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ALERT MEMORANDUM

The Federal Reserve's "Control" Proposal: Implications and Areas for Comment

May 9, 2019

In a highly-anticipated release, the Federal Reserve Board has invited comment on proposed amendments to its regulations governing when one company will be deemed to control another. The proposal would have significant implications for investments by and in banking organizations. It would provide greater certainty and transparency by codifying and clarifying a number of principles for analyzing control that have never before been set out in a comprehensive fashion or in formal regulation.

The definition of "control" is a foundational concept with far-reaching consequences. It informs when an investor in a banking organization requires Federal Reserve approval and faces the potentially prohibitive regulatory consequences associated with becoming a bank holding company. For bank holding companies and savings and loan holding companies, control defines the perimeter of subsidiaries that will be subject to Federal Reserve supervision and regulation, including activities restrictions applicable to U.S. banking organizations. Perhaps most relevant in the current environment, it affects the permissibility and structure of banking organization investments in non-bank companies, including fintech companies and other financial firms. The definition of control also has implications outside the United States, affecting investments by and in non-U.S. banking organizations.

The proposal largely focuses on clarifying when one company would be deemed to exert a "controlling influence" over another under the Bank Holding Company Act (BHC Act). This is often the focus of control determinations, since the other elements of the control definition are bright-line tests involving control of 25% or more of a class of voting securities or controlling the election of a majority of a company's board of directors. By contrast, controlling influence is a multi-factor determination, with no prescribed formula and based on specific facts and circumstances. Many key elements of control determinations have been based on a patchwork of guidance, precedents and unpublished practices, applied by the Federal Reserve on a case-by-case basis in a manner that has evolved over time. At the Federal Reserve Board's open meeting to approve the proposal, Vice Chair for Supervision Randal Quarles wryly likened aspects of the Federal Reserve's body of control lore to "gnostic secrets."

Market participants have engaged in extensive discussions with Federal Reserve staff over the last several years urging greater transparency, consistency, and in some cases revision of the application of the controlling influence element of the control definition. In particular, there has been concern that factors such as business relationships have been given undue weight when they have not enabled an investor to exercise a controlling influence in practice, resulting in limits that unreasonably impede investments and beneficial commercial relationships.

In many respects, the proposal would codify the Board's historical practice and precedents, rather than adopt significant changes in approach. However, it would make "targeted adjustments" to liberalize certain past practices, in some cases with significant effect. Most notably, it would make it easier for one company to "de-control" another, and it would provide significantly greater flexibility for minority investors willing to limit their voting interest to under 5%. This change would be particularly helpful for banking organizations' minority investments in fintech companies, which often represent a small percentage of voting equity but may involve significant business relationships.

However, the proposal's effort to provide certainty and transparency through a general rule also inevitably creates greater rigidity in how certain controlling influence factors would be assessed, and so investors above the 5% voting equity threshold could have less flexibility in certain areas. The proposal also appears to adopt stricter standards than the Federal Reserve's historical approach on certain narrow issues, such as re-characterization of certain instruments as equity and a presumption of control based on accounting consolidation.

Banking organizations and investors will no doubt weigh carefully whether to limit comments to highlighting unintended consequences, and generally to support prompt finalization of the proposal, or to press for further adjustments to the historical approach. Commenters will certainly want to identify aspects of the proposal that could potentially interfere with customary market practices for minority investments, particularly given the Board's stated intention in some areas to preserve typical market arrangements such as standard defensive protections. The Federal Reserve would have ample legal authority to further revise its approach to factors underlying control determinations.

The most notable elements and implications of the proposal include:

— Helpful clarification of the statutory **presumption of non-control for investments under 5% voting equity,** suggesting that business relationships, consent rights, expanded governance representation and management interlocks generally should not trigger control for these investments. While the proposal does not explicitly address whether compliance with the presumption should be sufficient to permit reliance **on Section 4(c)(6) of the BHC Act**, the proposal read together with Federal Reserve guidance on Section 4(c)(6) supports that view. This is a particularly significant issue given common reliance on Section 4(c)(6) for fintech and other minority investments, including by institutions subject to supervisory limits on investing in financial companies.

— Liberalization of the Federal Reserve's approach to **evaluating divestitures of control**, permitting an investor to retain a voting interest of up to 14.9% (or up to 24.9% with a two-year delay in effect). The Federal Reserve has recently permitted retention of voting interests up to 14.9%, but divestment down to 9.9% or 4.9% has been required in many cases. This issue is particularly important for spin-offs and similar transactions, and may also influence investors' willingness to take initially controlling positions if they know there is a predictable path to divesting control while retaining a significant equity investment.

— A relatively conservative and rigid approach to restricting **business relationships** for investments of more than 5% voting equity. The Federal Reserve did not take up suggestions that it should move away from its practice of imposing quantitative limits on business relationships. In fact, the proposal would codify limits on the percentage of revenue and expenses of both investor and investee that such relationships could represent, which would be as low as 2% for investments over 14.9% voting. Commenters are certain to argue that these limits are set significantly lower than levels that would actually permit an investor to exercise a controlling influence, and that there should be more room for a contextual analysis of the nature of the business relationship and consideration of factors beyond those simple percentages.

— Elaboration of the types of **protective consent rights and covenants** that would, and would not, trigger a presumption of control for investments of 5% or more voting equity, or result in an investor being deemed to control securities held by others. As with business relationships, while the clarity the proposal would provide is helpful, the proposal would limit investors' flexibility to tailor protections in a manner that addresses their concerns while avoiding consent rights that would create a controlling influence. Commenters will likely suggest revisions to the proposed protective rights lists to better reflect market practice.

— Clarification and liberalization of permitted **director and management interlocks**, including flexibility for a non-controlling investor to install senior management officials**.**

— Adoption of a codified (and novel, in some respects) approach to **calculation of total equity**, including regarding the inclusion of subordinated debt instruments and other interests "functionally equivalent to equity" in that calculation, potentially without regard to whether they are held alongside an equity interest.

— Adoption of an approach to **calculating voting percentage** based on the greater of the percentage of voting shares held or the percentage of votes that could be cast, which could artificially inflate the percentage significantly above an investor's actual voting power in a high-vote/low-vote share structure.

— Codification of the Federal Reserve's conservative **look-through approach to calculating voting securities** represented by options, warrants and other convertible instruments, which assumes that all such instruments held by the investor are converted (to their maximum potential voting equity holding) and no convertible instruments held by others are converted.

— A new presumption of control for any entity **consolidated under U.S. generally accepted accounting principles (GAAP)**, which is likely to be one of the more controversial elements of the proposal, given the potential impact on securitizations and other special purpose vehicles.

— Codification of the Federal Reserve's approach to control of **advised investment funds**, with helpful confirmation that control presumptions would not apply during a one-year seeding period. Commenters may suggest that the requirement to reduce voting equity to 4.9% after the seeding period of an advised fund should be aligned with the 24.9% voting interest permitted under the most recent relevant Federal Reserve precedent.[1]

The proposal can be found here. Comments will be due on the proposal 60 days after its publication in the Federal Register.

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1 See Federal Reserve Letter re: First Union, dated June 24, 1999.

Tiered Presumptions of Control and Non-control

The heart of the proposal is a new set of tiered presumptions of control based on the size of an investor's voting interest. The framework is designed to provide guidance on the factors that the Federal Reserve historically has considered in assessing whether an investor exercises a "controlling influence" over another company under the third prong of the BHC Act definition of control. Within the tiers of voting equity ownership (under 5%, 10%, 15% and 25% of a class of voting securities), the proposal spells out the rights and relationships that would trigger a presumption of control.[2] A summary of each tier is set out in Table 1 below.

The proposal also defines a new presumption of non-control for under 10% voting equity investments that do not otherwise trigger a control presumption in the new tiered framework. This represents a formal expansion of Regulation Y's existing presumption for under 5% voting equity investments. The proposal's revised non-control presumption is certainly helpful on its face, although its practical effect is less clear in the context of the new tiered framework.

Enhanced consistency, transparency and flexibility. Although the proposal largely codifies the Federal Reserve's historical practice in making control determinations, greater consistency and transparency will be extremely helpful to investors. The proposal also provides greater flexibility in certain areas, including for investments representing less than 5% of every class of voting securities, for de-controlling a previously controlled entity and for director representation and management interlocks.

Significance of rebuttable presumption. Historically, rebuttable "presumptions" have often been treated by both investors and Federal Reserve staff as de facto limitations.

In principle, an investor could rebut a presumption of control, presenting information and arguments for why certain factors should not be viewed as creating a controlling influence in the context of the specific investment. However, this process is time-consuming and uncertain, and investors typically structure their investments to avoid triggering a presumption.

Also, the Federal Reserve could find control even where a presumption is not triggered. The proposal helpfully affirms that "absent unusual circumstances" the Federal Reserve generally would not expect to find that a company controls another unless the relationship between the two triggers an applicable presumption. The proposal does not elaborate on the types of "unusual circumstances" that could arise, but they should be rare. If the Federal Reserve were to regularly find control in the absence of any facts triggering a control presumption it would undermine the proposal's stated goals of greater transparency, predictability and consistency of decision-making.

Passivity commitments. The categories of rights and relationships that are subject to limitations under the presumptions would track, to a significant extent, issues addressed in the standard passivity commitments that the Federal Reserve has typically required of non-controlling investors in banking organizations with voting equity interests above certain thresholds. Passivity commitments can be required in a variety of circumstances. They are often required when an investor acquires 10% or more of the voting shares of a bank holding company and the investor seeks to rebut control. Similar commitments were also required from private equity and similar investors in bank holding companies during the years after the financial crisis at lower levels, as low as 5%. And when bank holding companies or other companies

[2] The proposal's voting thresholds would be defined based on the percentage of a class of voting securities owned or controlled by an investor, consistent with the general approach to measuring voting rights under the BHC Act and Regulation Y. References to "voting equity" or "voting interests" in this memorandum are used as short-hand for the concept of a class of "voting securities," as defined in Regulation Y. See 12 C.F.R. § 225.2(q)(3).

request a determination from the Federal Reserve's Legal Division that a particular investment (whether in a bank or non-bank company) is non-controlling, passivity commitments are commonly required to support the request. In these cases, the voting ownership interest may be very small, even less than 5%.

— The proposal does not discuss how existing passivity commitments and investments would be affected by its adoption. Presumably, existing passivity commitments that are more restrictive than required under the new presumption framework could be deemed revised to align with the new framework without the need for issuance of firm-specific relief. This would be consistent with past Federal Reserve practice in the context of significant rule changes.[3] However, commenters are likely to seek clarification of this point.

Existing investments. Many existing investments were structured to avoid creating a controlling influence, based on analysis of published Federal Reserve guidance. To the extent that the Federal Reserve were to adopt any components of the new tiered framework that are stricter than published guidance (e.g., the presumption based on GAAP consolidation), existing investments presumably should not be affected where a non-control conclusion was based on a sound analysis of facts and circumstances at the time of investment. In other words, the Federal Reserve should not require investors to rebut the new presumptions retroactively for pre-existing investments.

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[3] See, e.g., Federal Reserve Final Rule, "Bank Holding Companies and Change in Bank Control (Regulation Y)," 62 Fed. Reg. 9290 (Feb. 28, 1997) (in connection with adoption of comprehensive amendments to Regulation Y, granting relief from certain conditions on permissible nonbanking activities to "all bank holding companies authorized to conduct each activity, without the need for a specific filing by any individual bank holding company"); see also Federal Reserve Final Conditions to Board Orders, "Amendments to Restrictions in the Board's Section 20 Orders," 62 Fed. Reg. 45292 (Aug. 27, 1997) (rescinding certain conditions previously imposed by the Federal Reserve in its Section 20 orders, extending beyond certain specifically cited orders to "any other order incorporating those conditions").

Table 1: Tiered Presumptions of Control*

	Less than 5% voting	5-9.99% voting	10-14.99% voting	15-24.99% voting
Presumption of Non-control	Presumption of non-control if no control presumption triggered	Presumption of non-control if no control presumption triggered	N/A	N/A
Representation on Board of Directors	Less than half	Less than a quarter; may not have power to make or block major operational or policy decisions	Less than a quarter; may not have power to make or block major operational or policy decisions	Less than a quarter; may not have power to make or block major operational or policy decisions
Director Service as Board Chair	Permitted	Permitted	Permitted	Not permitted
Director Service on Board Committees	Permitted	Permitted	Up to a quarter of the seats on a committee with power to bind the investee company	Up to a quarter of the seats on a committee with power to bind the investee company
Business Relationships – Quantitative Limits	N/A	Less than 10% of annual revenues or expenses of either investor or investee	Less than 5% of annual revenues or expenses of either investor or investee	Less than 2% of annual revenues or expenses of either investor or investee
Business Relationships – Market Terms Requirement	N/A	N/A	Transactions must be on market terms	Transactions must be on market terms
Officer/Employee Interlocks	Permitted	No more than one interlock; not CEO	No more than one interlock; not CEO	No interlocks
Restrictions on Contractual Rights Held by Investor; Management Agreements	Contractual protective rights generally permitted; no management agreements (e.g., to serve as a managing member, trustee or general partner)	No rights that significantly restrict discretion, or management agreements	No rights that significantly restrict discretion, or management agreements	No rights that significantly restrict discretion, or management agreements
Proxy Contests to Replace Directors	Permitted	Permitted	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity That May Be Held by Investing Company	Less than one third	Less than one third	Less than one third	Less than one quarter
Attribution of Related Party Holdings (senior management officials, directors, their immediate families, and sometimes controlling shareholders)	N/A	Attribute related party holdings of voting securities; presume control if combined interest is 25% or more unless related parties hold 50% or greater voting equity	Attribute related party holdings of voting securities; presume control if combined interest is 25% or more unless related parties hold 50% or greater voting equity	Attribute related party holdings of voting securities; presume control if combined interest is 25% or more unless related parties hold 50% or greater voting equity

* Presumption of control triggered if any relationship exceeds the amount or terms reflected in the table.

Key Observations

Increased Flexibility for Under 5% Voting Equity Investments

Beyond the increased transparency and consistency it provides, the proposal's most beneficial element for investors is likely its strengthening of the BHC Act's presumption of non-control for less-than-5% voting equity investments.[4]

One-third of total equity cap affirmed. First, the proposal affirms that a less-than-5% voting equity investor may own up to 33.3% of the total equity of an investee company (e.g., by acquiring a combination of common stock and non-voting convertible instruments), consistent with the Federal Reserve's 2008 policy statement on equity investments in banks and bank holding companies.[5]

Other control factors clarified. More importantly, the presumption of non-control for less-than-5% voting equity investors would apply regardless of:

— covenants and consent rights bearing on the investee's conduct of business;

— business relationships with the investee;

— officer/employee interlocks with the investee;

— investor director representatives on the investee's board (so long as they represent less than a majority); or

— service by an investor's director representative on key board committees or as chair of the board.

The Federal Reserve's decision to adopt a presumption of non-control for less-than-5% voting/one-third of total equity investments that would apply even where some or all of these factors may be present reflects a view that investors who do not hold a "material" voting equity interest in a company (e.g., 5% or more, from the Federal Reserve's perspective) generally cannot exercise a controlling influence over the company.[6]

— Notwithstanding the existing statutory presumption of non-control for less-than-5% voting equity investments, many market participants and practitioners have historically understood Federal Reserve staff to take a more restrictive view of the scope of governance arrangements, contractual rights and business relationships that would be consistent with a non-control determination.

— Accordingly, in recent years banking institutions have frequently had to limit less-than-5% voting/one-third total equity investments in non-banking companies to feature limited board participation rights; consent/veto rights over only matters that significantly and adversely affect the rights or preferences of the investor's shares; and limited, non-exclusive business relationships on market terms that are terminable at will by the investee company without material penalty. This significantly restricted their ability to benefit from standard minority investor protections.

The proposal's clarification that control presumptions would generally not apply to a less-than-5% voting/one-third of total equity investor represents a positive development, particularly for banking organizations seeking to make small investments in "fintech" companies. The start-up, high-growth nature of many fintech companies is not well-suited to rigid quantitative limits on business relationships, and banking organization investors are often substantial customers of the services provided by the fintech companies in which they invest.

[4] See 12 U.S.C. § 1841(a)(3).

[5] See Federal Reserve, Policy statement on equity investments in banks and bank holding companies (Sept. 22, 2008), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg%2020080922b1.pdf (2008 Policy Statement).

[6] See, e.g., proposal at p. 20 ("The combination of a material voting stake in a company, combined with material business relationships, frequently provides both a mechanism and incentive to exert a controlling influence over the management and policies of the company.").

Implications for Section 4(c)(6) investments. The proposal's clarification and codification of control factors for less-than-5% voting equity investments is particularly significant given the prevalence of banking organization investors seeking to structure investments to comply with the non-banking investment authority under Section 4(c)(6) of the BHC Act, driven by supervisory limits and other considerations.

The proposal does not explicitly address whether compliance with the limitations in the presumptions framework should be sufficient for less-than-5% voting equity investments to satisfy the Federal Reserve's expectations for passivity under Section 4(c)(6). By its terms, Section 4(c)(6) requires only that an investment not exceed 5% of the voting shares of the investee. However, the Federal Reserve has long expressed the view that Section 4(c)(6) should be available only for "passive" investments, interpreting the term "passive" to exclude investments where a banking organization controls the investee company or would, through concerted action with other investors, have the ability to engage in activity as an entrepreneur through the investee company.[7]

— The Federal Reserve's application of its control framework to this area has been especially opaque, and the extent to which the "passivity" requirement imposes additional considerations beyond non-control for a Section 4(c)(6) investment has been subject to varying interpretation by Federal Reserve staff.

— However, the proposal's stated goals of transparency, clarity, consistency of decision-making and reduction of regulatory burden for investors strongly suggest the implicit incorporation of the proposal into the Federal Reserve's interpretation of Section 4(c)(6).

— This understanding is especially clear in light of the fact that the tiered presumption framework would apply to investments in banks and bank holding companies under Section 3 of the BHC Act, where a comparable divide between passivity and control is drawn.

— Had the Federal Reserve intended for non-controlling investments under Section 4(c)(6) to be evaluated under a different standard, there are multiple places in the preamble where it would have been logical to make and explain the distinction.

— If the Federal Reserve were to treat Section 4(c)(6) investments as subject to a different non-control/passivity standard, the opacity of that standard would be fundamentally inconsistent with the stated policy goals of transparency and predictability in the proposal.

Given the importance of conforming investment terms to the requirements of Section 4(c)(6) in many circumstances, commenters may wish to recommend that the Federal Reserve explicitly confirm that complying with the proposal's guidance regarding the presumption of non-control for less-than-5% voting equity investments will satisfy the Federal Reserve's expectations for passivity under Section 4(c)(6).

Divesting Control

The proposal's revisions to Federal Reserve standards for effective divestiture of control of a subsidiary would, if adopted, represent one of the most significant changes to historical Federal Reserve practice.

— The move from a complex, contextual divestiture analysis to a codified bright-line test would simplify business planning for banking organizations and other investors.

— It would also open up opportunities for banking organizations to be more active in early stage and incubator investments. The proposed revisions may create flexibility for investors to take initially controlling stakes in early-stage fintech companies in order to support development of their business models, knowing that a clear path to effective

[7] See 12 C.F.R. § 225.137 (acquisitions of shares pursuant to Section 4(c)(6)). See also Federal Reserve Letter re: Clearing House/CHIPS, dated June 17, 1997; PNC Financial Corp., 69 Fed. Res. Bull. 925 (1983).

divestiture of control is available when the time comes to market interests in the companies to others.

Historically. The Federal Reserve has traditionally applied stricter scrutiny to non-control determinations in the context of divestitures than it has in the case of new investments. As stated in the proposal, the main concern underlying this principle is that a company could continue to exercise a controlling influence over its former subsidiary even after reducing its equity interest below bright-line statutory control thresholds.

— The Federal Reserve staff memorandum accompanying the proposal explains that a company typically has been required to reduce its voting equity interest in a company to less than 10% to achieve non-control in a divestiture transaction.[8] In some cases, the Federal Reserve has required divestment to less than 5% of voting equity.[9]

— The range of Federal Reserve precedents in this area attest to the nuanced, context-specific approach that staff has taken to date.[10] As a result, divesting companies regularly must commit extensive resources to negotiating the terms of a bespoke "de-control" determination with Federal Reserve staff.

— Typically, Federal Reserve approval of a de-control transaction has been conditioned on, among other things, substantial reduction in voting and total equity interests; strict limits on post-divestiture board representation and management interlocks, business relationships and consent/veto rights; and execution of tailored passivity commitments.

Clarified paths to "de-control." The Federal Reserve notes in the proposal that it seeks to "substantially revise" standards in this area. The proposal would provide two paths to achieving "de-control" of a subsidiary at closing of a divestiture transaction.

First, an investor could:

— Reduce its investment in the company to below 15% of any class of the company's voting securities; and

— Not otherwise trigger a presumption of control (e.g., total equity threshold, business relationships, board representation, senior management official interlocks).

The investor would need to remain below 15% of any class of the company's voting securities for at least two years (during which period the investor would not be deemed to control the company).

Alternatively, an investor could:

— Reduce its investment in the company in a transaction that results in a single unaffiliated party controlling a majority of each class of the company's voting securities; and

— Not otherwise trigger a presumption of control.

Non-controlling share exchange. In some cases a divesting company will receive shares of the acquiring company as consideration for the sale of a subsidiary. The proposal clarifies that a divesting company would not need to apply the divestiture presumption in cases where the interest it receives in the acquiring company is non-controlling.

Longer-term de-control approach. If a divesting investor does not wish to immediately reduce its investment below 15% of each class of voting, the

[8] Federal Reserve Staff Memorandum (April 16, 2019), https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-proposal-board-memo-20190423.pdf. But see Federal Reserve Letter re: Barclays Bank PLC, dated July 6, 2018 (permitting a retained voting interest of 14.9%).

[9] See, e.g., Federal Reserve Letter re: Helmerich & Payne, dated June 25, 1974 (noting that the Federal Reserve had "previously indicated its general position that divestiture down to less than 5 per cent of the voting shares of a bank is regarded as an effective and preferable means to terminate bank holding company status").

[10] See, e.g., Federal Reserve Letter re: GM/GMAC, dated March 24, 2009; Federal Reserve Letter re: Doral Financial Corp., dated July 18, 2007; Federal Reserve Letter re: Eaton Vance, dated October 24, 1995.

proposal would also permit an investor to achieve "de-control" of a subsidiary two years after reducing its investment in the company to between 15% and 24.9% of any class of the company's voting securities, so long as no other presumption of control is triggered.

Business Relationships

Restrictions on business relationships have been one of the most difficult areas for minority investors to navigate in the Federal Reserve's control framework. This has been particularly true for banking organizations seeking to make small minority investments in early-stage fintech companies that have not yet developed a diverse customer base, or are in need of services in addition to equity funding. The proposal would bring much-needed transparency and consistency to the issue and liberalize some aspects of the qualitative analysis. At the same time, it would come at the expense of a more rigid quantitative framework that creates presumptions without providing for a fully contextual understanding of business relationships.

— The Federal Reserve staff has long analyzed business relationships under the BHC Act's "controlling influence" prong using a totality of facts and circumstances approach. The resulting guidelines and lore, based on decades of largely unpublished precedents and staff positions, are understood by experienced practitioners but have generally been opaque to others.[11]

— Frequently, Federal Reserve staff has required investors seeking a formal non-control determination to execute restrictive passivity commitments imposing quantitative restrictions on metrics such as revenue derived from a business relationship or expenses represented by it (either in total or for specific business segments). These passivity commitments generally are not made public.

— In the 2008 Policy Statement, the Federal Reserve took a small step towards increased transparency when it described that it had frequently allowed non-controlling investors to have business relationships with investee companies that were "quantitatively limited and qualitatively nonmaterial," particularly in situations where the investor's voting equity interest was closer to 10% than 25%. But in that same discussion, the Federal Reserve indicated that it would continue to evaluate business relationships on a case-by-case basis, paying particular attention to their size and whether they would be on market terms, non-exclusive and terminable without penalty by the investee.[12]

The proposal goes much further than previous Federal Reserve attempts to clarify and codify the approach to business relationships by setting forth clear quantitative limits for each tier of presumptions. In it, the staff state that limits in the tiered presumptions would be "roughly in line with certain [Federal Reserve] precedents" but potentially more permissive than some past examples.

— The proposal would not impose a presumption of control regarding business relationships for less-than-5% voting/one-third of total equity investors. This would be a helpful development, providing increased flexibility and a measure of regulatory certainty for bank investors seeking to pursue mutually beneficial relationships with innovative fintech companies.

— For investors with 5%-or-greater voting equity interests, however, the new quantitative limits create relatively inflexible limits that seem likely to inhibit some business relationships that would not in practice create a relationship of dependency or leverage constituting a controlling influence.

[11] The proposal itself notes that "The [Federal Reserve]'s control precedents with respect to business relationships have varied significantly based on the facts and circumstances presented." See proposal at p. 30.

[12] See 2008 Policy Statement at p. 13.

The proposal would create a presumption of control that limits business relationships to:

— No more than 10% of total annual revenues or expenses of either company in the case of voting equity investments between 5% and 9.9%;

— No more than 5% of revenues or expenses of either company in the case of voting equity investments between 10% and 14.9%; and

— No more than 2% of revenues or expenses of either company in the case of voting equity investments between 15% and 24.9%.

Commenters are certain to argue that these thresholds are too low—particularly in the band of investments between 10% to 24.9% voting interests—and that an alternative or complementary approach that takes into account more qualitative considerations should be incorporated into the framework. For example, where an investee chooses to use a bank investor as a business partner or vendor representing 6% of the company's expenses in a highly competitive market where other banks are competing for the investee's business, the bank investor could not realistically exert a controlling influence over the other company through the commercial relationship.

The revenues and expenses test also evidences the Federal Reserve's concern not only with an investor's *ability* to exercise control (e.g., where business with an investor is material to the investee) but also with an investor's *incentive* to exercise control (e.g., where the business with the investee company is material to the investor).

— The emphasis in the proposal (and in previous Federal Reserve precedents) on an investor's incentives, and not just ability, to exercise control would seem to disregard obvious practical differences in the investor's influence over the investee. If an investor is unable to exercise a controlling influence over a company through its business relationships, its incentives to do so would not seem particularly relevant.

Helpfully, the proposal appears clear that business relationships would not be measured on a business line basis, nor would the quantitative limits distinguish between types of expenses.

In addition to the quantitative limits, the proposal also would create a presumption of control if an investor holds a 10%-or-greater voting equity interest and has business relationships with the investee that are not on market terms.

— This would appear to represent a sensible simplification of the Federal Reserve's traditional expectation that, as described in the 2008 Policy Statement, business relationships between a non-controlling investor and an investee be not only on market terms but also "non-exclusive and terminable [by the investee] without penalty."[13]

— The proposal does not define (and indeed seeks comment on appropriate standards for evaluating) "market terms." To the extent that the proposal's intention is to focus on whether a particular business relationship reflects terms customarily agreed by unaffiliated parties in a relevant market, it would appear to acknowledge that ordinary exclusivity arrangements and termination penalties may be appropriate in certain contexts (for example, early-stage fintech companies establishing an untested business model with an equity investor).

Total Equity Calculations

Total equity thresholds for control. The proposal reaffirms the Federal Reserve's most recent guidance on the total equity threshold for determining control. Consistent with the 2008 Policy Statement, the proposal would provide that an investor may own up to 33.3% of the total equity of a company (provided it does not have a 15%-or-greater voting equity interest). The familiar 25%-or-more equity ownership control threshold would apply only where an investor owns 15% or more of a class of an investee company's voting securities, or in the case of an investment fund,

[13] See id.

where an investor also serves as an investment adviser to the fund.

— In other contexts, including Regulation W,[14] the Federal Reserve has indicated that an investor that owns 25% or more of the "equity capital" of an investee company controls the investee (without regard to other factors, such as its ownership of voting shares or board representation). The proposal is silent with respect to any Federal Reserve plans to revise Regulation W's existing 25% of total equity control standard to align with the one-third or more standard in the proposal and the 2008 Policy Statement.

Standards for treating debt or other interests as equity. The proposal would provide that, for purposes of determining total equity, debt instruments or other interests would be treated as equity if they are functionally equivalent to equity. In general, the proposal would take a more expansive view of the types of debt and other interests that would be recharacterized as equity than is reflected in published Federal Reserve interpretations. In informal discussions with Federal Reserve staff, the approach to non-equity interests has historically been somewhat ad hoc and unpredictable. Greater transparency in this area would be welcome. However, the proposal's approach to non-equity interests risks perpetuating and even increasing uncertainty in this area, contrary to the overall movement of the proposal towards providing greater certainty and transparency.

Equity-like characteristics. The proposal sets forth a list of equity-like characteristics that may lead to a determination that a debt instrument is functionally equivalent to equity, including:

— Qualification as equity under tax law, GAAP or other applicable accounting standards;

— Qualification as regulatory capital under any regulatory capital rules applicable to the investee company;

— Subordination to other debt instruments issued by the investee company (but not simply to general creditors);

— Absence or inadequacy of equity capital underneath the instrument;

— Extremely long-dated maturity; and

— Terms that are inconsistent with market terms.

Other interests. The proposal cites contractual profit-sharing arrangements as an example of non-debt "other interests" with equity-like characteristics that may cause them to be deemed functionally equivalent to equity.

Recharacterization risk. The proposal indicates that none of the characteristics listed above is intended to result automatically in debt being treated as functionally equivalent to equity. Rather, each instrument would be subject to a facts-and-circumstances analysis. The proposal also states that the Federal Reserve expects that it would be "unusual" for debt (or "other interests") to be considered functionally equivalent to equity.

— In practice, this approach would create significant uncertainty about whether a broad range of instruments with few if any legal, economic or other traditional characteristics of equity are at risk of recharacterization, including subordinated debt and long-term loans. The proposal does not offer any further guidance on how to interpret the features set out in the list of equity-like characteristics. For example, it does not explain what length of maturity would constitute an equity-like feature of a debt instrument, or how

[14] See 12 C.F.R. § 223.3(g)(5) (presumption of control at 25% total equity). The Federal Reserve has not adopted any material amendments to Regulation W since prior to issuance of the 2008 Policy Statement. As of the date of this memorandum, the Federal Reserve has yet to issue proposed regulations revising Regulation W to reflect the Dodd-Frank Act's amendments to Section 23A of the Federal Reserve Act.

much equity capital would be sufficient to prevent recharacterization of an issuer's debt.

— The proposal's assertion that the Federal Reserve expects it to be "unusual" for debt (or "other interests") to be considered functionally equivalent to equity is helpful, but harder to square with the expansive list of equity-like characteristics in the proposed regulation.

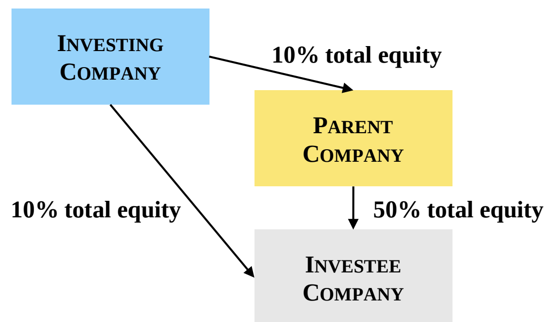
— For example, treating all contractual profit-sharing interests as the functional equivalent of equity would be inconsistent with published Federal Reserve precedent,[15] raising the question of whether other instruments never previously deemed equity interests or their equivalents could be captured under the proposal, such as total return swaps.

Commenters may wish to recommend that the Federal Reserve clarify these points, as well as circumstances under which an instrument would not be vulnerable to recharacterization as equity, in order to reduce the burdens associated with the proposal's open-ended facts-and-circumstances approach.

Similarly, commenters may wish to propose a safe harbor from recharacterization as equity for subordinated debt investments where the investor has no "material" equity investment in the issuer (e.g., less than 5%, by analogy to the proposal's reasoning for limiting most presumptions of control to investments of at least 5% voting equity). This would be consistent with the approach that the Federal Reserve has adopted in other contexts.[16]

Pro rata "look-through" approach for non-controlling investments in a parent company. The proposal would require proportional allocation of indirect interests held through a parent of an investee company. Specifically, the calculation of an investor's total equity (not voting interest) investment in an investee company would include both the *direct* total equity investment and an *indirect* equity interest deemed to be held through the investee's parent company, calculated based on the percentage interest held in the parent and the parent's total equity interest in the investee, as demonstrated in Diagram 1 below.

Diagram 1. *Application of look-through approach for determining total equity*.



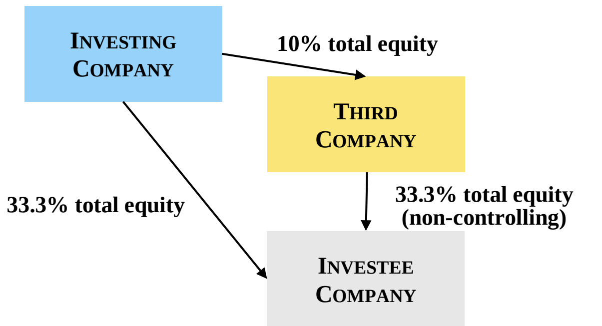
Under the proposal's proportional allocation approach, the investor's total equity interest in the investee company would be 15% (10% held directly plus 10% of the 50% held in the investee by the parent company)

Proportional allocation is required only for investments in parent companies that control an investee company. Therefore, no proportional allocation of an investment in a "parent" company would be required for purposes of determining an investor's total equity percentage in the investee company if the parent does not have a controlling interest in the investee. See Diagram 2 below for an example illustrating a tiered investment that would not trigger proportional allocation under the proposal.

[15] See Federal Reserve Letter re: Doral Financial Corp., dated July 18, 2007 (in connection with a determination that Bear Stearns' participation in a proposed equity financing transaction would not cause it to be deemed to acquire more than 5% of the equity of an additional depository institution, determining that the carried interest did not represent an equity interest).

[16] Specifically, Regulation K provides that an investor's holdings of an investee's subordinated debt will not be aggregated with its holdings of the company's equity capital for purposes of determining its total investment amount, provided that the investor holds less than 5% of the company's equity capital. 12 C.F.R. § 211.2(m). See also, e.g., Federal Reserve Letter re: Sumitomo/Goldman Sachs, dated Nov. 25, 1986.

Diagram 2. *Proportional allocation not required.*



Under the proposal, the investor's total equity interest in the investee company should be deemed 33.3%, because proportional allocation would not apply to investments in parent companies that do not control the investee company.

This look-through approach has not previously been clarified or publicized by the Federal Reserve. It also runs counter to the longstanding view that equity investments held by "parent" companies are not attributed to an investor in that parent company unless the investor controls the parent company.[17]

Elimination of "vertical stacking" methodology for calculating certain voting equity interests. Helpfully, the proposal appears to definitively retire the "vertical stacking" theory for determining whether a banking organization's non-controlling voting equity interest in a vertical chain of entities above a target bank or bank holding company would be combined toward thresholds for approval under Section 3 of the BHC Act. This methodology, which complicated several private investments in distressed bank holding companies during the financial crisis, was widely viewed as inconsistent with the Federal Reserve's longstanding interpretive position that a company will be attributed "indirect" ownership of voting securities only through subsidiaries. The proposal explicitly clarifies that a bank or other company does not control any voting securities controlled by a company that is not a direct or indirect subsidiary of the bank or other company.

GAAP-based methodology for determining total equity. The proposal also would codify a methodology for determining total equity based on GAAP. While this GAAP-based methodology has been applied by Federal Reserve staff for many years when evaluating investments, the Federal Reserve has never described the methodology in publicly disclosed guidance or precedents. This would appear to supersede the "dollars invested" test for total equity in the case of shares acquired directly from an issuer. However, the calculation can significantly overstate an investor's total equity percentage in situations where the investee company has negative retained earnings, which is commonly the case for fintech companies and other start-ups.

Under the proposal, an investor's percentage of total equity would equal the sum of "investor common equity" and "investor preferred equity," divided by total shareholders' equity.

— Investor common equity would equal the greater of (i) zero and (ii) the total number of common shares held by the investor divided by the total number of outstanding common shares, multiplied by the portion of shareholders' equity that is not attributed to preferred stock in the investee's GAAP balance sheet.

— Shareholders' equity is not defined in the proposal, but under GAAP it generally would include the paid-in par value of all common and preferred shares, any additional paid-in capital associated with these shares, retained earnings and accumulated other comprehensive income, less treasury stock. The preamble also specifically clarifies that retained earnings would be allocated to common stock, and not to preferred stock, under the proposal's methodology.

— Investor preferred equity would equal, for each class of preferred stock, the greater of (i) zero and (ii) the total number of preferred shares held by the investor divided by the total number of outstanding preferred shares, multiplied by the

[17] See 12 U.S.C. § 1841(g)(i); 12 C.F.R. § 225.2(e)(2)(i).

portion of total shareholders' equity allocated to preferred stock.

The GAAP methodology focuses on the liquidation value of the investment. As a result, it can distort total equity calculations if there are changes in retained earnings over time that lead to an increase or decrease in the inputs to an investor's total equity percentage calculation without any change in the investor's share ownership or underlying economic entitlements. This possible result may be somewhat mitigated by the proposal's helpful clarification that total equity percentages do not need to be calculated on a continuous basis. However, an investor would still be required to recalculate its total equity in an investee company "each time" the investor acquires additional (or ceases to control) interests in the investee. This could lead to an increase in an investor's total equity percentage in connection with a partial divestiture, which would appear to be a strange result.[18]

The methodology presents a particularly distorted picture when used for investments in companies expected to run a loss in early years, such as fintechs and other start-ups. However, the proposal also includes several questions to commenters asking for feedback on whether the total equity calculation methodology should be revised in order to take into account, among other things, negative retained earnings. Commenters are likely to raise significant objections to the GAAP methodology for determining total equity and to propose modifications, such as eliminating retained earnings from the total equity calculation.[19]

Total Equity Test Applied to Savings and Loan Holding Companies. The proposal would apply the same total equity calculation and presumption of control based on total equity to both bank holding companies (for BHC Act purposes) and savings and loan holding companies (for purposes of the Home Owners' Loan Act (HOLA)).

— The proposal notes that the Federal Reserve has previously recognized that the statutory control frameworks under the BHC Act and HOLA are "nearly identical."[20] Although HOLA has an independent control threshold measured by 25% of contributed capital, the proposal concludes that this need not be viewed as inconsistent with the one-third of total equity standard the Federal Reserve has adopted under the BHC Act, because the proposal's definition of total equity would rely on shareholders' equity calculated under GAAP rather than contributed capital, which the Federal Reserve considers to be a distinct concept.[21]

— Regulation LL would continue to provide that, for purposes of HOLA, an investor that has contributed more than 25% of the capital of a company has control of the company.[22]

— The Federal Reserve's statement that it plans to apply the proposal's control presumptions and thresholds consistently to savings and loan holding companies and bank holding companies indicates that the Federal Reserve does not consider a

[18] The Federal Reserve specifically requests comment on whether an investor should be required to calculate its total equity percentage on a continuous basis or upon any transaction by the investee company that increases or decreases the shareholders' equity of the investee company by a material percentage. While this change would address the problem of an investor's total equity percentage potentially increasing in connection with a partial sale, it would create significant burdens and risk in requiring monitoring of a non-controlled investee company's total equity and other potential problems, including potentially disproportionate increases in the investor's total equity percentage following a stock repurchase by the company.

[19] See also the immediately following discussion about the difference between HOLA's contributed capital standard and total equity.

[20] See proposal at p. 78.

[21] The proposal indicates that the Federal Reserve generally defines contributed capital to mean paid-in capital, which would not include retained earnings or certain other components of GAAP shareholders' equity.

[22] 12 C.F.R. § 238.2(e)(2).

contributed capital test to be an appropriate alternative to the GAAP methodology for determining total equity. This effective dismissal of the contributed capital methodology could present challenges for identifying a practical alternative methodology for total equity that is not vulnerable to the distortions presented by negative retained earnings.

Calculating Voting Equity

The proposal would require that an investor's voting equity be deemed to be the greater of (i) the percentage of the number of shares of a class of voting securities and (ii) the percentage of the number of votes entitled to be cast by the shares owned by the investor (i.e., actual voting power).

— The proposal asserts that the bifurcated, "greater of" approach is "consistent with longstanding Board practice."[23] However, older Federal Reserve precedents took inconsistent approaches to the calculation of the percentage of a class when voting power differed from number of shares. And in transactions reviewed by senior Legal Division staff in the past decade, determinations of non-control have been focused on voting power.

— Retaining a number-of-shares test in addition to a voting power test would be difficult to apply in some cases. In other cases, such as investments in companies with high-vote/low-vote shares structures (which are increasingly common), it could radically overstate an investor's deemed percentage of a class of voting securities in comparison to its actual voting power.

— A "number of shares" test, when divorced from actual voting power, has no independent bearing on the ability to control a company. While it was logical and appropriate to interpret a percentage of a class of voting securities to refer to voting power, so that the limit could not be evaded through use of high-vote shares, there is no apparent rationale or basis to require that it be interpreted also to apply to the number of voting shares without regard to voting power. The statutory limit could simply be interpreted to mean a limit on the number of votes that can be cast by the holder of the shares.

— In this respect, a "number of shares" test would be inconsistent with the general thrust of the proposal, which focuses on practical effects to a greater degree than previous Federal Reserve regulations or policy statements.

Look-through treatment of options, warrants and contingently convertible instruments. The proposal would codify the Federal Reserve's historical approach requiring that an investor look through a non-voting instrument that converts into a voting security and treat it as a voting security for purposes of determining the investor's voting percentage.

— The look-through approach can present a distorted view of an investor's practical ability to control the voting equity of a company, because under the Federal Reserve's approach, an investor must calculate its voting interest assuming that all such instruments held by the investor are converted or exercised, but no other holders of such instruments exercise their conversion rights. This disregards practical considerations such as the shared incentives for other option holders to convert based on obvious financial considerations.

— This calculation method would be required even when the future contingency that would permit exercise or conversion is remote and when the options are deeply out of the money.

— Notwithstanding the strong arguments that this calculation approach can significantly overstate an investor's actual control of voting securities (or its related influence), this element of the proposal simply makes more transparent the Federal Reserve's longstanding practice and precedents.

The proposal does confirm that where, by the terms of the instrument, an investor may exercise an option

[23] See proposal at p. 65.

only when all outstanding options in a class are simultaneously exercised, the investor would not be required to assume that only its options (and no others) were exercised, since this would be impossible under the terms of the securities. It also confirms that options or convertible interests that arise from preemptive rights designed to prevent dilution and certain securities purchase agreements also would be excluded from the look-through approach.

Convertible instruments and "blockers" limiting transfer of non-voting securities. The proposal also would incorporate into Regulation Y the 2008 Policy Statement's recognition of so-called "blocker" provisions that limit the applicability of the look-through approach to convertible instruments by preventing conversion outside of certain transfer arrangements. Blocker provisions enable the investor to preserve much of the economic value of a common stock investment and to exit the investment without conveying control to another party.

Consistent with the 2008 Policy Statement, the proposal would not require application of the look-through approach to a convertible instrument if the terms of the instrument provide that the instrument may convert into voting securities only following a transfer in connection with the specific circumstances prescribed in the 2008 Policy Statement:

— a widespread public distribution;

— a transfer to the issuer;

— a transfer in which no transferee or group of associated transferees would acquire 2% or more of any class of voting securities of the issuer; or

— a sale to a transferee that would control more than 50% of every class of voting securities of the issuer even without any transfer from the investor.

Consent Rights and Other Minority Protections

The proposal would codify two separate areas of Federal Reserve policy and precedent important for investors seeking to avoid control while negotiating protective rights in minority investments. The additional clarity on the Federal Reserve's views regarding permissible and problematic protective rights may prove helpful to investors by providing greater certainty and transparency. However, the proposed list of impermissible consent rights is overbroad in certain respects and may hinder the more nuanced analysis present in some Federal Reserve precedents.

The table of minority rights included in the Appendix provides a full list of the rights set out in the proposal under each category.

Contractual control over securities. The proposal would retain the general rule codified in Regulation Y that contractual restrictions limiting "in any manner" another person's rights over securities they control would presumptively create control over those securities (which would cause those securities to be counted towards the relevant presumptions and control thresholds). However, the proposal also expands and elaborates on the previously codified exceptions to this rule. The newly codified exceptions are broadly consistent with Federal Reserve precedents, and their inclusion in a final rule would provide helpful transparency on this issue.

Currently under Regulation Y, restrictions on a security create a presumption of control over that security, subject to exceptions, with at least a theoretical possibility that the presumption could be rebutted. Under the proposal, control of the securities would be definitive, rather than presumptive (subject to the Federal Reserve's reservation of authority to determine the securities are not controlled). As a result, it may become more challenging to conclude that other standard protective rights that are on market terms and reasonably tailored but are not included in the proposal's list of exceptions should be permissible.

Exceptions for common protective rights. The proposal identifies a number of exceptions from the general rule, including for a number of common protective contractual provisions such as customary:

— Rights of first offer and first refusal;

— Rights of last refusal;

— "Tag-along" rights;

— "Drag-along" rights;[24] and

— Anti-dilution provisions and similar rights.

The proposal notes that the Federal Reserve does not intend for provisions of this type to convey control of securities, so long as they do not impose "significant, non-market standard constraints" on transfer of the securities.[25] As examples of disfavored provisions, the proposal cites rights of last refusal priced at a deep discount to market or featuring an unnecessarily long exercise period.[26]

Other exceptions. The proposal also would exempt, consistent with Federal Reserve precedent:

— pledges of securities and other restrictions incidental to bona fide loan transactions;

— temporary restrictions on transferring shares pending the consummation of an acquisition or to require a vote in favor of a proposed acquisition;

— reasonable arrangements among shareholders to preserve tax benefits; and

— short-term revocable proxies.[27]

Confirmation that a temporary voting agreement in the context of an acquisition does not create control over the voting shares helpfully puts to rest an occasionally contentious issue. Although it reflects a consistent, longstanding Federal Reserve position, those unaware of the precedents have in some cases resisted requests for reasonable lock up and support agreements in M&A transactions.

Consent rights and covenants. The proposal would retain the Federal Reserve's longstanding policy that contractual rights that significantly limit an investee company's discretion over operational and policy decisions create a presumption of control over the investee.[28] It helpfully clarifies, however, that this presumption would apply only if the investor holds a 5%-or-greater voting equity interest and that this principle is not intended to prevent minority shareholders from participating in "most standard types of shareholder agreements" or benefiting from "certain defensive rights."

The proposal provides a non-exclusive list of examples of contractual provisions that would and would not constitute limiting contractual rights giving rise to a presumption of control, set forth in the attached Appendix.

The list of contractual rights that would give rise to a presumption of control is quite broad, and does not appear to entertain the possibility that their influence could be mitigated if certain rights were exercisable only to block an action that would significantly and adversely affect the rights of the investor in the specific circumstances of the investment.

The proposal also does not address the permissibility of limits on an investee company's discretion over issues like insider and affiliate transactions, initiating and defending litigation and other disputes, and reputational risk, which might ordinarily be viewed as less controversial given the subject matter. In some cases, it arguably should be permissible to retain a modified version of contractual rights listed in the proposal. For example, while a non-controlling investor may not be able to dictate the hiring or firing of an auditor, perhaps it should be permitted to require that an auditor be chosen from a list of five well-known, reputable auditors agreed in advance.

[24] Typically, the ability to drag another investor along in a sale was viewed as a restrictive right that could result in attribution of the other investor's shares to the investor with the drag along right. The proposal confirms that an investor may have the benefit of a drag-along right if the drag requires approval of a majority of shareholders.

[25] See proposal at p. 61.

[26] Id.

[27] The current Regulation Y presumption includes just three of these exceptions—for rights of first refusal (when mutual), restrictions incident to a bona fide loan and restrictions related to a waiting period for regulatory approval of a transaction. 12 C.F.R. § 225.31(d)(1)(ii).

[28] See 2008 Policy Statement at pp. 13-14.

Importantly, these presumptions based on contractual restrictions would apply regardless of whether the contractual rights arise from the terms of an equity investment or a wholly separate contractual arrangement (e.g., a loan or other business arrangement). Thus, a contractual restriction on a company that would be viewed as wholly reasonable in the context of a senior loan or a specific business arrangement could create control if its counterparty also has a 5%-or-greater voting equity interest in the company.

Non-controlling restrictive debt covenants. The proposal affirms the Federal Reserve's longstanding position that, standing alone, even highly restrictive debt covenants do not give rise to control. But it does not discuss one of the key premises of this position—that the restrictive impact of a generally impermissible consent right or covenant is mitigated by the investee company's ability to prepay, call or redeem the interest and thus free itself from the restriction.[29] The omission of this rationale, which is not explained in the proposal, has at least two significant implications.

- First, it could create an impression that the ability to prepay or redeem a debt instrument, or refinance away from the lender or debt investor, is no longer relevant as a consideration (which would be a major departure from existing Federal Reserve precedent and practice).
- Second, this principle has also been extended to redeemable equity securities such as preferred stock (some forms of which have debt characteristics).[30] The omission would raise questions whether the principle would no longer apply in those contexts.

MFN clauses. Market-standard "most favored nation" (MFN) clauses would not themselves give rise to a presumption of control, but this begs the question of how to analyze an MFN clause that allows an investor to claim rights that would give rise to a presumption of control.

Safety and soundness considerations. In multiple contexts, the proposal takes pains to distinguish between a particular contractual right or relationship's control implications and its implications for safety and soundness. These references are notable, and seem clearly intended to highlight that even non-controlling rights and relationships can give rise to safety and soundness concerns. Most but not all of the references to safety and soundness are explicitly or implicitly oriented to issues that would arise in the context of an investment in a bank holding company or bank (and not bank holding company investments in other companies).

The frequency of these references throughout the proposal suggests concern on the part of Federal Reserve supervisory staff that greater flexibility under the proposed framework could create other risks associated with investments in and relationships among companies.

Management contracts or similar agreements. The proposal would retain in slightly modified form Regulation Y's existing presumption of control for "management agreements."[31] In its revised form under the proposal, the presumption would be triggered by one company entering into a "management contract or similar agreement" that confers "significant influence or discretion" over another company's "general management, overall operations, or core business or policy decisions" without regard to whether one company has an equity investment in the other.

- The proposal cites examples of an agreement that would be deemed a "management contract" or similar agreement, including an agreement to act as general partner, managing member, trustee or in a similar capacity with respect to an investee company. As with the current management agreement presumption in Regulation Y,

[29] See, e.g., 12 C.F.R. § 225.143(d)(2).

[30] See, e.g., Federal Reserve Letter re: Moneygram, dated March 21, 2012; Federal Reserve Letter re: Confidential Recipient, dated Aug. 24, 2005; Federal Reserve Letter re: Mercantile Texas Corp., dated July 8, 1983.

[31] See 12 C.F.R. § 225.31(d)(2)(i).

investment advisory contracts are explicitly excluded and would not trigger this presumption.

— Banking organizations and other investors provide services to structured investment vehicles pursuant to contracts that, though often styled as "management" agreements, are better evaluated as variants of the type of investment advisory agreements excluded from the presumption.

Fiduciary exception. The proposal provides that the presumptions in the new framework would not apply in the case of securities controlled by an investor "in a fiduciary capacity without sole discretionary authority to exercise the [securities'] voting rights." The Proposal states that the existing exception in Regulation Y for securities held in a fiduciary capacity would be "retained in full."[32] Adopting the Regulation Y fiduciary exception into the new presumptions framework should not affect the existing statutory exemptions in Sections 3 and 4 of the BHC Act (relating to, respectively, control of voting securities of a bank or bank holding company and of a non-banking company), which are codified elsewhere in Regulation Y.[33]

Board Representation

The proposal would clarify and in some cases introduce a more flexible approach to the limits historically imposed on an investor's ability to participate on an investee company's board of directors (including limits found in the Federal Reserve's standard passivity commitments).[34]

Limits on overall board representation. The proposal would institute a more permissive approach to the level of board representation a non-controlling investor may have.

— The proposal would establish a presumption of control for any investor with a 5%-or-greater voting equity interest that appoints 25% or more of an investee company's board. The preamble clarifies that this presumption is intended to provide investors that hold between 10% and 24.9% of a company's voting equity interests with more flexibility to appoint a number of directors proportional to their voting equity, subject to the 25% overall limit.

— Board representation for a less-than-5% voting investor would be dictated by the bright-line test in the BHC Act, which irrebuttably deems a company to control an investee company where the investor controls the election of a majority of the investee's board.

This additional flexibility would be helpful for minority investors in starts-ups with boards of three or four where the investor may be willing to cap its voting interest at 4.9% but still seeks to have one seat on the board. In existing practice, even less-than-5% voting equity bank holding company investors have sought to avoid board representation that would constitute 25% or more of the board.

Board chair. The proposal would establish a new presumption of control in the case of a 15%-or-greater voting equity investor that has a director representative who also serves as chair of the board.

By applying this presumption only to 15%-or-greater voting equity investors, the proposal would offer additional flexibility to smaller investors. The Federal Reserve's standard passivity commitments and the 2008 Policy Statement generally prohibit a non-controlling investor from appointing a board chair.[35]

Key board committee participation. The proposal would establish a presumption of control for a 10%-or-greater voting equity investor whose directors represent more than 25% of any committee of an investee company's board of directors that has the

[32] See proposal at p. 51, citing 12 C.F.R. § 225.31(d)(2)(iv) and 12 U.S.C. § 1841(a)(5)(A).

[33] See 12 U.S.C. §§ 1842(a)(A)(i), 1843(c)(4); see also 12 C.F.R. §§ 225.12(a), 225.2(d), 225.22(d)(3).

[34] See 2008 Policy Statement at pp. 6-8.

[35] See id. at p. 8 (stating the Federal Reserve's belief that a representative of a minority non-controlling investor should not serve as chair of an investee company's board or of any board committee).

power to bind the company without action by the full board. The preamble cites audit, compensation and executive committees as examples of such key committees.

This would represent additional flexibility for investors familiar with the Federal Reserve's standard passivity commitments, which historically did not permit representatives of a non-controlling investor to comprise 25% or more of any board committee (consistent with the 2008 Policy Statement)[36] or to serve on certain key committees at all (absent mitigating factors).

— Adopting a "more than 25%" standard in place of the traditional "25% or more" threshold should permit a non-controlling investor's representative to serve as one of four members of, for example, a board's executive committee (and/or to chair the committee).

Unusual board rights. Consistent with Federal Reserve precedent (e.g., standard passivity commitments and the 2008 Policy Statement)[37] and aligned with the proposal's approach to contractual consent rights, the proposal would establish a presumption of control to address "unusual" provisions that allow the director representatives of a 5%-or-greater voting equity investor effectively to control major operational or policy decisions of an investee company. The preamble cites supermajority voting requirements and individual veto rights as examples of these types of provisions. This presumption would not apply in the case of less-than-5% voting equity investors.

Definition of director representative. The proposal adopts a broad approach to the scope of individuals who would be deemed to be an investor's representatives. The inclusion of any person nominated or proposed by the investor, former (within two years) employees, directors and agents of the investor and their immediate families could capture individuals who are not actually serving at the direction of the investor, including independent nominees proposed by the investor.

Management Interlocks

The proposal would meaningfully reduce existing limits on officer/employee interlocks between an investor and an investee, opening up flexibility for minority non-controlling investors to have interlocks at the C-suite level. Historically, many Federal Reserve non-control determinations have been conditioned in part on an absence of officer or employee interlocks, and the Federal Reserve's standard passivity commitments typically prohibit any officer or employee interlocks.[38]

Senior management interlocks. The proposal would revise Regulation Y's existing presumption of control for management interlocks[39] to apply in the case of:

— A 5%-or-greater voting equity investor, where at least two employees or directors of the investor serve as "senior management officials" of the investee company or its subsidiary; and

— A 15%-or-greater voting equity investor, where one or more employees or directors of the investor serves as a senior management official of the investee company or its subsidiary.

Because the proposal's interlocks presumption would cover only "senior" management officials,[40] it would relax the existing interlocks presumption in Regulation Y, which applies in the case of any "management official" interlock between a 5%-or-greater voting equity investor and an investee company.

CEO interlock. The proposal would establish a specific presumption of control for an interlock

[36] See id.

[37] See id.

[38] See, e.g., Federal Reserve Letter re: Cerberus/Ally, dated Aug. 7, 2012; Federal Reserve Letter re: BlackRock/Barclays, dated Dec. 15, 2009.

[39] See 12 C.F.R. § 225.31(d)(2)(iii).

[40] The proposal defines a "senior management official" 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."

involving an employee or director of a 5%-or-greater voting equity investor that serves as CEO (or in a "similar capacity") of the investee company.

Practical implications. The proposal's approach to management interlocks would represent a meaningful shift in this area. A less-than-5% voting investor could have unlimited management interlocks, including the CEO, CFO, etc., without triggering the presumption (even if the total investment represented 33.3% of the company's total equity). An investor between 5% and 14.9% voting could install a senior management official, including the CFO or CRO, but not the CEO, without triggering the presumption. And even a 24.9% voting investor could install one or more management officials without triggering the presumption, as long as they are not senior management officials. Nothing approaching these types of management interlocks would have been contemplated in the existing framework. The ability to have management interlocks could be especially important for private equity investors in banking organizations. And implicitly, the latitude for less-than-5% voting investors in banking organizations should also inform the standards for investments by banking organizations in non-bank companies under Section 4(c)(6).[41]

Proxy Solicitations

The proposal would expand the ability of investors to solicit proxies with respect to board representation and other matters without being deemed to control an investee company. This part of the proposal is likely to be more relevant to investors in banking organizations (i.e., bank holding companies and savings and loan holding companies, or their banking subsidiaries) than to banking organization investors in other types of companies.

The proposal appears to reflect a recognition that ordinary participation in shareholder democracy generally should not raise controlling influence concerns.

Directors. The proposal would establish a presumption of control for 10%-or-greater voting equity investors that solicit proxies to elect nominees representing 25% or more of a board of directors.

A 10%-or-greater voting equity investor therefore could solicit proxies to elect less than 25% of a board (counting any existing board representative of the investor against this limit) without triggering the presumption.

— This would represent a meaningful change from current practice. Currently, assuming a 10%-or-greater voting investor is required to rebut control (generally the case for investors in publicly traded bank holding companies), the investor generally would be prohibited from soliciting proxies in opposition to board or management proposals, including to elect an alternative slate of directors (of any number).

— This new presumption would allow 10%-or-greater voting equity investors to solicit proxies to elect directors (including in opposition to management and board recommendations) so long as the number of directors to be elected through the proxy solicitation does not exceed the number of representatives the investor could appoint to the board. The preamble notes that the proposal would "align the presumption for proxy solicitations to elect directors with the proposed presumption for having director representatives."[42]

The proposal would not formally limit proxy solicitations to elect directors by less-than-10% voting equity investors, although the Federal Reserve has historically taken the view that soliciting proxies to replace a majority of a board gives rise to control under the bright-line second prong of the BHC Act's definition of control, which presumably still applies.

Proxies on other matters. The preamble states that the Federal Reserve is not proposing a presumption of control at any level of voting equity ownership for soliciting proxies on matters other than board

[41] See p. 9 above.

[42] See proposal at p. 29.

representation, permitting a greater degree of latitude for non-controlling investors to exercise shareholder rights.

— In this respect, too, the proposal would represent a meaningful change. For 10% (or greater) voting investors in banking organizations, the Federal Reserve's standard passivity commitments generally prohibit the investor from soliciting proxies on any matter.

Control of voting shares. In the related context of deemed control over securities, the proposal provides that a person would not acquire control of securities simply by virtue of holding a short-term, revocable proxy to vote the securities.[43]

— Although the Federal Reserve's regulations implementing the Change in Bank Control Act (CIBC Act) have long included a similarly phrased exemption from that act's prior notice requirements,[44] to date the Federal Reserve has not adopted a general exception for purposes of BHC Act control standards for proxy solicitations.[45]

— The treatment of voting rights acquired in connection with proxy contests has arisen in connection with hostile acquisitions.[46]

Implications for activist investors in banking organizations. In principle, loosening restrictions on proxy solicitations could make it easier for an activist investor to accumulate a significant voting stake and solicit proxies to elect directors or effect other changes at a banking organization. As a practical matter, however, the proposed revisions are unlikely to meaningfully affect how activist shareholders engage with bank holding companies and savings and loan holding companies.

— The existing framework, like the proposed new tiered framework, essentially allows an activist shareholder to acquire up to 9.9% of a banking organization's voting shares without being required to rebut control or commit not to solicit proxies, propose directors in opposition to management, seek a representative on the board or otherwise influence management.[47]

— The proposal's increased flexibility would be most significant for an activist investor owning 10% or more of the voting shares of a banking organization. In that zone, the current framework (including standard Federal Reserve passivity commitments) would generally prohibit solicitations of proxies or nominating a slate of directors against the slate proposed by management and the board (among other things). In contrast, the proposal would allow solicitation of proxies on matters unrelated to board elections and would allow solicitation of proxies to elect a permissible number of directors (i.e., less than 25%).

— In practice, many activist shareholders—in the stocks of banking organizations as well as other sectors—are successful at launching a public campaign and negotiating for governance, strategic and operational changes with accumulations of shares well below the 10% voting threshold. There are a number of reasons

[43] Proposal, § 225.9(b)(5).

[44] See 12 C.F.R. § 225.42(a)(5).

[45] The BHC Act and Regulation Y include an exemption from the definition of "bank holding company" for companies acquiring voting rights through a proxy solicitation. See 12 C.F.R. § 225.2(c)(1).

[46] See, e.g., North Fork Bancorporation, Inc., 86 Fed. Res. Bull. 767 (Sept. 27, 2000) (in connection with approving North Fork's application to acquire Dime Bancorp in a contested transaction, finding that North Fork's previous solicitation of proxies from Dime stockholders in opposition to an alternative proposed merger did not constitute an unlawful acquisition of control, where the proxies solicited were "of limited duration and scope" and North Fork owned only a small percentage of Dime's shares at the time; citing 12 C.F.R. § 225.2(c)(1)(iii)); see also FleetBoston Financial Corp., 86 Fed. Res. Bull. 751 (Sept. 27, 2000).

[47] In the current and proposed framework, an activist shareholder at any ownership level would be limited in its ability to solicit proxies to elect a slate of directors representing a majority of the board, but strategies to elect a majority of the board are rare.

for this unrelated to BHC Act control rules, including securities law compliance, filing requirements and consequences, securities exchange rules, corporate law considerations, the activist's own strategy and the simple fact that larger stakes require a larger financial commitment. As a result, the proposal's increased flexibility at and above 10% voting is not likely to result in a change in the current strategies employed by activists in agitating for change at banking organizations.

Presumption of Control Due to GAAP Consolidation

The proposal would create a new presumption of control for any entity that a company consolidates on its financial statements under U.S. GAAP. (It would not, however, create a reverse presumption of non-control for a company that is not consolidated for GAAP purposes.)

The proposal explains this proposed presumption by noting that GAAP consolidation generally is required "when the consolidating entity has a controlling financial interest over the consolidated entity."[48] The proposal does not address scenarios where GAAP consolidation may be required but where the relationships between the consolidating and consolidated entity would not trigger traditional BHC Act control doctrines (e.g., in the absence of an equity investment).

— For example, GAAP consolidation of a variable interest entity (VIE) could be required even in the absence of any equity investment in the entity, if a company has "the power to direct the activities of a VIE that most significantly impact the VIE's economic performance" and "the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE."[49]

— In the structure reporting context, the Federal Reserve has provided that VIEs generally are not controlled.[50]

— This aspect of the proposal is certain to generate comment from industry given the significant implications for securitizations and other special purpose vehicles that qualify as VIEs, where GAAP consolidation may be required even when a bank or bank holding company has no equity or voting interest in the VIE, such as affiliated collateral managers receiving fees, holding certain interests in orphan CLOs or holding certain types of beneficial interests in trusts.

The proposal does not include any discussion of specific types of investments or relationships that would be treated as non-controlling for BHC Act purposes solely on the basis of the GAAP consolidation presumption.

For many holding companies, GAAP consolidation triggers closer internal review of the BHC Act control question (particularly when some change in facts causes an entity to be consolidated for the first time), but the industry has historically taken a nuanced, facts-and-circumstances approach to analyzing BHC Act control in the context of VIEs.

— Affirmative rebuttals before the Federal Reserve are not likely to be practical, given the number of VIEs, and the diversity of structures, prevalent in the asset financing markets.

— If a presumption of control based on GAAP consolidation were to survive in a final rule, the Federal Reserve will presumably need to consider some forms of categorical rebuttals or further interpretive guidance to cover types of structures and relationships that would be relevant to many bank holding companies and vehicles.

48 See proposal at p. 43.

49 See ASC 810-10.

50 See Federal Reserve, Instructions for Preparation of Report of Changes in Organizational Structure: Reporting Form FR Y-10 at NBK-2 (updated February 2018).

The use of GAAP consolidation to determine control has a precedent in the federal banking agencies' capital rules, which similarly provide that a banking organization controls any company that it consolidates for financial reporting purposes, even if the company would not be deemed controlled under the BHC Act, Regulation Y and related Federal Reserve precedents.[51] The agencies first incorporated this definition of control when revising the capital rules to implement the Basel II advanced approaches in 2007.

However, the logic of using GAAP consolidation as a proxy for control under the agencies' capital rules does not extend to control under Regulation Y. The capital rules' definition was necessary to clarify which companies would be considered affiliates of the banking organization for regulatory capital purposes—to limit recognition of guarantees provided by affiliates as eligible credit risk mitigation.

Control Framework as Applied to Investment Funds

The proposal would codify several important principles related to control of investment funds. These principles have implications for investments in both investment companies registered under the Investment Company Act of 1940 (RICs) and investment funds exempt from registration, as well as their foreign equivalents.

The Federal Reserve has consistently taken the view that managing or advising an investment fund, by itself, does not create control over the fund, or make the fund a subsidiary, for BHC Act purposes. This is true notwithstanding the fact that a fund adviser may make all meaningful decisions regarding purchases or sales of securities, voting of shares, etc., in the fund's portfolio in the ordinary course of business. A key premise to this treatment is that the fund's board of directors, general partner, or other governing body or control person has the authority to retain and terminate the investment adviser.

Beyond this simple principle, questions have arisen over decades regarding permissible investments in the securities of an investment fund that, when combined with a role as a fund adviser or manager, may or may not result in BHC Act control.

Advised funds. The proposal would establish a presumption of control for a company that both serves as investment adviser to an investment fund and controls 5% or more of the fund's voting equity or 25% or more of the fund's total equity. It also would establish two important exemptions to otherwise applicable presumptions of control.

— *Seeding*. For any investment fund, the presumption of control for advised funds would not apply during an initial one-year seeding period.

— *RICs*. The proposal would provide a broader exemption from all presumptions of control (including, for example, in relation to business relationships, directors and officer/employee interlocks) for a company's relationship with a RIC meeting the following conditions:

- The business relationships between the company and the RIC are limited to investment advisory, custodian, transfer agent, registrar, administrative, distributor and securities brokerage services provided by the company to the RIC;
- The company's directors constitute 25% or less of the board of directors or trustees of the RIC; and
- After a one-year seeding period, the company controls less than 5% of the RIC's voting equity and less than 25% of the RIC's total equity.

[51] See, e.g., 12 C.F.R. § 217.2 (definition of "control"). This definition of control is limited to the 25% of voting securities test in the BHC Act and the consolidation test discussed above and disregards whether the banking organization controls the majority of a company's board of directors or has other means of exercising a controlling influence.

In some respects, this presumption and the related exemptions are consistent with past Federal Reserve precedents. For example, it is well established that a bank holding company may organize, sponsor, advise and serve as an administrator (and in the other listed roles) for an investment fund, and hold a limited equity stake in the fund, without creating control (although financial holding company status is required in some cases, such as to distribute open-ended mutual funds).[52]

However, the presumption's post-seeding limits on ownership of voting shares (less than 5%) is inconsistent with current Federal Reserve precedents, which is likely to be an area for comment.

— Prior to passage of the Gramm-Leach-Bliley Act, Federal Reserve staff had concluded that a bank holding company that reduced its initial seed investment in an advised mutual fund to less than 25% of the voting shares of the fund after a six-month seeding period would not control the fund.[53]

— The Federal Reserve's implementation of the Gramm-Leach-Bliley Act affirmed the authority of a financial holding company to organize, sponsor, and manage a mutual fund, so long as the financial holding company's investment in the fund is reduced to less than 25% of the equity of the fund within one year of sponsoring the fund.[54] A financial holding company may be able to hold a significant investment in a mutual fund for a longer period in reliance on its merchant banking authority.[55]

The proposal helpfully clarifies that there is no BHC Act control during an initial seeding period. This conclusion is implied in the First Union letter, but some have doubted whether its control analysis applied only to the Glass-Steagall Act or also extended to the BHC Act. Later citations to the First Union letter in the Volcker Rule adopting release and the Federal Reserve's final rule defining what it means to be "predominantly engaged in financial activities" under the Dodd-Frank Act each supported interpreting it to extend to the BHC Act.[56] The citation to the First Union letter in this proposal should erase any lingering doubts about its precedential value for BHC Act control.[57]

In the Volcker Rule context, the Federal Reserve and other implementing agencies have permitted a banking entity to own up to 24.9% of the voting equity of a RIC or a foreign public fund after a seeding period without deeming the fund to be a "banking entity"—a status generally defined to be conterminous with the BHC Act concepts of control and affiliate—and have confirmed that in some cases a banking entity may own more than 25% of the voting equity of a RIC or foreign public fund for a multi-year seeding period

[52] See, e.g., Lloyds, 84 Fed. Res. Bull. 116 (1998); Commerzbank, 83 Fed. Res. Bull. 678 (1997); 12 C.F.R. § 225.86(b)(3).

[53] See Federal Reserve Letter re: First Union, dated June 24, 1999.

[54] 12 C.F.R. § 225.86(b)(3).

[55] See Federal Reserve Letter to Société Générale, dated May 17, 2001.

[56] See Final Rule, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds", 79 Fed. Reg. 5536, 5676 (Jan. 31, 2014) (citing the First Union letter for the proposition that "a bank holding company does not control a mutual fund for which it provides investment advisory and other services and that complies with the limitations of section 4(c)(7) of the BHC Act[], so long as (i) the bank holding company reduces its interest in the fund to less than 25 percent of the fund's voting shares after a six-month period, and (ii) a majority of the fund's directors are independent of the bank holding company and the bank holding company cannot select a majority of the board"); Federal Reserve Final Rule, "Definitions of 'Predominantly Engaged In Financial Activities' and 'Significant' Nonbank Financial Company and Bank Holding Company", 78 Fed. Reg. 20756, 20761 (Apr. 5, 2013) (citing the First Union letter for the proposition that "prior to enactment of the [Gramm-Leach-Bliley Act] in 1999, the [Federal Reserve] permitted bank holding companies to own more than 5 percent (and up to 25 percent) of the shares of an open-end investment company").

[57] See proposal at p. 42.

without treating the fund as a banking entity.[58] The proposal should not be read as superseding those FAQs to shorten the permitted seeding period or reduce the threshold for post-seeding period investments under the Volcker Rule. However, recognition in the Volcker Rule context that a seeding period in excess of a year is required in practice would provide a basis for more flexibility in the control context as well.

The proposal invited comment on both the appropriate voting and total equity thresholds and on the appropriate length of the seeding period.

Investors in limited partnerships and limited liability companies. The proposal would clarify that interests in limited partnerships or limited liability companies would not be considered voting securities if the limited partnership or membership interest has defensive voting rights limited to voting (i) for the removal of a general partner or managing member for cause, (ii) to replace a general partner or managing member due to incapacitation or following the removal of such person or (iii) to continue or dissolve the company after removal of the general partner or managing member.

In certain contexts, the Federal Reserve has previously indicated that a limited partnership interest will not be deemed a voting security if it does not confer on the holder the authority to participate in electing, removing or appointing a general partner,[59] although this has not previously been clarified as a general control principle under Regulation Y. The proposed clarification should ease pressure on banking institutions to scrutinize and waive commonly held and important limited partner/member voting rights for what are fundamentally passive investments in investment funds.

Similar principles should apply to holders of interests in a trust that have limited rights to, for example, remove the trustee for cause, consistent with the equivalent treatment of the ability to control the election of a majority of trustees, general partners, or directors elsewhere in Regulation Y.[60]

The proposal's revision of the definition of "voting securities" may also serve as a basis for seeking long overdue interpretive relief from an overbroad application of the Volcker Rule's general prohibition on banking organizations holding proprietary "ownership interests" in "covered funds."

— The definition of "ownership interest" in the Federal Reserve's regulations implementing the Volcker Rule can be read to capture debt interests with no other equity-like characteristics, simply on the basis of conferring on a holder the right to participate in a vote to remove for cause an issuer's general partner, managing member, trustee, director, investment manager or similar party.[61]

— The terms of senior and other debt securities issued by many structured finance vehicles captured by the definition of "covered fund" frequently include this right, resulting in widespread concern following issuance of the Volcker Rule regulations that otherwise non-equity like debt instruments could be subject to the Volcker Rule's general prohibition on proprietary banking entity investments in covered funds.

Attribution of Securities Held by Related Parties

General attribution rule. The proposal would adopt a general attribution rule for 5%-or-greater voting equity investors that would deem the investor to control any

[58] See Volcker Rule FAQs 14 and 16, https://www.federalreserve.gov/supervisionreg/faq.htm.

[59] See, e.g., Federal Reserve, Instructions for Preparation of Report of Changes in Organizational Structure: Reporting Form FR Y-10 at GL-2 n. 3 (updated Feb. 2018).

[60] See, e.g., 12 C.F.R. § 225.2(e)(1)(i) (defining "control" generally under Regulation Y, except with respect to Subpart E's CIBC Act regulations). See also, e.g., 12 C.F.R. § 248.10(d)(9) (defining "sponsor" under the Volcker Rule to include serving as a general partner, managing member, or trustee).

[61] See 12 C.F.R. § 248.10(d)(6)(i).

securities of an investee company that are controlled by certain related parties of the investor (senior management officials, directors or controlling shareholders of the investor, or their immediate families). This general attribution rule would apply for all purposes under Regulation Y, including the existing rebuttable presumption of control under the CIBC Act triggered by acquisitions of 10% or more of the voting equity of an insured bank or bank holding company.[62]

Presumption of control. Regulation Y currently applies a presumption of control where an investor holds 5% or more of the voting equity of an investee company and, together with management officials (including directors), controlling shareholders and their immediate families, controls 25% or more of a target's voting equity.[63]

The proposal would revise this presumption in two significant respects.

— First, the revised presumption would apply to voting securities controlled by a 5%-or-greater voting equity investor's "senior" management officials, rather than all management officials, as covered by the current presumption.[64]

— Second, the revised presumption would not apply if an investing company controls less than 15% of an investee's voting equity and the investor's related parties control 50% or more of voting equity.[65]

The practical effect of this limit on the revised presumption is unclear in light of the proposed general attribution rule, which would appear to deem an investor definitively to control voting securities of an investee company amounting to control of the company where the investor holds 5% or more of the investee's voting equity and its "senior management officials," directors and their immediate families hold an additional 20% or more of the investee's voting equity.[66]

While the basic concept of the new general attribution rule would be consistent with the Federal Reserve's traditional view of investments by certain related parties, as proposed it would apply more broadly and seemingly with more rigidity. The proposal solicits comment regarding whether the proposed general attribution rule should apply only for purposes of controlling influence determinations, rather than providing for strict attribution in all cases that will affect compliance with statutory thresholds and filing requirements.

A uniform attribution rule would differ from the approach taken recently in the Volcker Rule, where shares of a related party are only attributed to a banking entity for purposes of measuring compliance with the rule's fund ownership limits where the banking entity provided financing for the acquisition of the interests.[67] Although the purpose of attribution in Regulation Y would be to assess control (or, arguably, controlling influence), not limit risk, commenters may take up the proposal's question about whether the attribution rule should apply only in the more limited circumstances where financing is provided, there is an agreement regarding voting or transfer of the securities, or the company indemnifies the related parties for any losses on the securities.[68]

Adoption of the generally applicable attribution rule might require adjustments to banking organizations'

[62] See 12 C.F.R. § 225.41(c)(2).

[63] See 12 C.F.R. § 225.31(d)(2)(ii).

[64] See note 40. "[M]anagement official" is defined in Regulation Y as "any officer, director (including honorary or advisory directors), partner, or trustee of a bank or other company, or any employee of the bank or other company with policy-making functions." 12 C.F.R. § 225.2(i).

[65] See proposal at pp. 47-48 (citing Vickars-Henry Corp. v. Fed. Reserve Sys., 629 F.2d 629 (9th Cir. 1980)).

[66] The proposal includes a reservation of authority for the Federal Reserve to determine that securities are or are not controlled by a company based on facts and circumstanced presented, which applies by its terms specifically to the proposed general attribution rule.

[67] See 12 C.F.R. § 248.12(b)(1)(iv).

[68] See proposal at p. 64, Q. 43.

policies and procedures for monitoring related party holdings, including those of immediate family members, and could prompt increased supervisory scrutiny of such policies.

…

A final rule incorporating most of the elements of the proposal would be a welcome development. For many decades there has been a need to create more transparency and consistency in control determinations, and to subject the important interpretive questions underlying control determinations to the rigor and scrutiny of the notice and comment process. The breadth and thoughtfulness of the proposal represents a significant step forward, and it solicits comments on virtually all of the main issues that will shape its eventual adoption as a final rule. In this respect, the proposal provides a solid basis for development of a comprehensive control framework that clarifies and refines the Federal Reserve's interpretations and policy, taking into account customary market practices and other practical considerations relevant to determining control. Given the significance of the issues and the number of key elements that will become codified in regulation, all stakeholders will have a keen interest in considering the proposal and providing comments to ensure that a final rule addresses their concerns. It may be many years before the industry has a comparable opportunity to help shape the Federal Reserve's control rules.

…

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Appendix: Treatment of Common Minority Protective Rights

Non-controlling contractual restrictions on securities held by another

Contractual restrictions on another person's rights over their securities can create control over those securities. This column lists the proposal's categories of restrictions that **do <u>not</u> create control** over securities held by another person, listed below.

→ Rights of first offer, rights of first refusal, rights of last refusal and similar provisions requiring that a holder of securities offer the securities for sale to another person for a reasonable period of time prior to transferring the securities to a third party

→ "Tag along" rights requiring a seller of securities provide another person with the opportunity to participate in the sale

→ "Drag along" rights requiring a person to participate in a sale of securities to a third party if a majority of shareholders agree to sell their shares

→ Share pledges and other restrictions incident to a bona fide loan transaction in which the securities serve as collateral

→ Short-term and revocable proxies

→ Reasonable, time-limited restrictions imposed in connection with a transfer or sale of shares (including time to obtain any required governmental approval)

→ Reasonable, time-limited requirements to vote securities in favor of a specific acquisition of control of the issuing company, or against competing transactions (including time to obtain any required governmental approval)

When a minority investor has a 5%-or-greater voting equity investment in an investee company, the proposal would find a presumption of control if the investor also has "limiting contractual rights" that would allow the investor to "restrict significantly" the discretion of the investee company over operational and policy decisions. These columns list the proposal's examples of rights that do and do not give rise to a presumption of control when combined with a 5%-or-greater voting equity interest.

Rights that do <u>not</u> give rise to a presumption of control in combination with a 5%-or-greater voting equity interest

→ Contractual rights attached to securities limited 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

→ Restrictions on issuance of securities senior to the securities owned by the investor

→ Financial reporting requirements of the type ordinarily available to common stockholders

→ Requirements to maintain corporate existence

→ Reasonable, periodic consultation rights

→ Compliance with applicable statutory and regulatory requirements

→ Notice requirements over material events affecting the company

→ Market standard "most-favored nation" requirements that one investor receive similar contractual rights as those held by other investors

Rights that give rise to a presumption of control in combination with a 5%-or-greater voting equity interest

→ Restrictions on activities in which the investee 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 investee company

→ Restrictions on how a company directs the proceeds of the investment

→ Restrictions on personnel matters such as:

- Hiring, firing, or compensating one or more senior management officials,
- Modifying policies or budget concerning the salary, compensation, employment, or benefits plan for employees

→ Restrictions on the ability to merge or consolidate

→ Restrictions on the ability to acquire, sell, lease, transfer, spin-off, recapitalize, liquidate, dissolve, or dispose of subsidiaries or assets

→ Restrictions on the ability to make investments or expenditures

Non-controlling contractual restrictions on securities held by another
→ An agreement among shareholders of the issuing company intended to preserve the tax status or tax benefits of the company → Pro rata preemptive rights and anti-dilution provisions that provide a person with the ability to acquire securities in future issuances or to convert non-voting securities into voting securities (provided they do not allow the person to acquire a higher percentage of the class of voting securities than the person controlled immediately prior to the future issuance or conversion)

Rights that do <u>not</u> give rise to a presumption of control in combination with a 5%-or-greater voting equity interest	Rights that give rise to a presumption of control in combination with a 5%-or-greater voting equity interest
→ Pro rata preemptive rights to purchase additional shares issued by the investee company in order to maintain the investor's percentage ownership → Rights of first offer and first refusal requiring that any shareholder that intends to sell its shares provide other shareholders, or the issuer itself, the opportunity to purchase the shares before the shares can be sold to a third party → Requirements to take reasonable steps to ensure the preservation of tax status or tax benefits	→ Requirements to achieve or maintain a financial target or limit (<u>e.g.</u>, 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) → Restrictions on the payment of dividends on any class of securities, redemption of senior instruments or voluntary prepayment of indebtedness → Restrictions on the ability to authorize or issue additional junior equity or debt securities or amend the terms of equity or debt securities → Restrictions on the 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 investor to have the same status as other securities of the same class → Restrictions on the ability to amend articles of incorporation or by-laws, other than in a way that is solely defensive → Restrictions on the removal or selection of a company's independent accountant, auditor, investment adviser, or investment banker → Restrictions on an investee company's ability to significantly alter its accounting methods and policies, or its regulatory, tax, or liability status (<u>e.g.</u>, converting from a stock corporation to a limited liability company)