

# Federal Reserve Board Proposes Clarifications on Presumptions of Control

On Tuesday, April 23, 2019, the Federal Reserve Board (Federal Reserve) issued for public comment a long-awaited proposed revision to its rules (Proposed Rule) related to control determinations for banks, bank holding companies, and savings and loan holding companies (collectively, BHCs). The Proposed Rule clarifies existing standards related to control determinations, which are ambiguous and not always applied consistently. In addition, the Proposed Rule generally relaxes some previous presumptions of control. If finalized as proposed, the Proposed Rule may make it easier and simpler to make significant investments in BHCs or potentially fintech companies seeking a bank charter.

## Some Needed Clarity

Most investors in BHCs structure their investments to avoid a control determination (and the accompanying supervision and regulation by the Federal Reserve). The Proposed Rule may make it easier, or at least provide a clearer path, for investors to make non-controlling investments in BHCs. The Proposed Rule eliminates some, but not all, of the uncertainty related to such investments. The Proposed Rule helps ensure that presumptions of control are applied in a clear, transparent and consistent manner.

The Federal Reserve deems an investor with less than 5% of the voting shares of a BHC not to be in control, and an investor with more than 25% voting shares to be in control. Investments between 5% and 25% of voting shares have been subject to case-by-case control determinations by the Federal Reserve.

While the Proposed Rule provides some clarity with respect to investments between 5% and 25% of voting shares, the Federal Reserve retains discretion to: (1) find control based upon the facts and circumstances of a particular case within those thresholds; and (2) raise safety and soundness or other concerns regarding either controlling or non-controlling relationships.

## Tiered Framework

The Federal Reserve proposes a “tiered” framework for determining whether an investor is presumed to have control of a BHC. The framework is structured so that as an investor’s ownership percentage in the BHC increases, the additional relationships and other factors considered must decrease to avoid control. Within this range (between 5% and 25% control), the Federal Reserve proposes a series of presumptions of control, and if an investor does not meet any of those presumptions, an investment may be able to proceed without application or confirmation from the Federal Reserve. However, as noted above, the Federal Reserve retains some discretion, including on safety and soundness grounds. The presumptions of control are divided into two categories:

- Specific thresholds of equity investments, including the size of the voting equity investment and the total equity investment; and
- Scope of relationships between the investor and the BHC, including:
  - Rights to director and committee representation on the board of directors
  - Use of proxy solicitations
  - Management, employee or director interlocks
  - Agreements influencing or restricting management or operational decisions
  - The business relationships between the investor and the BHC

See the Appendix for a table released by the Federal Reserve in conjunction with the Proposed Rule, which summarizes this framework.

## Increased Director and Committee Representation

The Proposed Rule materially increases the number of directors that an investor may have and the roles of those directors on the board of a BHC. The Federal Reserve has historically limited an investor’s director representation to one or, in limited circumstances, two director representatives. The Proposed Rule permits an investor controlling:

- Less than 5% of the voting shares to have representation of up to 50% of the directors; and
- Between 5% and 24.99% of the voting shares of a BHC to have representation of up to 25% of the directors of the BHC.

The Proposed Rule also increases the roles that director representatives may have on board committees. Historically, the Federal Reserve has presumed control when an investor's directors comprise more than 25% of the members of any committee or any of its directors served on a committee with the power to bind the BHC. Also, the Federal Reserve has prohibited such directors from serving as chair of the board. Under the Proposed Rule, if an investor controls less than 10% of voting shares, there are no restrictions on committee membership. If the investor controls less than 15% of voting shares, its director representatives may constitute no more than 25% of a committee with the power to bind the BHC. Additionally, the Proposed Rule permits investors controlling less than 15% of the voting shares to have a director representative serve as the chair of the board.

## Liberalization of Proxy Solicitations

Historically, the Federal Reserve has taken the position that an investor may not rebut a presumption of control and solicit proxies contrary to the recommendations of the board of directors. Under the Proposed Rule, the Federal Reserve recognizes that investors may exercise their core rights as shareholders and may solicit proxies in certain circumstances without exerting control over the BHC, so long as the number of directors proposed in the proxy, aggregated with the investor's existing directors, would not exceed the percentage permitted without triggering control.

## Clarity for Management Interlocks

The Proposed Rule provides a clear test regarding management interlocks. An investor will be deemed to be in control if it controls 5% or more of any class of voting shares and has more than one senior management interlock or the investor has an employee or director that serves as the chief executive officer of the BHC. In addition, if an investor controls 15% or more of any class of voting shares of a BHC and has any senior management (defined as any person who has the authority to participate, other than in the capacity as a director, in major policymaking functions of the BHC) interlock, it will be deemed to be in control.

## Guidance on Contractual Provisions

The Federal Reserve continues to be concerned about contractual provisions found in shareholder agreements, investor agreements, debt relationships, or other business relationships, restricting the discretion of a BHC over major operational or policy decisions. The Proposed Rule includes a list of examples of contractual rights in favor of investors that the Federal Reserve considers to be "limiting" and giving rise to a presumption of control. Examples of "limiting" contractual provisions include: (1) limiting merger or consolidation, or acquisition, sale, lease, transfer, spin-off, recapitalization, liquidation, dissolution, or disposition of subsidiaries or assets; (2) imposing prohibitions on entering into new lines of business, making substantial changes to or discontinuing existing lines of business, or entering into contracts imposing significant financial obligations on the BHC; (3) restricting significant investments or expenditures; and (4) restricting authorization or issuance of additional junior equity or debt securities, or amending the terms of any outstanding equity or debt securities.

The Proposed Rule also includes a list of examples of contractual rights not considered to be "limiting," such as: (1) restricting issuance of securities senior to the non-common stock securities controlled by the investor; and (2) providing the investor with financial reports ordinarily available to common stockholders.

## Concerning Business Relationships

While much of the Proposed Rule eased control restrictions, the Proposed Rule reflects the Federal Reserve's continued belief that certain business relationships between an investor and a BHC can raise control concerns. To avoid presumptions of control, business relationships need to decrease as equity interests increase. The Federal Reserve presumes no control if an investor:

- Controls between 5% and 9.99% of the voting shares and limits its business relationships to less than 10% of the total annual revenues or expenses;
- Controls between 10% and 14.99% of the voting shares and limits its business relationships to less than 5% of the total annual revenues or expenses; or
- Controls between 15% and 24.99% of the voting shares and limits its business relationships to less than 2% of the total annual revenue or expenses.

There are no limits on business relationships for purposes of the control determination if the investor controls less than 5% of the voting shares. The Proposed Rule also takes into consideration whether the terms of the business relationship are on market terms, and if not, and the investor controls between 10% and 24.99% of the voting shares, then the Federal Reserve presumes control. While certain business relationships may not be limited for purposes of the control determination, BHCs and investors may be restricted by other rules and guidance, including independence tests for directors who may be affiliated with an investor.

## New Divestiture Standards

The Federal Reserve's requirements regarding divestiture of control have been particularly restrictive. This has made it difficult for an investor previously deemed to have a controlling interest to terminate an existing control relationship. The Federal Reserve traditionally has taken the position that an investor that has controlled a BHC for a significant period may be able to exert control over the BHC even after a substantial divestiture. As a result, the Federal Reserve typically required an investor to divest to below 5% of voting shares to terminate an existing control relationship.

The Proposed Rule eases that standard and allows investors to sever control relationships while retaining greater levels of ownership. Under the Proposed Rule, the Federal Reserve presumes that an investor is no longer in control if:

- The investor holds less than 15% of the voting shares and does not trigger any of the other presumptions of control;
- The investor holds more than 15% but less than 25% of the voting shares and has remained at that level during the preceding two years; or
- An unrelated single individual or company owns more than 50% of the voting shares.

While the Proposed Rule does not represent a significant shift in policy for the Federal Reserve, it does provide much-needed clarity and transparency to a highly technical set of rules and does provide some additional flexibility for investors. The Proposed Rule includes 56 questions, which indicates a continued willingness to fine-tune the Proposed Rule. The public comment period is open for 60 days after the Proposed Rule is published in the Federal Register.

## 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
<b>Directors</b>	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
<b>Director Service as Board Chair</b>	N/A	N/A	N/A	No director representative is chair of the board
<b>Director Service on Board Committees</b>	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
<b>Business Relationships</b>	N/A	Less than 10% of revenues or expenses	Less than 5% of revenues or expenses	Less than 2% of revenues or expenses
<b>Business Terms</b>	N/A	N/A	Market Terms	Market Terms
<b>Officer/Employee Interlocks</b>	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
<b>Contractual Powers</b>	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
<b>Proxy Contests (directors)</b>	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
<b>Total Equity</b>	Less than one third	Less than one third	Less than one third	Less than one quarter

## Contacts

For more information about these or other governance and financial regulatory topics, please contact the lawyers listed here.

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