

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Date: April 16, 2019  
To: Board of Governors  
From: Vice Chair for Supervision Quarles  
Subject: Notice of proposed rulemaking to revise the Board's rules for determining whether a company has control over another company

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Attached are a memorandum to the Board and draft notice of proposed rulemaking to revise the Board's rules for determining whether a company has control over another company for purposes of the Bank Holding Company Act and the Home Owners' Loan Act. The proposal would clarify, streamline, and memorialize in regulation the Board's control standards under these statutes by introducing a series of presumptions of control based on particular relationships between one company and another company.

The Committee on Supervision and Regulation has been briefed on the proposal and I believe that the materials are ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Date: April 16, 2019  
To: Board of Governors  
From: Staff<sup>1</sup>  
Subject: Notice of proposed rulemaking to revise the Board's rules for determining whether a company has control over another company

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**ACTIONS REQUESTED:** Staff seeks approval of the attached draft *Federal Register* notice (proposal) that would invite public comment on a proposal to revise the Board's rules for determining whether a company has control over another company for purposes of the Bank Holding Company Act (BHC Act) and the Home Owners' Loan Act (HOLA). Staff also requests authority to make minor and technical changes to the attached draft notice to prepare it for publication in the *Federal Register*.

**EXECUTIVE SUMMARY:**

- The proposal would simplify and provide transparency for the Board's "control" standards under the BHC Act and HOLA by proposing a new, comprehensive framework for determining control.
- If a company controls a depository institution, the company generally is a bank holding company or savings and loan holding company and is subject to the Board's supervision and regulation.
- The BHC Act and HOLA provide that the Board may determine that one company controls another company, after notice and opportunity for hearing. Currently, the Board's regulations provide standards for control only under specific, limited circumstances. As a result, control determinations often have been made by the Board on a case-by-case basis and, while general standards for assessing control have developed over time, these standards have not been codified into regulation or provided to the public in a comprehensive manner.
- The proposal would codify these general standards by establishing a comprehensive set of standards under which a company would be presumed to control another company. These standards would be based on the voting ownership and other relationships between the two companies.

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<sup>1</sup> Mark Van Der Weide, Laurie Schaffer, Alison Thro, Greg Frischmann, Mark Buresh, and Brian Phillips (Legal Division) and Susan Motyka, Katie Cox, Jevon Gordon, Melissa Clark, and Sheryl Hudson (Division of Supervision and Regulation).

- The proposal generally would be consistent with current practice, with certain targeted adjustments.
- The proposal invites comment from the public for a period of 60 days following publication in the *Federal Register*.

## **DISCUSSION:**

### **A. Background**

Under the BHC Act and HOLA, a company that controls a bank or savings association is a bank holding company or savings and loan holding company, respectively, and thus subject to the Board's supervision and regulation, as well as certain activities restrictions.<sup>2</sup> Similarly, a company that is controlled by a bank holding company or savings and loan holding company must comply with activities restrictions as a subsidiary of the regulated holding company.<sup>3</sup>

For purposes of the BHC Act, 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 directors 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> The definition of control in HOLA is substantially similar.<sup>5</sup>

In both the BHC Act and HOLA, the first two prongs of control involve relatively straightforward, bright-line rules. The third prong of control, on the other hand, involves a fact-based determination by the Board regarding whether a company has the ability to exercise a controlling influence over another company.

Currently, the Board and staff evaluate the third prong of control using a variety of factors. These factors include assessing the size and structure of the company's voting and total equity investment; the company's rights to director representation; any common management, employees, or directors between the two companies; any covenants or other agreements that allow a company to influence or restrict management decisions of the other company; the nature

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<sup>2</sup> 12 U.S.C. §§ 1841(a)(2) and 1467a(a)(2).

<sup>3</sup> 12 U.S.C. §§ 1843 and 1467a(c).

<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).

and scope of the business relationships between the two companies; and other indicia of the ability or incentive of a company to exercise a controlling influence over the other company.

For many questions of control, the general standards previously articulated in Board statements and on a case-by-case basis over time provide a framework to address the issues raised. However, this general framework is not provided in a single document and many of the specific standards have not been issued publicly. As a result, greater transparency around the Board's control framework would be helpful to many interested parties.

The lack of a comprehensive, public statement describing the common features of investments that raise control concerns makes it difficult for interested parties to evaluate these issues. Investors and financial institutions have in the past expressed frustration with the Board's control framework, raising concerns about fairness and transparency, and noting the adverse consequences the present framework may have on banking organizations seeking to raise capital or make strategic investments. This is a particular issue for community banking organizations, which may need to rely on substantial investments from a few significant investors to raise capital.

The proposal is intended to bring transparency and consistency to issues of control and clarify when common situations may give rise to control concerns. A transparent and consistent framework should also help to facilitate investments in and by banking organizations.

## **B. The Proposal**

The proposal would simplify and make transparent the Board's standards for determining whether one company has the power to exercise a controlling influence over the management or policies of another company and therefore controls the other company. The proposal would establish a framework that makes clear the major factors and thresholds that the Board views as presenting control concerns.

Under the proposal, if an investor increases its percentage of voting securities in another company, the investor generally must decrease relationships in other areas to avoid being presumed to control the other company. In addition, the proposal would establish a new standard for when a company generally would not be considered to control another company and would provide additional guidance on control-related items, such as how to measure an investor's total equity investment in another company.

The proposal would codify a significant portion of the Board’s historical practices and precedents with respect to control. Additionally, the proposal also would include certain targeted adjustments. For example, compared to past practice, the proposal would permit an investor to have a greater number of director representatives at the target without raising control concerns and would allow investors seeking to terminate an existing control relationship to do so while retaining greater levels of ownership compared with past practice.

*1. Tiered Framework*

The proposed framework would provide simplicity and transparency by introducing a series of “presumptions of control,” where a company would be presumed to be in control of another company if certain conditions are met. The presumptions would be based on a company’s level of voting securities of another company and would be based on three levels of voting ownership: 5 percent, 10 percent, and 15 percent.

The framework would focus on certain relationships between the companies that are important in determining whether the overall relationship provides a company the ability to exercise a controlling influence over another company. In addition to the level of voting ownership, the tiered framework would look at the following factors: the size of a company’s total equity investment; rights to director representation; the use of proxy solicitations; individuals serving as management, employees, and directors at both companies; restrictive rights to influence management or operational decisions, and the scope of business relationships. As a general matter, an investor with a larger percentage of voting securities in another company must have smaller relationships in other areas to avoid control over the other company. See Appendix.

*2. Additional Proposed Presumptions*

The proposal also contains a handful of additional presumptions of control and a presumption for when a firm would be presumed not to be in control. For example, the proposal would include a new presumption relating to a company seeking to divest control that would differ from the Board’s past practice. Historically, the Board generally has applied a stricter standard when evaluating whether a company seeking to divest control over another company has been successful, compared to the standard applied when evaluating a new investment by a company that has not previously been in control. Typically, this has required the divesting company to reduce its voting ownership below 10 percent to effectively divest itself of control.

Under the proposal, a company generally would be required to divest to less than 15 percent to no longer control, or to divest to less than 25 percent and allow two years to pass.

In addition, the proposal would contain a new presumption of noncontrol. Specifically, under the BHC Act, a company that owns less than 5 percent of the voting securities of another company is presumed not to control the other company. Under the proposal, a new presumption of noncontrol would be established that would apply where a company that owns less than 10 percent of the voting securities of a second company and does not trigger any of the presumptions of control. This aspect of the proposal generally reflects the current practice of the Board.

### *3. Definitional and Other Matters*

The proposal also defines several items that are consistent with the Board's current practice but that have not been previously codified in regulation. For example, the proposal would include standards for determining the amount of voting shares that an investor owns under various circumstances, such as indirect ownership and ownership of options or convertible securities.

### **RECOMMENDATIONS:**

For the reasons discussed above, staff recommends that the Board approve the attached draft notice of proposed rulemaking for publication in the *Federal Register*. Staff also recommends that the Board authorize staff to make minor and technical changes to the attached materials prior to publication.

Attachment

## Appendix

### Summary of Tiered Presumptions

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

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