive for the first company;

(K) The removal or selection of any independent accountant, auditor, investment adviser, or investment banker employed by the second company;

(L) The second company's ability to significantly alter accounting methods and policies, or its regulatory, tax, or liability status (e.g., converting from a stock corporation to a limited liability company); and

(ii) A limiting contractual right does not include a contractual right that would not allow the first company to significantly restrict, directly or indirectly, the discretion of the second company over operational and policy decisions of the second company. Examples of contractual rights that are not limiting contractual rights may include:

(A) A right that allows the first company to restrict or to exert significant influence over decisions relating to the second company's ability to issue securities senior to securities owned by the first company;

(B) A requirement that the first company receive financial reports or other information of the type ordinarily available to common stockholders;

(C) A requirement that the second company maintain its corporate existence;

(D) A requirement that the second company consult with the first company on a reasonable periodic basis;

(E) A requirement that the second company provide notices of the occurrence of material events affecting the second company;

(F) A requirement that the second company comply with applicable statutory and regulatory requirements;

(G) A market standard requirement that the first company receive similar contractual rights as those held by other investors in the second company;

(H) A requirement that the first company be able to purchase additional securities issued by the second company in order to maintain the first company's percentage ownership in the second company;

(I) A requirement that the second company ensure that any securityholder who intends to sell its securities of the second company provide other securityholders of the second company or the second company itself the opportunity to purchase the securities before the securities can be sold to a third party; or

(J) A requirement that the second company take reasonable steps to ensure the preservation of tax status or tax benefits, such as status of the second company as a Subchapter S corporation or the protection of the value of net operating loss carry-forwards.

(6) *Second company* means the company whose potential control by a first company is the subject of determination by the Board under this subpart.

(7) *Senior management official* means any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of a company.

(f) *Reservation of authority*. Nothing in this subpart shall limit the authority of the Board to take any supervisory or enforcement action otherwise permitted by law, including an action to address unsafe or unsound practices or conditions, or violations of law.

12. Sections 238.22 is added to read as follows:

**§ 238.22 Rebuttable presumptions of control of a company.**

(a) *General*. (1) In any proceeding under section 238.21(b)(2) or (c) of this part, a first company is presumed to control a second company in the situations described in subsections (b) through (i) of this section. The Board also may find that a first company controls a second company based on other facts and circumstances.

(2) For purposes of the presumptions in this section, any company that is a subsidiary of the first company and also a subsidiary of the second company is considered to be a subsidiary of the first company and not a subsidiary of the second company.

(b) *Management contract or similar agreement*. The first company enters into any agreement, understanding, or management contract (other than to serve as investment adviser) with the second company, under which the first company directs or exercises significant influence or discretion over the general management, overall operations, or core business or policy decisions of the second company. Examples of such agreements include where the first company is a managing member, trustee, or general partner of the second company, or exercises similar powers and functions.

(c) *Ownership or control of 5 percent or more of voting securities.* The first company controls 5 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) (i) Director representatives of the first company or any of its subsidiaries comprise 25 percent or more of the board of directors of the second company or any of its subsidiaries; or

(ii) Director representatives of the first company or any of its subsidiaries are able to make or block the making of major operational or policy decisions of the second company or any of its subsidiaries;

(2) Two or more employees or directors of the first company or any of its subsidiaries serve as senior management officials of the second company or any of its subsidiaries;

(3) An employee or director of the first company or any of its subsidiaries serves as the chief executive officer, or serves in a similar capacity, of the second company or any of its subsidiaries;

(4) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the second company, each on a consolidated basis; or

(5) The first company or any of its subsidiaries has any limiting contractual right with respect to the second company or any of its subsidiaries, unless such limiting contractual right is part of an agreement to merge with or make a controlling investment in the second company that is reasonably expected to close within one year and such limiting contractual right is designed to ensure that the second company continues to operate in the ordinary course until the merger or

investment is consummated or such limiting contractual right requires the second company to take an action necessary for the merger or investment to be consummated.

(d) *Ownership or control of 10 percent or more of voting securities.* The first company controls 10 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) The first company or any of its subsidiaries propose a number of director representatives to the board of directors of the second company or any of its subsidiaries in opposition to nominees proposed by the management or board of directors of the second company or any of its subsidiaries that, together with any director representatives of the first company or any of its subsidiaries on the board of directors of the second company or any of its subsidiaries, would comprise 25 percent or more of the board of directors of the second company or any of its subsidiaries;

(2) Director representatives of the first company and its subsidiaries comprise more than 25 percent of any committee of the board of directors of the second company or any of its subsidiaries that can take action that binds the second company or any of its subsidiaries; or

(3) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that:

(i) Are not on market terms; or

(ii) Generate in the aggregate 5 percent or more of the total annual revenues or expenses of the second company, each on a consolidated basis.

(e) *Ownership or control of 15 percent or more of voting securities.* The first company controls 15 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) A director representative of the first company or of any of its subsidiaries serves as the chair of the board of directors of the second company or any of its subsidiaries;

(2) One or more employees or directors of the first company or any of its subsidiaries serves as a senior management official of the second company or any of its subsidiaries; or

(3) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that generate in the aggregate 2 percent or more of the total annual revenues or expenses of the second company, each on a consolidated basis.

(f) *Accounting consolidation.* The first company consolidates the second company on its financial statements prepared under U.S. generally accepted accounting principles.

(g) *Control of an investment fund.* (1) The first company serves as an investment adviser to the second company, the second company is an investment fund, and the first company, directly or indirectly, or acting through one or more other persons:

(i) Controls 5 percent or more of the outstanding securities of any class of voting securities of the second company; or

(ii) Controls 25 percent or more of the total equity of the second company.

(2) The presumption of control in paragraph (h)(1) of this section does not apply if the first company organized and sponsored the second company within the preceding 12 months.

(h) *Divestiture of control.* (1) The first company controlled the second company under paragraph (e)(1) or (2) of section 238.2 of this part at any time during the prior two years and the first company controls 15 percent or more of any class of voting securities of the second company.



(2) Notwithstanding paragraph (i)(1) of this section, a first company will not be presumed to control a second company under this paragraph if 50 percent or more of the outstanding securities of each class of voting securities of the second company is controlled by a person that is not a senior management official or director of the first company, or by a company that is not an affiliate of the first company.

(j) *Securities held in a fiduciary capacity.* For purposes of the presumptions of control in this section, the first company does not control securities of the second company that the first company holds in a fiduciary capacity, except that if the second company is a depository institution or a depository institution holding company, this paragraph (j) only applies to securities held in a fiduciary capacity without sole discretionary authority to exercise the voting rights of the securities.

13. Section 238.23 is added to read as follows:

**§ 238.23 Rebuttable presumption of noncontrol of a company.**

(a) In any proceeding under section 238.21(b)(2) or (c) of this part, a first company is presumed not to control a second company if:

(1) The first company controls less than 10 percent of the outstanding securities of each class of voting securities of the second company; and

(2) The first company is not presumed to control the second company under section 238.22 of this part.

(b) In any proceeding under this subpart, or judicial proceeding under the Home Owners' Loan Act, other than a proceeding in which the Board has made a preliminary determination that a first company has the power to exercise a controlling influence over the management or policies of a second company, a first company may not be held to have had control over a second

company at any given time, unless the first company, at the time in question, controlled 5 percent or more of the outstanding securities of any class of voting securities of the second company, or had already been found to have control on the basis of the existence of a controlling influence relationship.

**By order of the Board of Governors of the Federal Reserve System, [January 30, 2020].**

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**Ann Misback,**  
*Secretary of the Board.*