

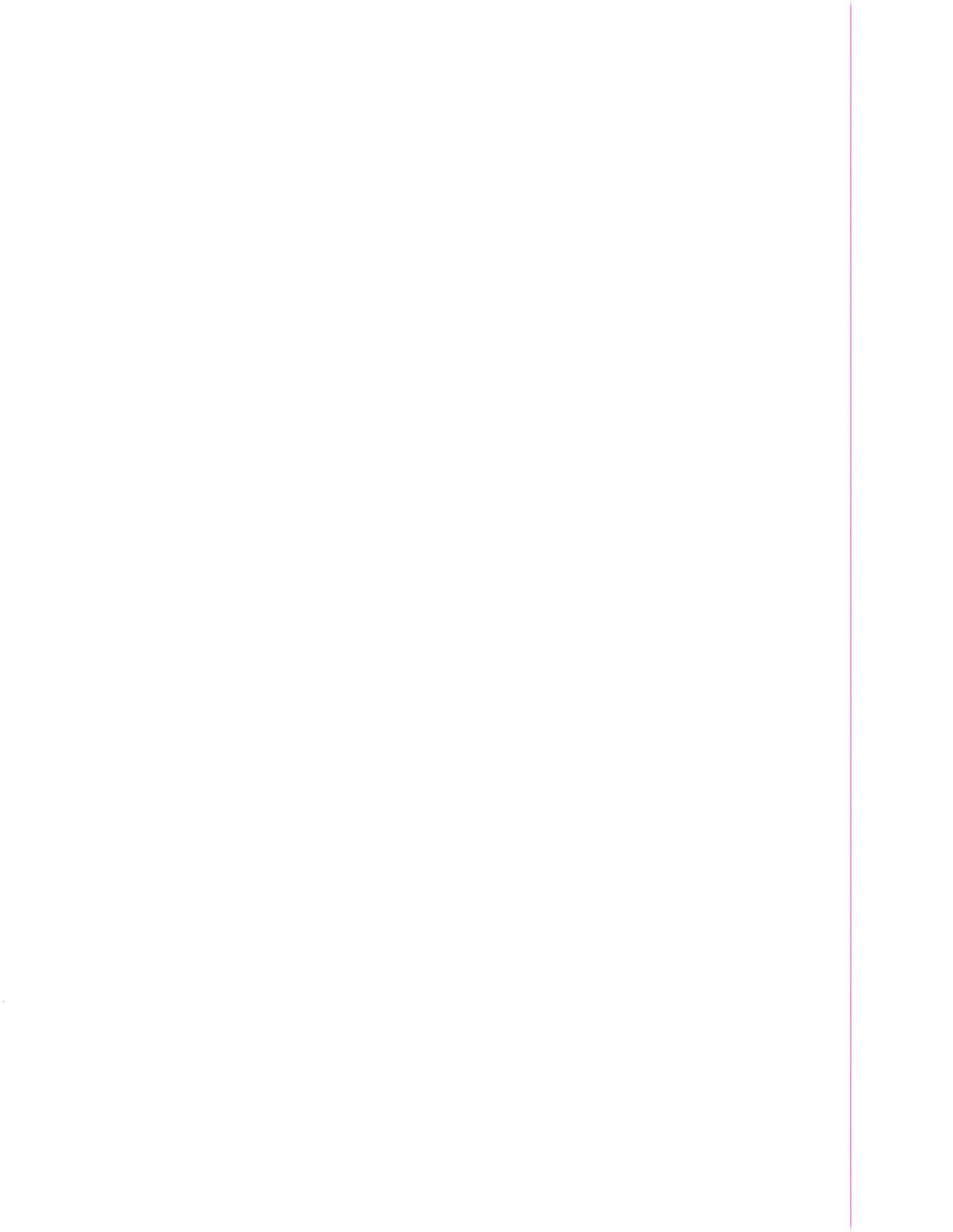
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: January 23, 2020
To: Board of Governors
From: Vice Chair for Supervision Quarles
Subject: Final rule to revise the Board's framework for determining whether a company has control over another company under the Bank Holding Company Act and the Home Owners' Loan Act

Attached are a memorandum to the Board and draft notice for a final rule 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 final rule would clarify, rationalize, and memorialize in regulation the Board's control standards under these statutes by establishing a series of presumptions of control based on particular relationships between one company and another company.

I reviewed the package and believe it is ready for Board consideration.

Attachments



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: January 23, 2020
To: Board of Governors
From: Staff¹
Subject: Final rule to revise the Board’s framework for determining whether a company has control over another company under the Bank Holding Company Act and the Home Owners’ Loan Act

ACTIONS REQUESTED: Staff seeks approval of the attached draft final rule that would revise the Board’s framework 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 final rule to prepare it for publication in the *Federal Register*.

EXECUTIVE SUMMARY:

- The Board invited public comment on a proposal in April 2019 to simplify and increase the consistency and transparency of the Board’s “control” standards under the BHC Act and HOLA by proposing a comprehensive new framework for making control determinations.
- The proposal included certain targeted adjustments to the Board’s existing control policies and practices. These adjustments would have allowed noncontrolling investors in some situations to have modestly larger director representation and other relationships than current practice.
- Commenters largely supported the increased simplicity, consistency, and transparency that the proposal offered. They also made recommendations to adjust the calibration of certain parts of the proposal and the scope of certain defined terms and presumptions in the proposal.
- The final rule would adopt a comprehensive public framework for the Board’s control determinations under the BHC Act and HOLA. Under the final framework, whether a company controls another company principally would be based on several factors including:
 - Voting interest in another company;
 - Total equity ownership in another company;
 - Director representation at another company; and

¹ Mark Van Der Weide, Laurie Schaffer, Alison Thro, Mark Buresh, Greg Frischmann, Brian Phillips, and Markas Puidokas (Legal Division) and Barbara Bouchard, Susan Motyka, Katie Cox, Jevon Gordon, Melissa Clark, Sheryl Hudson, and Sviatlana Phelan (Division of Supervision and Regulation).

- Business relationships with another company.
- The final framework would be largely consistent with the proposal, with several changes to the proposed framework in response to comments. The key modifications in the final rule include a modest re-calibration of the total equity thresholds, a modest re-calibration of the business relationship thresholds, and the elimination of one of the investment fund control standards.

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 certain activities restrictions and the Board's supervision and regulation.² A company that is controlled by a bank holding company or savings and loan holding company is also subject to activities restrictions and reporting as a subsidiary of the regulated holding company.³

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.⁴ The definition of control in HOLA is substantially similar.⁵

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

² 12 U.S.C. §§ 1841(a)(2) and 1467a(a)(2).

³ 12 U.S.C. §§ 1843 and 1467a(c).

⁴ 12 U.S.C. § 1841(a)(2); 12 CFR 225.2(e).

⁵ See 12 U.S.C. § 1467a(a)(2); 12 CFR 238.2(e). As discussed further below, one difference between the BHC Act and HOLA is that the definition of control under HOLA includes situations where a company has contributed more than 25 percent of the capital of another company.

Historically, the Board and its staff have considered a variety of factors for purposes of the third prong of control, including the size and structure of a company's voting and total equity investment in the other company; a company's rights to director representation at the other company; common management, employees, or directors between the two companies; covenants or other agreements that allow a company to influence or restrict management decisions of the other company; the nature and scope of 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. The Board has not previously issued detailed, public standards identifying the combination of features of investments that may raise control concerns. The lack of a comprehensive, public control standard has raised concerns about the fairness and transparency of the Board's control decisionmaking, as well as potential adverse consequences on banking firms seeking to raise capital or make strategic investments.

The final rule should bring consistency and transparency to the Board's control framework by clarifying when control concerns may arise in common investment fact patterns.⁶ A consistent and transparent framework should help to facilitate investments in and by banking firms. The final rule should be particularly useful for community banking firms, which may more frequently rely on a few significant investors to raise capital, and therefore may encounter control-related issues more frequently than larger banking firms.

B. Major comments on the proposal

The Board issued a proposed control framework for public comment in April 2019.⁷ Most comments were supportive of the proposal for the increased transparency and certainty that it would provide. Many commenters encouraged the Board to raise the thresholds used in the proposal to provide greater leeway for companies to make minority investments and have other relationships—particularly business relationships—without raising control concerns. Commenters also asked the Board to clarify or narrow the scope of certain defined terms. Below is a summary of the major items raised by commenters.

- Business relationships – Commenters urged the Board to raise the various quantitative thresholds for business relationships used in the proposal. Moreover, commenters

⁶ Nothing in the final rule would limit the ability of the Board to take action to address unsafe and unsound practices or conditions or other issues.

⁷ 84 FR 21634 (May 14, 2019).

suggested that the significance of business relationships be measured only from the perspective of the investee company, not from the perspective of both the investor company and the investee company.

- Total equity – Commenters encouraged the Board to raise the various total equity thresholds used in the proposal. In addition, commenters argued that the proposed methodology for calculating one company’s total equity in another company could result in excessive measured total equity levels under certain conditions. Commenters also asked for clarification on the interaction of the proposed total equity thresholds and the concept of contributed capital under HOLA.
- Accounting consolidation – Commenters asked that the final rule not presume control when one company consolidates another company on its financial statements under U.S. generally accepted accounting principles.
- Investment funds – Commenters stated that the control presumptions related to investment funds should permit an investment advisor to have higher levels of ownership in an advised fund before raising control concerns.
- Prior control – Commenters recommended that the Board remove a proposed presumption of control for divestiture transactions.

C. The final rule

The final rule would establish a comprehensive framework for determining whether a company controls another company under the BHC Act and HOLA. The final rule also clarifies certain control-related concepts, such as how to measure a company’s voting equity or total equity percentage in another company.⁸

The final rule includes certain targeted adjustments to the Board’s current control policies and practices. For example, the rule would permit a noncontrolling investor in some situations to have modestly larger nonvoting equity investment and director representation than current practice. The final rule is also largely consistent with the proposal, though staff recommends making certain changes in response to public comment, as described below.

1. The tiered framework of control presumptions

⁸ The final rule includes a certification by the Board that the final rule will not have a significant economic impact on a substantial number of small entities for purposes of the Regulatory Flexibility Act. 5 U.S.C. § 601 *et seq.*

The central element of the final rule is a series of “presumptions of control,” where one company would be presumed to control another company. Most of these presumptions are based on a company’s level of voting securities in the other company, director representation at the other company; management official and employee interlocks with the other company; contractual rights to determine management or operational decisions of the other company; total equity investment in the other company; and extent of business relationships with the other company. 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 for a chart of the tiered presumptions.

The tiered framework in the final rule differs from the proposal in three notable ways. First, the final presumptions of control based on the level of business relationships between an investing company and an investee company only take into account the significance of the business relationships from the perspective of the investee company. The proposal took into account the significance of business relationships from both the perspective of the investor and the investee. Staff believes that this change in the final rule appropriately simplifies the presumptions and recognizes that business relationships that are significant from the perspective of the investee company provide the investing company with a more direct and powerful tool for the exercise of control than business relationships that are significant from the perspective of the investing company.

Second, staff has simplified the presumptions of control based on total equity ownership. Under the proposal, an investor with a voting interest of 15 percent or more in another company could avoid control only by keeping its total equity percentage in the other company below 25 percent. An investor with a voting interest of less than 15 percent could avoid control only by keeping its total equity percentage below one-third. The final rule establishes a single total equity threshold of one-third for investors, regardless of their voting interest in the other company. Staff believes that this change in the final rule appropriately simplifies the framework and better reflects the lesser relative power of nonvoting equity compared to voting equity for purposes of control.

Third, the final rule simplifies the control framework for savings and loan holding companies. Because of a unique “25 percent of contributed capital” prong in the HOLA definition of control, the proposal included a “total equity” presumption of control in addition to

the “contributed capital” statutory standard of control for savings and loan holding companies. In response to comments received on the proposal and further staff analysis, the final rule does not include a presumption of control based on total equity for savings and loan holding companies. Instead, the preamble to the final rule states that contributed capital under HOLA generally means the same thing as total equity in the Board’s regulations implementing the BHC Act. Accordingly, the relevant total equity threshold for savings and loan holding companies under the final rule will be 25 percent, not the one-third that applies to bank holding companies. Staff believes that this change is appropriate as it simplifies the control framework for savings and loan holding companies and is consistent with precedents interpreting contributed capital under HOLA.

2. Additional presumptions

The proposed rule contained a handful of additional presumptions of control (outside of the core tiered framework) and a presumption for when a firm would not have control. The final rule includes these presumptions, substantially unchanged from the proposal.

Like the proposal, the final rule retains a presumption relating to when a company that previously controlled another company would be considered to have divested control. Under the final rule, as under the proposal, a formerly controlling company could escape presumed control only by (i) divesting to a voting interest of less than 15 percent; or (ii) divesting to a voting interest of less than 25 percent and waiting two years. Although commenters urged the Board to eliminate the proposed divestiture presumption, the legislative history and case law strongly support retention of a form of this presumption. Therefore, staff believes it is appropriate to include the divestiture presumption in the final rule as provided in the proposal.

The proposed rule contained a presumption of control where a company consolidates another company on its financial statements for purposes of U.S. general accepted accounting principles. Although commenters requested that the Board remove or weaken this presumption, staff believes that it is appropriate to include the presumption in the final rule without change, as the accounting consolidation standards generally identify situations where a controlling influence would be present. In addition, reliance on accounting standards in the Board’s control rule will increase transparency, reduce burden, and increase harmony between the accounting and bank regulatory frameworks.

The proposal contained both a broad presumption of control for investment funds and a narrow exclusion for SEC-registered investment companies. The final rule retains the presumption of control for investment funds but eliminates the exclusion for SEC-registered funds. Staff believes the retained control presumption provides sufficient transparency to the public about how the Board views control in the investment fund context. The proposed presumption of noncontrol for SEC-registered funds provided some marginal additional clarity for certain relationships with such funds, but did not materially affect the scope of the presumptions. The proposed presumption of control for investment funds provided that an investment advisor to a fund would be presumed to control the fund if the adviser owns more than 5 percent of the voting interests of the fund. Commenters asked the Board to lift the 5 percent voting interest threshold in the investment fund presumption. Staff recommends keeping the threshold at 5 percent, as the 5 percent threshold is consistent with most of the Board's precedent in this area and reflects the material influence of an investment advisor over its advised investment funds.

Finally, the proposal contained a new presumption of noncontrol for 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. The final rule also contains this presumption.

3. Definitional and other items

The proposed rule defined several control-related items in a manner consistent with the Board's current practice but that previously have not been codified in regulation. These include a definition of a director representative of one company at another company; standards for determining the amount of voting securities that an investor controls under various circumstances, including indirect ownership and ownership through options or convertible securities; and a standard for determining a company's total equity ownership in another company.

The final rule adopts these provisions as well, with a few minor adjustments. For example, in response to comments, the final rule's definition of director representative is narrower and less prescriptive than the proposal's definition. In addition, in response to comment, staff has revised the proposal's total equity provisions so that an investor is only required to measure its total equity position in another company at the time the investor makes an investment in the other company. The proposal had also required an investor to measure its total

equity position in the other company at the time the investor reduced its investment in the other company. Staff believes that these changes are appropriate to simplify and clarify the framework and believes these changes will not result in materially different outcomes relative to the proposal.

RECOMMENDATIONS:

For the reasons discussed above, staff recommends that the Board approve the attached draft final rule for publication in the *Federal Register* and the attached draft delegation order. 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 of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
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	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less