

Key Takeaways for Investors From the Federal Reserve's Final "Control" Rule

by William E. Stern, Alexander J. Callen, Samantha M. Kirby, Matthew Dyckman

On January 30, 2020, the Board of Governors of the Federal Reserve System (Federal Reserve) issued a final [rule](#) (Rule) that revises the Federal Reserve's regulations related to determinations of whether a first company (an investor) exercises a "controlling influence" over a second company (a target) for purposes of the Bank Holding Company Act (BHCA) or the Home Owners' Loan Act (HOLA). The Rule is "largely consistent" with the version proposed in the Federal Reserve's Spring 2019 [notice of proposed rulemaking](#), with modest modifications adopted by the Federal Reserve in response to public comments. Among other key elements of the Rule:

- The Rule establishes a rebuttable presumption of noncontrol for an investment that does not comprise 10% or more of any class of voting securities of a target and does not otherwise trigger a presumption of control.
- The Rule provides additional flexibility for investors to have representatives serve on a target's board of directors.
- The Rule specifies the level of business relationships that the Federal Reserve will regard as material given an investor's ownership or control of a particular percentage of voting securities, and it provides a non-exclusive list of examples of contractual rights that may be indicia of control. This additional guidance will provide more certainty to investors, targets and legal practitioners.
- The Federal Reserve has significantly relaxed the way in which it intends to treat divestitures from its historic practice of, at a minimum, requiring a divestiture below 5% of a class of voting securities in order to eliminate control. As a result, the Rule should make it easier for an investor to divest control of a company.
- The Federal Reserve clarified that the presumptions of control contained in the Rule apply for purposes of investments made under Section 4(c)(6) of the BHCA and, in particular, the requirement that such investments be "passive," which should provide greater clarity about whether an investment qualifies under that authority.

The Rule is intended to promote a transparent and consistent framework for control determinations, reducing an investor's risk of unexpectedly acquiring control of a target and the associated regulatory burden. Although the Federal Reserve previously has issued policy statements (including one as recently as 2008), the Federal Reserve has not materially modified its regulatory presumptions related to control since the 1980s. These prior policy statements remain in effect to the extent not superseded by the Rule.

Potential Impact

The Rule applies not only to determinations of whether an investor controls a banking organization in which it has invested, but it also governs determinations of whether a banking organization has acquired control of a target in which it has invested. As a result, the Rule could benefit banks and FinTech companies alike at a time when banks are increasingly considering investments in FinTech companies and FinTech companies are considering whether to form or acquire depository institution subsidiaries.

The Rule's additional transparency could also make investments in financial institutions and their holding companies more appealing to investors. However, the greater certainty provided by the Rule about what may or may not constitute control of a banking organization may encourage shareholder activism. In addition, the practical effect of the presumption of control related to significant business relationships means that certain

investors may continue to favor making investments that are less than 5% of any class of a target's voting securities.

Background on "Control"

Under the BHCA, which applies to companies (as opposed to individuals, which are generally subject to the Change in Bank Control Act), an investor "controls" a target if (1) the investor directly or indirectly owns, controls, or has power to vote 25% or more of any class of a target's voting securities, (2) the investor controls in any manner the election of a majority of a target's directors or trustees, or (3) the Federal Reserve determines, after notice and opportunity for hearing, that the investor directly or indirectly exercises a "controlling influence" over the management or policies of the target. For purposes of the controlling influence prong, the BHCA establishes a presumption that an investor that directly or indirectly owns, controls, or has power to vote less than 5% of any class of a target's voting securities does not control the target. The HOLA's definition of control is very similar to the BHCA's definition.

The control provisions of the BHCA and HOLA are designed to help ensure that a control person has the financial and managerial capacity to exercise control of a bank or savings association in a safe and sound manner and that banking remains separate from commerce. Accordingly, a determination of control under the BHCA or HOLA has important consequences. An investor that controls a bank or savings association is regulated as a bank holding company or savings and loan holding company and subject to supervision and examination by the Federal Reserve, including the Federal Reserve's significant operational, managerial, and financial requirements. If a target is deemed to be controlled by a bank holding company or savings and loan holding company, the target's activities may be restricted, and the target may be subject to a variety of other limitations.

Technically, a determination by the Federal Reserve of whether an investor exercises a controlling influence over a target requires notice and opportunity for a hearing. Such proceedings are rare; rather, investors and targets often seek to structure investments and business relationships to avoid triggering a presumption of control by treating the presumptions in the Federal Reserve's Regulation Y and Regulation LL as "bright line" rules, by evaluating other guidance provided by the Federal Reserve, and by consulting with Federal Reserve staff.

The Rule revises Regulation Y and Regulation LL to consolidate and clarify Federal Reserve precedent. In the Rule's adopting release, the Federal Reserve stated that it generally does not expect to find that an investor controls a target unless the investor triggers a presumption of control with respect to the target. However, the Federal Reserve also reserved the right to find that a controlling influence exists based on the facts and circumstances presented by a particular case; and it further cautioned that the absence of a presumption of control does not necessarily mean that an investment or other aspects of a relationship are consistent with safe and sound banking practices or the Federal Reserve's other expectations or requirements.

The Rule's Tiered Framework

The Rule creates a tiered framework that incorporates the major factors and thresholds that the Federal Reserve often views as presenting controlling influence concerns. As an investor's ownership percentage in a target increases, the Federal Reserve will require other factors through which the investor could exercise control to decrease in order to avoid triggering a presumption of control. According to the Federal Reserve, an investor's voting ownership level is "one of the most salient" considerations for determining control. The Rule does not differentiate between closely held and widely held targets, and it generally does not consider the presence of a majority third-party shareholder. An investor's total voting ownership level (e.g., 5%, 10%, and 15%) forms the backbone of the tiered framework, and these ownership levels interact with several other key

factors to determine whether a controlling influence exists, including the investor's total equity investment; overlapping directors, officers, and employees; contractual arrangements; and the scope of business relationships.

The Rule also includes presumptions of control that are not related to the ownership tiers, as well as an express rebuttable presumption of noncontrol for investors controlling less than 10% of every class of a target's voting securities, if the investor does not trigger any other presumption of control factor.

To provide investors with more transparency into control determinations, the Federal Reserve supplemented the Rule with a [table](#) showing how different combinations of ownership levels and key factors will or will not result in a presumption of control.

Size of Total Equity Investment

The Federal Reserve regards the overall amount of an investor's equity investment in a target (both voting and nonvoting) as a significant indicator of whether the investor controls the target. The Rule presumes that an investor controls a target if the investor holds 33.33% or more of the target's total equity, without regard to the investor's voting securities percentage. The Rule also includes provisions addressing the calculation of this threshold, including the impact of options, warrants, convertible securities, or similar rights. The Rule adopts the proposed approach of measuring the value of equity in accordance with U.S. generally accepted accounting principles (GAAP) or equivalent methodology for companies not subject to GAAP. The Federal Reserve rejected public comments seeking special treatment where targets, such as start-up technology companies, have negative retained earnings.

In response to public comments, the Federal Reserve clarified that "contributed capital" for purposes of the HOLA generally has the same meaning as "total equity" for purposes of the BHCA. Under the HOLA, an investor controls a target if the investor has contributed more than 25% the target's capital.

Director Representation

The Rule relaxes some of the Federal Reserve's historical standards for evaluating whether an investor's representation on a target's board of directors confers control over the target. Historically, an investor owning at least 10% of a class of a target's voting securities could have one director on a target's board without triggering a presumption of control. However, the Federal Reserve permitted an investor to have a second director representative, consistent with the investor's noncontrolling status, if the second director's representation on the target's board was proportional to the investor's voting interest in the target and there was another large bank holding company investor that controlled the target.

Under the Rule, there is no presumption of control related to board representation with respect to an investor whose investment does not comprise 5% or more of any class of a target's voting securities. However, as noted above, the ability to select a majority of directors will separately trigger control under the second prong of the statutory definition of control. Consequently, such investors could have director representatives that constitute less than half the members of the board of directors without having control under the statutory definition of control in the BHCA. An investor owning 5% or more, but less than 25%, of any class of a target's voting securities will be permitted to have director representation of less than 25% of a target's board without triggering a presumption of control.

The Rule also treats certain governance rights and board committee participation as indicia of control. The Rule presumes control of a target exists where an investor that controls:

- 5% or more of any class of a target's voting securities has director representatives who have the power to make or block major operational or policy-making decisions, such as through supermajority voting requirements, veto rights, or similar arrangements.
- 10% or more of any class of a target's voting securities has directors occupying 25% or more seats on any board committee having the power to bind the target without needing additional action by the full board.
- 15% or more of any class of a target's voting securities has a director serving as chair of the board.

In the Rule's adopting release, the Federal Reserve rejected public comments seeking different standards for private and publicly traded targets, and consideration of the presence of independent directors who could limit the influence of the chair of the board. The Federal Reserve also confirmed that an advisory committee lacking the ability to bind a company is not a committee covered by the presumption.

Investors should carefully consider and closely monitor the roles played by their director representatives to avoid triggering the committee- or chair-related presumptions.

Senior Management Interlocks and Attribution

The Rule presumes control exists where an investor owning 5% or more of any class of a target's voting securities also has more than one senior management interlock with the target or has an employee or director who serves as the target's chief executive officer. This presumption is more restrictive than the Federal Reserve's current practice, which does not consider a management interlock with a company in which an investor does not hold 10% or more of any class of a target's voting securities as presumptively resulting in control and which does not specifically address interlocks involving the chief executive officer. In addition, the Rule presumes control of a target exists where an investor that controls 15% or more of any class of a target's voting securities has any senior management official interlock with the target.

Additionally, an investor controlling 5% or more of any class of a target's voting securities is deemed to control all securities issued by the target that are controlled by the investor's senior management officials, controlling shareholders, and their immediate family members, unless the investor controls less than 15% of each class of the target's voting securities and the investor's senior management officials, controlling shareholders, and their immediate family members own 50% or more of each class of the target's voting securities.

These presumptions focus on senior management officials, rather than "management officials" more generally, with a "senior management official" being any person who participates or has authority to participate in major policy-making functions (other than as a director). Recognizing that this definition lacks precision, the Federal Reserve indicated in the Rule's adopting release that it will consider providing additional clarity to the definition after acquiring more experience with the Rule's presumptions.

Proxy Solicitations

The Rule presumes that control exists where an investor that controls 10% or more of any class of a target's voting securities also solicits proxies to appoint a target's directors in opposition to nominees proposed by the target's management or its directors, where the investor's nominees (and any of its other director representatives) together would comprise 25% or more of the target's board. The Rule does not impose a presumption of control where an investor that controls 10% or more of any class of a target's voting securities solicits proxies on other issues.

Management Agreements

The Rule identifies specific types of arrangements that the Federal Reserve would view as conferring control, consistent with precedent. These types of arrangements include those that allow an investor to direct or

exercise significant influence over the core business or policy decisions of a target, such as serving as a managing member, trustee, or general partner of a target.

Contractual Provisions

The Rule presumes control exists where an investor that controls 5% or more of any class of a target's voting securities also has a contractual right that significantly restricts, or allows the investor to significantly restrict, the target's discretion over major operational or policy decisions. Commercial agreements and loan agreements with targets that contain a "limiting contractual right" will not trigger a presumption of control in the absence of an accompanying equity position in the target. Notably, the contractual restrictions that will trigger a presumption of control under the Rule are similar to the negative covenants that private equity or venture capital investors often seek to obtain in connection with their investments.

A presumption of control will be triggered by the following "limiting contractual rights":

- Restrictions on a target's business and strategic activities, including (1) entering new business lines, (2) substantially changing or discontinuing existing business lines, (3) entering into contractual arrangements with third parties that impose significant financial obligations on the target, (4) materially altering the target's policies or procedures, (5) making significant investments or expenditures, or (6) ability to merge or consolidate, or on its ability to acquire, sell, lease, transfer, spin off, recapitalize, liquidate, dissolve, or dispose of subsidiaries or major assets.
- Restrictions on a target's financing and capital activities, including ability to (1) pay or not pay dividends, change its dividend payment rate on any class of securities, redeem senior instruments, or make voluntary prepayment of indebtedness, (2) authorize or issue additional junior equity or debt securities, or amend the terms of any equity or debt securities issued by the company, (3) engage in a public offering or to list or delist securities on an exchange, (4) remove or select any independent accountant, auditor, or investment banker, or (5) significantly alter accounting methods and policies, or its regulatory, tax, or corporate status, such as converting from a stock corporation to a limited liability company.
- Requirements that the target (1) 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, or (2) not exceed a specified percentage of classified assets or nonperforming loans.
- Restrictions on the target's ability to (1) hire, fire, or compensate its senior management officials, or (2) significantly modify employee salary, compensation, employment, or benefits plan policies.
- Restrictions on the target's ability to amend its articles of incorporation or bylaws, other than limited restrictions that are solely defensive for the investor.

A presumption of control will not be triggered by the following "limiting contractual rights":

- Restrictions on a target's ability to issue securities senior to the securities owned by the investor.
- Requirements that the target (1) provide the investor with ordinary financial reports or other information of the type ordinarily available to common stockholders (which suggests that more extensive information rights may be problematic), (2) consult with the investor on a reasonable periodic basis, or (3) notify the investor of material events affecting the target or significant assets.
- Market standard "most-favored nation" clauses.
- Drag-along or 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 carryforwards, or other similar rights.
- Requirements that the target (1) maintain its corporate existence, or (2) comply with applicable statutory and regulatory requirements.

The Rule includes an exclusion from the presumption of control for “limiting contractual rights” in the context of a pending merger that are designed to ensure that a target operates in the ordinary course while the merger is pending.

In the Rule’s adopting release, the Federal Reserve also noted that a contractual provision that establishes a reasonable and non-punitive mechanism for an investor to reduce its investment to comply with the activities restrictions of the BHCA or HOLA generally will not be construed to be a “limiting contractual right” that would trigger a presumption of control.

Business Relationships

The Federal Reserve has historically regarded significant business relationships between an investor and a target as a way for an investor with a significant equity position to exert control over the target. Such relationships have also been viewed as potentially inconsistent with the requirement for an investor to act in a passive manner when making a noncontrolling investment in a target under Section 4(c)(6) of the BHCA. The Rule does not include a presumption of control relating to business relationships with a target where the investor does not hold 5% or more of any class of the target’s voting securities, but it does create several presumptions of control where significant business relationships accompany investments of 5% or more of any class of voting securities. Specifically, the Rule presumes control of a target exists where an investor controls:

- 5% or more of any class of a target’s voting securities and has business relationships with the target that generate in the aggregate 10% or more of the total annual revenues or expenses of the target.
- 10% or more of any class of a target’s voting securities and has business relationships with the target that (1) generate in the aggregate 5% or more of the total annual revenues or expenses of the target, or (2) are not on market terms.
- 15% or more of any class of a target’s voting securities and has business relationships with the target that generate in the aggregate 2% or more of the total annual revenues or expenses of the target.

The Rule does not include a presumption of control based on threats to alter or terminate business relationships.

The Federal Reserve rejected public comments seeking to change the business relationship thresholds, adjust the revenue and expense calculations, exclude specific types of business relationships from coverage, and eliminate the presumption of control related to relationships that are not on market terms. The Federal Reserve did, however, narrow the frame of reference for revenues and expenses to those of the target only, rather than those of either the investor or target as in its prior proposal. These presumptions may limit investments of 5% or more a class of voting securities in a start-up company, particularly where the investor is seeking access to the target’s technology or services.

In response to public comments seeking clarification that an investment that does not trigger a presumption of control and is less than 5% of any class of voting securities should be considered passive for purposes of section 4(c)(6) of the BHCA, the Federal Reserve replied that the control framework in the Rule applies for purposes of Section 4(c)(6). As a result, it appears that investments that are less than 5% of any class of voting securities and do not otherwise trigger a presumption of control should qualify under Section 4(c)(6).

Investment Advisers and Investment Companies

The Rule presumes control exists where an investor owning 5% or more of any class of an investment fund’s voting securities or 25% or more of the investment fund’s total equity also serves as the investment fund’s investment adviser. However, this presumption of control will not apply when the investor organized and offered the target investment fund within the prior 12 months to provide an initial seeding period. The Federal

Reserve rejected public comments seeking to provide for a “reasonable” seeding period or extend its duration to three years for consistency with the Volcker Rule and to expand the exemptions availability to fund participants, rather than only to fund organizers and sponsors.

Divestitures

The Rule substantially relaxes the Federal Reserve’s existing standards regarding divestiture of control. Under the Rule, an investor that previously controlled a target (e.g., a subsidiary) during the preceding two years will be presumed to continue to control the target if the investor owns 15% or more of any class of the target’s voting securities. As a result, a company generally will not be presumed to control a subsidiary if it either (1) divested to below 15%, or (2) divested to between 15% and 25% and waited for two years to pass. This presumption of control will not apply if 50% or more of the outstanding securities of each class of the subsidiary being sold is controlled by a single unaffiliated person or company. In response to public comments, the Federal Reserve clarified that this exception only applies when an unaffiliated person controls 50% or more of the outstanding securities of each class of voting securities of the company being divested. Other presumptions of control, such as those related to business relationships and interlocks, will continue to apply. The Rule does not presume control upon an investor’s threat to dispose of securities of a target, including large-block disposals.

Accounting Consolidation

The Rule presumes control exists where an investor consolidates a target under GAAP. The Federal Reserve rejected public comments advocating abandonment of this presumption of control. In the Rule’s adopting release, the Federal Reserve further stated that although this presumption of control, by its terms, relates only to those investors who prepare financial statements under GAAP, the Federal Reserve is likely to have similar control concerns where an investor consolidates a target on its financial statements under another accounting standard, particularly if the other accounting standard has consolidation standards similar to GAAP’s.

Fiduciary Exception

The Federal Reserve previously proposed to exclude from a presumption of control securities held by a company in a fiduciary capacity without sole voting authority. In response to public comments that the criteria for this exception were too restrictive, the Rule now provides that securities of a target held in a fiduciary capacity are not controlled for purposes of the presumptions of control, but if the target is a depository institution or a depository institution holding company, then such relief is extended only when its securities are held in a fiduciary capacity without sole discretionary authority to exercise voting rights with respect to such securities. For these purposes, treatment under the HOLA parallels that under the BHCA.

Passivity Commitments

In the Rule’s adopting release, the Federal Reserve stated that it does not intend to obtain standard-form passivity commitments going forward in the ordinary course, but it will continue to obtain control-related commitments in specific contexts (e.g., ESOPs and mutual fund complexes). The Federal Reserve invited investors that have previously provided the standard-form passivity commitments to contact the Federal Reserve or the appropriate Federal Reserve Bank to seek relief from such commitments, and the Federal Reserve indicated that it expects to be receptive to such requests “absent unusual circumstances.” Because the Federal Reserve’s standard form passivity commitments are in some respects more restrictive than the Rule, and because the Federal Reserve requests that investors periodically certify compliance with commitments, there may be some benefit to seeking relief from such commitments.

Effective Date and Next Steps

The final rule becomes effective on April 1, 2020. The Rule does not include any grandfathering provisions or any phase-in or transition periods.

The Federal Reserve does not intend to revisit existing structures that were previously reviewed by the Federal Reserve and have not changed materially.

Our team is ready to help you evaluate the Rule's impact on your organization and help you structure investments that take into account the revised control framework. For additional information, please contact one of the authors or another member of Goodwin's [Banking](#) practice, part of its [Financial Industry](#) group.

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CONTACTS:

William E. Stern

Partner

+1 212 813 8890

wstern@goodwinlaw.com

Alexander J. Callen

Associate

+1 212 459 7122

acallen@goodwinlaw.com

Samantha M. Kirby

Partner

+1 617 570 8794

+1 202 346 4250

skirby@goodwinlaw.com

Matthew Dyckman

Counsel

+1 202 346 4113

mdyckman@goodwinlaw.com

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