CLEARY GOTTLIEB

ALERT MEMORANDUM

Federal Reserve's Final Rule on "Control":

Observations and Analysis

February 24, 2020

In a highly-anticipated release, the Federal Reserve has issued a final rule amending its regulations governing when one company will be deemed to control another.

The changes will have significant implications for investments by and in banking organizations.[1] On balance, it will 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. At the same time, the Final Rule and its preamble raise their own questions of interpretation, making it likely that the coming years will see the emergence of a new body of unwritten lore and informal interpretation of the rule. In addition, because the Final Rule is stricter in some respects than the earlier framework, and generally does not adopt a grandfathering concept for existing investments, banking organizations are actively focused on developing approaches to address investments made before the Final Rule's release, as well as "pipeline" investments scheduled to close before the effective date of the Final Rule (April 1, 2020).

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[1] Federal Reserve, Final Rule, Control and Divestiture Proceedings (Jan. 30, 2020) (to be codified at 12 C.F.R. Pts. 225 and 238), available at https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-rule-fr-notice-20200130.pdf (the "Final Rule").

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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 Final Rule largely focuses on clarifying when one company would be deemed to exert a "controlling influence" over another under the Bank Holding Company 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 control of the election of a majority of a company's board of directors. By contrast, controlling influence is a multi-factor determination, with no statutorily-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. The Final Rule is designed to make the controlling influence determination more predictable and transparent.

The preamble to the Final Rule suggests that it largely codifies existing Federal Reserve precedents and interpretative views. However, it departs from precedent in certain respects, codifies certain views that were not previously consistently applied and also imposes bright-line presumptions of control regarding certain elements of the controlling influence calculus that previously were judged on a facts-and-circumstances basis.

Measured against the control framework that existed previously, the Final Rule makes a number of meaningful improvements. 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% of a class of voting securities (even with non-voting interests as high as 33%). This change will 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. It will also simplify investments where an investor seeks certain protective consent rights but is willing to limit its voting interest to under 5%.

On the other hand, measured against the proposal, the Final Rule fell short of expectations in a number of areas where commenters had raised concerns or requests for clarifications. On several topics, the Federal Reserve dismissed in a conclusory way (in some cases without any comment) significant objections to the logic and consequences of the proposal. One important example was the implicit rejection of comments on the proposed total equity calculation and lack of discussion of the potential negative consequences it would have for investments in early-stage fintech companies. After reciting some of the areas addressed by commenters on the proposed methodology, the Federal Reserve's explanation of its reasoning was limited to a statement that: "The Board believes that the GAAP-based core methodology of the Final Rule is effective, fit for purpose, well-understood, and easy to apply." The summary dismissal of thoughtful comments has contributed to some concerns about how the Final Rule may be applied in practice going forward.

In that regard, while investors have generally shared the Federal Reserve's goals of greater certainty and transparency, and the Final Rule advances those goals, a general rule with codified presumptions could also create greater rigidity in how certain controlling influence factors will be assessed. For example, investors above the 5% voting equity threshold will have less flexibility in certain areas than has been the case in practice under the earlier informal framework. This will be especially true if the presumptions are difficult to rebut in practice (as earlier

presumptions have been). As a result, control analyses could in practice be less tailored to specific facts and circumstances. The rule also adopts stricter standards than the Federal Reserve's historical approach on certain specific issues, such as re-characterization of certain instruments as equity and a presumption of control based on accounting consolidation.

The most notable aspects of the Final Rule, including changes (or absence of changes) from the proposal include:

— Helpful clarification of the statutory **presumption of non-control for investments under 5% voting equity**, establishing that business relationships, consent rights, expanded governance representation and management interlocks generally should not trigger control for these investments. In the preamble to the Final Rule the Federal Reserve also confirms what was implicit in the proposal—that compliance with the presumption should be sufficient to permit **reliance on Section 4(c)(6) of the Bank Holding Company Act**. 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 expansion or on additional investments.

— 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). Shortly before issuing the proposed rule, the Federal Reserve had permitted, in at least one public interpretation, retention of voting interests up to 14.9%. However, divestment down to 9.9% or 4.9% had been required in many earlier 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 5% or more of voting equity. The Federal Reserve rejected suggestions that it should move away from its practice of imposing quantitative limits on business relationships and consider more qualitative factors, such as the availability of alternative service providers. Like the proposal, the Final Rule codifies limits on the percentage of revenue and expenses of the investee that such relationships could represent—restricted to as low as 2% for investments over 14.9% voting. The Federal Reserve did modify the rule to specify that the significance of business relationships would be measured only from the perspective of the investee company (not the investor), although in practice few, if any, investments had foundered based on a concern about the materiality of a business relationship to the investor.

— Elimination of the voting percentage cap (14.9%) in the Federal Reserve's 2008 policy statement on equity investments in banks and bank holding companies[2] that applied in order for an investor to own more than 25% (i.e., up to 33.3%) of the total equity of a company while avoiding control. In order to take advantage of this additional flexibility to own up to 24.9% of a class of voting securities and **33.3% of the total equity** of a company without creating control, the investor would also be required to avoid triggering the other presumptions in the Final Rule.

— 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 Final Rule provides is helpful, the Final Rule limits investors' flexibility to tailor protections in a manner that addresses their concerns while avoiding consent rights that would create a controlling influence. The end result of the Final Rule will

[2] 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").

be to limit flexibility to make contextual determinations regarding control rights without engaging with Federal Reserve staff.

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

— Adoption of a codified approach to **calculation of total equity** that has the effect of inflating the total equity percentage of preferred equity investors in a company with negative retained earnings, creating significant issues for existing and prospective investments in fintech companies. The total equity calculation will also potentially include subordinated debt instruments and other interests "functionally equivalent to equity," 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 the number of voting shares held or the actual voting power, which will artificially inflate certain investors' percentages above their actual voting power in a high-vote/low-vote share structure.

— Codification of the Federal Reserve's longstanding, conservative **look-through approach to calculating voting securities** represented by options, warrants and other convertible instruments, which assumes that, when calculating ownership percentages, 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")**. This was one of the more controversial elements of the proposal, given the potential impact on securitizations and other special purpose vehicles, but was adopted as proposed with only limited discussion of the public comments. For foreign banking organizations, the Federal Reserve did clarify that in the absence of an ownership interest in an SPV there would not be a need to transfer a consolidated SPV or non-ownership-interest contractual relationships to a foreign bank's intermediate holding company under Regulation YY.

— With respect to control of **advised investment funds**, rejection of commenters' suggestion 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. Although the precedent was considered a watershed development at the time, the Federal Reserve dismissed it in adopting the final rule as a "single case."[3]

— An explicit statement that the Final Rule applies **only to Bank Holding Company Act control determinations** and not to questions of control under the Change in Bank Control Act ("CIBC Act"), Regulation O and Regulation W, three contexts where the definition of control has significant consequences.

— An apparent rejection of arguments to broadly "grandfather" **existing investments** that would be presumed controlling as a result of innovations in the Final Rule, although the wording of the preamble suggests that significant room remains for banking organizations to develop thoughtful approaches to consider their portfolios of pre-Final Rule effective date investments.

The Final Rule can be found here. Our memorandum on the proposal can be found here.

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

Special Considerations for Existing Investments

In explaining the Final Rule, the Federal Reserve indicated that the Final Rule is "generally consistent with," and "is not a fundamental change to," its current practice.[4] However, the Final Rule contains some new elements of control interpretation and deviations from understood principles. In addition, the Federal Reserve's focus in the Final Rule on increased clarity and transparency through bright-line presumptions results in dividing lines lacking the contextual facts-and-circumstances analysis that guided control determinations by banking organizations and their advisors for decades. Seen in this context, the Final Rule raises questions regarding both retroactive application to existing investments and the process for potentially reviewing previous internal decisions at banking institutions.

The Federal Reserve stated that it "does not expect to revisit structures that have already been reviewed by the Federal Reserve System unless such structures are materially altered from the facts and circumstances of the original review."[5] On the other hand, "[t]o the extent that a company previously considered an existing relationship between two companies not to constitute control, the relationship was not reviewed by the Federal Reserve System, and the relationship would be presumed to be a controlling relationship under the Final Rule, the company may contact the Board or its staff to discuss potential actions."[6]

Although the Final Rule's reliance on presumptions could suggest that an analysis of countervailing factors would be relevant,[7] it may be difficult to rebut the presumptions in practice, particularly in the early days following adoption, before there is experience implementing the rule and development of precedents laying the groundwork for potential rebuttals. Previously, the rebuttable presumptions in Regulation Y operated effectively as rules, since the prospects of rebutting the codified presumptions were generally considered unlikely. However, with the proliferation of presumptions in the Final Rule, and the calibration of the presumptions at relatively low levels or strict standards in some cases (e.g., business relationships or the total equity calculation), it is possible that institutions will be more likely to attempt to rebut a presumption through consultation with the Federal Reserve.

In the short term, some institutions may decide to approach the Federal Reserve with potential issues (including questions about conformance or arguments for rebuttal) prior to the April 1, 2020 effective date. We offer several considerations for banking institutions that are reviewing existing or future investments:

A well-documented review process. It likely will be helpful for bank holding companies to be able to document a deliberate and organized approach to considering existing investments—even if an institution determines that a broad reconsideration of such investments is not required. Institutions with significant numbers of affected

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[4] Final Rule at p. 86.

[5] Final Rule at p. 87.

[6] Final Rule at pp. 86–87. (emphasis added). The use of the word "may" in this sentence contrasts with other Federal Reserve instructions to approach the Federal Reserve's staff. See, e.g., Final Rule at p. 73 ("Companies should consult with the Board or its staff in order to determine whether equity instruments would be excluded from total equity." (emphasis added)).

[7] The presumptions are generally an evidentiary tool "intended to assist the Board in the context" of both a determination and a hearing on such determination. An affected company has the right to provide supporting facts and circumstances to contest the determination directly or at a hearing. See Final Rule at pp. 16-17.

A number of countervailing and mitigating factors urged by commenters were excluded from the Final Rule, not because the Federal Reserve rejected their potential relevance to rebutting a presumption, but because including them in the Final Rule would have disrupted the Federal Reserve's goal of providing understandable lines and of avoiding complexity. See, e.g., Final Rule at pp. 8 and 52-53 (listing "the presence of countervailing shareholders of the other company" in factors that the Federal Reserve has traditionally considered, but then indicating that "adding exceptions to certain presumptions of control because the second company is closely held or majority-controlled by a third party would significantly increase the complexity of the rule . . . [and] create practical difficulties for investors").

investments should document a review plan and its rationale and consider keeping examiners informed of the plan and progress. An institution should take special care if it is subject to any restrictions on expansion or acquisitions, such as those under a Section 4(m) agreement, which might create additional implications for any investments determined not to fall within the authority of Section 4(c)(6). It is highly likely that such reviews will require prioritization based on risk. Areas that seem most likely to potentially create issues for existing investments include the total equity test, GAAP consolidation, and business relationships. The Final Rule provides that the total equity test is measured as of the date of investment, which may put that element in a slightly different posture from other elements, such as business relationships (which are measured on an ongoing basis).

Consideration of mitigating/countervailing factors in any rebuttal. There are many potential mitigants and countervailing factors that could support a contextual non-control determination or a rebuttal of a presumption. These include the role of larger or majority controlling shareholders, prepayment or redemption provisions in debt instruments with restrictive covenants, qualitative factors related to business relationships, etc. These and other mitigating factors should be analyzed and documented as appropriate. Any institution considering a rebuttal for one or more groups of broadly similar transactions may want to prioritize the review by considering common countervailing factors characteristics, particularly if reviewing a number of historical investments.

Using precedent wisely. The Federal Reserve indicated that it "does not expect to revisit structures that have already been reviewed by the Federal Reserve System." To the extent that a bank holding company believes that its investment falls squarely within an existing precedent (whether provided to the bank holding company or to another institution), a bank holding company may be able to use this determination, at least in its prioritization of review.

Differences between the presumptions and the modified definitions. The simplicity and clarity of the Final Rule's presumptions may provide reviewers and examiners something obvious and measurable against which to determine whether an approach to Federal Reserve staff may be necessary. By contrast, some of the modified definitions leave room for interpretation, as several are structured to use examples that "generally" would be considered to meet the definition in question, or are phrased in non-definitive terms (e.g., "may").

General advocacy. There may still be room for more general advocacy by the industry not tied to a specific existing or future investment review. Changes to specific language in the rule text would be challenging, but there should be greater room where preamble language rather than rule text seemed not fully considered, and institutions may also conclude it is worthwhile to communicate to the Federal Reserve staff the significance of some departures from past precedent. For example, the Federal Reserve's apparent dismissal of the First Union precedent[8] as "single" and "unusual" was inconsistent with industry interpretations of that precedent—it had been relied upon widely by the industry and was cited favorably by the Federal Reserve recently as a key interpretation under the Bank Holding Company Act (and not just in the context of the Volcker Rule).[9] Other concepts may also be ripe for a broader effort by the industry.

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[8] Federal Reserve letter re: First Union, dated June 24, 1999 ("First Union Letter").

[9] 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, 5732 (Jan. 31, 2014) (the "2013 Volcker Rule Release") (cited as a determination "for purposes of the [Bank Holding Company] Act," not unique to the Volcker Rule); 2013 Volcker Rule Release, 79 Fed. Reg. at 5732 (cited as "long recognized").

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 investee	Less than 5% of annual revenues or expenses of investee	Less than 2% of annual revenues or expenses of 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	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	BHC: Less than 1/3 SLHC: Less than 1/4 contributed capital	BHC: Less than 1/3 SLHC: Less than 1/4 contributed capital	BHC: Less than 1/3 SLHC: Less than 1/4 contributed capital	BHC: Less than 1/3 SLHC: Less than 1/4 contributed capital
Attribution of Related Party Holdings (senior management officials, directors, controlling shareholders, or their immediate families)	N/A	Attribute related party holdings of voting securities if the investor holds 5% or greater of any class of voting securities, unless the investor holds less than 15% of each class and related parties hold 50% or greater of each class	Attribute related party holdings of voting securities if the investor holds 5% or greater of any class of voting securities, unless the investor holds less than 15% of each class and related parties hold 50% or greater of each class	Attribute related party holdings of voting securities if the investor holds 5% or greater of any class of voting securities, unless the investor holds less than 15% of each class and related parties hold 50% or greater of each class

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

Analysis of the Final Rule

Presumptions of Control and Non-control

The heart of the Final Rule is a new set of tiered presumptions of control based on a matrix linking the size of an investor's voting interest with various other indicia of control. 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. Within the tiers of voting equity ownership (under 5%, 10%, 15% and 25% of a class of voting securities), the Final Rule spells out the rights and relationships that would trigger a presumption of control.[10]

A summary of each tier is set out in Table 1 above. Table 1 is based on a visual representation published by Federal Reserve staff, with additional detail and information added based on the overall guidance in the Final Rule preamble.

Existing guidance. The Federal Reserve indicated that the Final Rule generally codifies existing guidance and precedents. Therefore, the Federal Reserve has left in place existing policy statements related to control to the extent they are not superseded by (i.e., not inconsistent with) the Final Rule. For example, the 2008 Policy Statement effectively allowed an investor to have a maximum of two representatives on a board of directors, subject to certain conditions.[11] It also did not allow service as board chair.[12] The Final Rule supersedes this guidance, potentially allowing an investor to appoint a board chair and to appoint up to one-quarter or one-half of directors, depending on its voting equity percentage. In addition, the Federal Reserve noted that "[t]he 2(g)(3) policy statement remains relevant because it reflects the Board's longstanding position that terminating control requires reducing relationships to lower levels than would be consistent with a new noncontrolling relationship."[13]

Significance of rebuttable presumption. Historically, rebuttable "presumptions" have often been treated by both investors and Federal Reserve staff as de facto limitations, particularly in a context where it is not practical for the Federal Reserve to review every control situation.

In principle, an investor could rebut a presumption of control through an approach to the Federal Reserve, presenting information and arguments for why certain factors should not be viewed as creating a controlling influence, or should otherwise be mitigated by countervailing factors, in the context of a 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 Final Rule helpfully affirms that the Federal Reserve generally expects these circumstances to be rare and does not expect to find that a company controls another unless the relationship between the two triggers a presumption. If the Federal Reserve were to regularly find control in the absence of facts triggering a control presumption, it would undermine the Final Rule's stated goals of greater transparency, predictability and consistency of decision-making.

Certain presumptions of non-control. The Final Rule retains the proposal's new presumption of non-control for under 10% voting equity investments that do not

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10 The Final Rule'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 measurement under the Bank Holding Company 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) (post-Final Rule).

11 See 2008 Policy Statement.

12 2008 Policy Statement.

13 Final Rule at p. 48, n. 53. See 12 C.F.R. § 225.139.

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. This new non-control presumption is certainly helpful on its face, although its practical effect is less clear in the context of the new tiered framework. This is because it can be negated by triggering another control presumption described in the under-10% tiers.

In addition to being potentially rebutted by control factors applicable to the less-than-5% or less-than-10% tiers, it also appears that both the statutory 5% and the new regulatory 10% non-control presumptions are categorically rebutted in certain contexts where the Federal Reserve has created a presumption of control outside of the voting percentage-based tier structure. In particular, GAAP consolidation appears to create a presumption of control that overrides the 5% or 10% presumptions of non-control. The factors for GAAP consolidation do not, in certain instances, require equity ownership at all.[14]

Passivity commitments.

The Federal Reserve stated that it no longer intends to obtain "the standard-form passivity commitments going forward in the ordinary course."[15] Companies that provided passivity commitments to the Federal Reserve in the past must contact the Federal Reserve to seek relief, and the Federal Reserve noted it would be receptive to relief "[a]bsent unusual circumstances."[16]

Increased Flexibility for Under 5% Voting Equity Investments

Beyond the increased transparency and consistency it provides, the Final Rule's most beneficial element for investors is likely the expansion of flexibility for investments benefitting from the Bank Holding Company Act's presumption of non-control for less-than-5% voting equity investments.[17] Going forward, the presumption of non-control for less-than-5% voting equity investors will permit the following:

— covenants and consent rights bearing on the investee's conduct of business (provided these fall short of constituting a "management agreement");

— 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); and

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

The Federal Reserve's decision to clarify that some or all of these factors may be present without creating control reflects a view that investors who do not hold a "material" voting equity interest in a company (5% or more, from the Federal Reserve's perspective) generally cannot exercise a controlling influence over the company.

Furthermore, the Federal Reserve helpfully confirmed that "the control framework in the final rule applies for purposes of section 4(c)(6) [of the Bank Holding Company Act] and, in particular, the Board's interpretation of section 4(c)(6) located in section 12 C.F.R. § 225.137 of the Board's Regulation Y." This should put to rest any concerns that the Federal Reserve would layer on additional limitations beyond those spelled out in the under-5% tier of the new control framework in order to rely on that authority. The reference to "passive investments" in 12 C.F.R. § 225.137 (applying Section 4(c)(6)) has at times raised questions about whether additional restrictions were necessary for that authority beyond those traditionally deemed necessary for the Federal Reserve to deem an investment non-controlling.

[14] See Financial Accounting Standards Board, Accounting Standards Codification (ASC) Topic 810 (Consolidation).

[15] Final Rule at p. 86.

[16] Final Rule at p. 86.

[17] See 12 U.S.C. § 1841(a)(3).

Banking institutions have frequently limited (as a precautionary matter or at Federal Reserve direction) even less-than-5% voting investments in non-banking companies with respect to board participation rights, consent/veto rights (other than over matters that significantly and adversely affect the rights or preferences of the investor's shares), and material business relationships. This significantly restricted investors' ability to benefit from standard minority investor protections and made 4(c)(6) challenging to use for investments that were designed to combine an equity investment with collaboration or services. The Federal Reserve's recognition in the Final Rule that an investor holding an under-5% voting interest generally should not be viewed as controlling and should be permitted protective rights or business relationships is therefore extremely beneficial.

Unfortunately, absent further clarification from the Federal Reserve, this positive development may be negated in practice with respect to investments in certain companies—start-ups and "fintechs" in particular—that are likely to have negative retained earnings in their early stages. The requirement to calculate total equity under the formula the Federal Reserve codified in the Final Rule may effectively block even small investments in such companies because negative retained earnings can severely overstate a preferred equity investor's total equity percentage, often making it challenging to stay below one-third of total equity.

Board Representation

The Final Rule generally adopts the board representation presumptions as proposed, but revises the definition of "board representative."

The Final Rule clarifies, and in some cases introduces 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).[18]

Board representation. The Final Rule institutes a more permissive approach to the level of board representation a non-controlling investor may have.

— The Final Rule establishes 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. While the preamble of the proposal clarified that this presumption is intended to provide investors with more flexibility to appoint a number of directors proportional to their voting equity, the Final Rule does <u>not</u> impose a proportionality requirement. Thus, any non-controlling 5%-or-greater investor may appoint board representatives constituting less than 25% of the board without triggering control.

— Board representation for a less-than-5% voting investor is generally permissible, subject to the bright-line control test in the Bank Holding Company 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 is helpful for minority investors in starts-ups with small boards where the investor may be willing to cap its voting interest below 25% but still seeks to have a seat on the board.[19] Under existing practice, bank holding company investors have often been limited to one voting director (and in some cases agreed to relinquish any director rights in the interest of demonstrating ("passivity"), and at times felt constrained by attempting to maintain proportionality with their voting equity percentage.

Board chair. The Final Rule establishes a 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.

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[18] <u>See</u> 2008 Policy Statement at pp. 6-8.

[19] We note, however, that the presumption is triggered if an investor's representatives "comprise <u>25 percent or more</u> of the board of directors of the second company or any of its subsidiaries." 12 C.F.R. § 225.32(d)(1)(i) (post-Final Rule). Therefore, one out of four directors would trigger the presumption.

By applying this presumption only to 15%-or-greater voting equity investors, the Final Rule offers significant new flexibility to smaller investors. For example, the Federal Reserve's standard passivity commitments and the 2008 Policy Statement generally prohibited a non-controlling investor from appointing a board chair regardless of the size of their voting interest.[20]

Commenters suggested that more permissive standards should apply to publicly traded companies due to the fact that they are subject to heightened standards of board composition.[21] Commenters also suggested that the presumption should take into account the presence of independent directors on a board, as such directors could limit the influence of the board chair. However, the Federal Reserve declined to adopt changes to address these comments, citing the "substantial complexity" and uncertainty incorporating such standards would add to the framework.

Key board committee participation. The Final Rule establishes 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 if that committee has the power to bind the company without action by the full board. The Final Rule noted that, with this power, such committees are nearly equivalent to the full board of directors with respect to the decisions that they are empowered to make unilaterally. The preamble to the proposal cited audit, compensation and executive committees as examples of such key committees.

This represents 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)[22] or to serve on certain key committees at all (absent mitigating factors).

Setting this standard at "more than 25%," instead 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 audit or compensation committee (and/or to chair the committee).

Powers of board members. Consistent with Federal Reserve precedent (e.g., standard passivity commitments and the 2008 Policy Statement)[23] and aligned with the Final Rule's approach to contractual consent rights, the Final Rule establishes 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. Regardless of the number of director representatives an investor has on a board, if an investor has a 5%-or-greater voting equity interest and the investor's director representatives have these types of protective rights, it would be sufficient to trigger a presumption of control.

Definition of director representative. Based on comments received on the proposal, the Federal Reserve modestly revised the definition of a director representative. Although the Federal Reserve stated that the revisions were intended to make the definition "more functional and more narrow,"[24] the Final Rule relies on a broader general definition coupled with examples, in contrast to the proposal's itemized definition. The Federal Reserve did, however, remove immediate family members of employees, directors or

[20] See 2008 Policy Statement 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).

[21] See, e.g., Item 407 of SEC Regulation S-K; NASDAQ Listing Rules, Rule 5605; NYSE Listed Company Manual, Sections 303A.01, 303A.02.

[22] See 2008 Policy Statement at p. 8.

[23] See 2008 Policy Statement at p. 8.

[24] Final Rule at p. 82.

agents of the investor from the list of defined representatives.

Under the Final Rule, "director representative" is defined generally as an individual that represents the interest of an investor through service on the investee's board of directors. The Final Rule then provides a non-exclusive list of examples of persons who generally would be considered to be director representatives, which include:

— individuals who are officers, employees or directors of the investor company,

— individuals who were officers, employees or directors of the investor company within the preceding two years, and

— individuals who were nominated or proposed by the investor company to be directors of the investee company.[25]

The Federal Reserve declined to respond to certain critical questions posed by commenters. For example, commenters requested further information about "individuals who were nominated or proposed" and questioned whether an investor that advised on, or even merely suggested, potential nominees could run afoul of this provision. The Federal Reserve suggested contacting staff for further guidance on particular individuals.

Business Relationships

The Final Rule generally adopts the business relationship presumptions as proposed, but makes one substantive change by measuring the relevance of business relationships based only on revenues and expenses of the investee company, rather than also those of the investor.

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 Final Rule brings transparency and consistency to the issue. At the same time, these benefits come at the expense (for greater-than-5% voting investors) of a more rigid quantitative framework that creates presumptions without providing for a fully contextual understanding of business relationships.

Quantitative vs. Qualitative Factors. In the Final Rule's tiered presumptions, the Federal Reserve focused on quantitative limits for business relationships, rather than qualitative factors, such as whether a business relationship would be difficult to replace or necessary for core functions. Nevertheless, the Federal Reserve left open the possibility of a more qualitative approach to its own determinations.

Presumption Thresholds. In the Final Rule, the Federal Reserve stated that limits in the tiered presumptions are "generally consistent with its past practice."[26] Although commenters urged the Federal Reserve to raise the quantitative thresholds, the Final Rule adopts the thresholds as proposed. The Final Rule creates a presumption of control that limits business relationships to:

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

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

[25] Compare 12 C.F.R. § 212.2(n) (in management official interlocks rules, defining "representative or nominee" as "a natural person who serves as a management official and has an obligation to act on behalf of another person with respect to management responsibilities. The [Federal Reserve] will find that a person has an obligation to act on behalf of another person only if the first person has an agreement, express or implied, to act on behalf of the second person with respect to management responsibilities.").

[26] Final Rule at p. 25.

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

Overall Effect. The Final Rule would not impose a presumption of control regarding business relationships for less-than-5% voting/one-third of total equity investors. This is a helpful development, providing increased flexibility and a measure of regulatory certainty for bank investors seeking to combine mutually beneficial relationships with innovative fintech companies with a stake in their future.

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

Measurement of Business Relationships. In response to comments, the Federal Reserve recognized that the size of the relationship from the perspective of the investor is not necessarily indicative of the investor's ability to control the second company, even though it may provide an incentive to do so. In some ways, this conclusion by the Federal Reserve is similar to other conclusions regarding indirect influences, such as the Federal Reserve's determination in connection with the Final Rule that a threat by an investor to dispose of its investment will no longer be deemed a controlling influence.[27]

Helpfully, the Final Rule appears to clarify that business relationships are not measured on a business line basis, nor do the quantitative limits distinguish between types of expenses.

Timing of Measurement. The Final Rule requires that business relationships be measured once annually based on the investee company's prepared financial statements.

Commenters requested transition or grace periods should a business relationship trigger a presumption, but the Federal Reserve did not include any additional flexibility, arguing that an annual measurement allows sufficient time for companies to manage day-to-day volatility in business relationships. The practical effect of rejecting these requests would appear to be that greater-than-5% voting investors will manage business relationships sufficiently below the already low thresholds to leave headroom for unexpected developments.

Commenters sought other clarifications, including specific exclusions from the business relationship presumptions, longer periods of time over which to measure business relationships or relief for start-up companies in their first several years. The Federal Reserve declined to include exclusions for any of these particular scenarios, noting instead that the Final Rule establishes generally applicable standards that aim to capture the economic significance of business relationships between an investor and investee.

Market Terms. In addition to the quantitative limits, the Final Rule also creates 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 appears 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."[28]

— Although the proposal sought comment on appropriate standards for evaluating "market terms," the Final Rule does not provide such standards.[29]

[27] Final Rule at pp. 38-39.

[28] See 2008 Policy Statement at 13.

[29] Section 23B of the Federal Reserve Act, 12 U.S.C. § 371c-1, and the Federal Reserve's implementing Regulation W, 12 C.F.R. Part 223, also require that transactions between a bank and its affiliates be on market

Officer/Employee Interlocks

The Final Rule adopts the presumptions related to officer/employee interlocks as proposed.

The Final Rule meaningfully reduces 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 were conditioned in part on an absence of officer or employee interlocks, and the Federal Reserve's standard passivity commitments typically prohibited any officer or employee interlocks.[30]

Senior management interlocks. The Final Rule revises Regulation Y's existing presumption of control for management interlocks[31] 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.

The new framework will permit a greater number of interlocks than the existing presumption because the Final Rule's interlocks presumption covers only "senior" management officials,[32] whereas the existing interlocks presumption in Regulation Y applies in the case of any "management official" interlock. In the preamble, the Federal Reserve noted that the focus on senior management officials captures those interlocks most likely to raise control concerns while permitting an investor the flexibility to have multiple junior employee interlocks.

Although commenters criticized the scope of senior management officials as unclear and encouraged the Federal Reserve to limit the scope to a clearly identifiable group, the Federal Reserve adopted the presumption without revision. The Federal Reserve did recognize that the definition was "not precise" and stated that it would consider providing additional clarity in the future after observing the effects of the presumption.[33]

CEO interlock. The Final Rule establishes a specific presumption of control for an interlock 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 Final Rule's approach to management interlocks represents a meaningful shift from prior standards. 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).[34] An investor between 5% and

terms. The Regulation W provisions similarly do not explicitly require nonexclusivity or termination rights and bank practice under these rules may provide some guidance for assessing business relationships under the Final Rule. See 12 C.F.R. § 223.51.

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

[31] See 12 C.F.R. § 225.31(d)(2)(iii) (pre-Final Rule).

[32] The Final Rule 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." This contrasts with Regulation Y's current definition of "management official" which does not focus on "major" policymaking: "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) (pre- and post-Final Rule). Compare also 12 C.F.R. § 212.2(j) (defining "management official" differently for purposes of management official interlocks rules) and 12 C.F.R. § 225.71(c) (defining "senior executive officer" for purposes of certain notification rules as "any other person identified by the [Federal Reserve] or Reserve Bank, whether or not hired as an employee, with significant influence over, or who participates in, major policymaking decisions of the regulated institution," and listing C-suite officers as automatically "senior executive officers").

[33] Final Rule at p. 32.

[34] See "Increased Flexibility for Under 5% Voting Equity Investments" above.

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.

Contractual Protections

The Final Rule adopts the presumptions regarding contractual rights and protections as proposed, while making clear that the specifically listed "limiting" and "non-limiting" contractual rights are non-exclusive examples.

The additional clarity on the Federal Reserve's views regarding permissible and problematic minority protective rights may prove helpful to investors by providing greater certainty and transparency. However, as many industry commenters observed, the list of impermissible consent rights is overbroad in certain respects. As the Federal Reserve did not amend the list in its Final Rule, the presumption-based approval of the Final Rule 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 "limiting" and "non-limiting" rights set out in the Final Rule.

Consent rights and restrictive covenants over a company's policy and operational decisions.

The Final Rule retains the Federal Reserve's longstanding policy that "limiting contractual rights" that significantly restrict an investee company's discretion over operational and policy decisions create a presumption of control over the investee.[35] It helpfully clarifies, however, that this presumption applies only if the investor holds a 5%-or-greater voting equity interest. The proposal further clarified 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." Nevertheless, it appears that benefiting from a single impermissible limiting contractual right, when coupled with 5%-or-greater ownership, is sufficient to trigger the presumption.[36]

The Final Rule provides a non-exclusive list of examples of contractual provisions that do and do not constitute limiting contractual rights giving rise to a presumption of control. These lists are also set forth in tabular format in the attached Appendix.

The list of contractual rights that would give rise to a presumption of control is quite broad, as noted by many commenters, 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.[37] Commenters also argued that this presumption of control should be revised not to apply if the investor cannot exercise the right unilaterally or if the investor company is not the largest single decider of the exercise of the right.

The Federal Reserve did not constrain the breadth of contractual rights or their applicability in the Final Rule, but did add language emphasizing that both lists (limiting and not limiting) consist of examples and are not exclusive. The Federal Reserve also deferred other comments or criticisms by stating that companies with questions on specific rights may contact the Federal

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

[36] See Final Rule at p. 35 (describing "a" limiting contractual right).

[37] As in the proposal, the Final Rule 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 their intention to protect an investor or lender from adverse treatment by management or majority shareholders.

Reserve Board or its staff to address the specific situation.

Separately, market-standard "most favored nation" ("MFN") clauses would not themselves give rise to a presumption of control, but this apparent flexibility may not address the question of how to analyze an MFN clause that allows an investor to claim rights that are limiting contractual rights and thus would themselves give rise to a presumption of control.

> ***Covenants in a loan agreement***. Many commenters urged clarity on the question of protective covenants in relation to loan agreements. The Final Rule affirms the Federal Reserve's longstanding position that, standing alone, even highly restrictive debt covenants do not give rise to control. However, this affirmation was significantly undercut by the Federal Reserve's caveat that when combined with a "material" equity interest, defined by the Federal Reserve as 5% or more of any class of voting equity, the presumption can be triggered based on contractual restrictions regardless of whether the contractual rights arise from the terms of the equity investment or from a wholly separate contractual arrangement (such as 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 a presumption of control if the party also has a 5%-or-greater voting equity interest in the company.

The Federal Reserve also did not discuss one of the key premises of their position with regard to loan covenants not accompanied by a "material" equity interest—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 loan or debt instrument and thus free itself from the restriction.[38] The omission of this rationale, which is not explained in the Final Rule or 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, the omission could also raise questions about precedents extending this principle to redeemable equity securities such as preferred stock (some forms of which have debt characteristics).[39]

Contractual control over securities.

The Final Rule retains the general rule codified in Regulation Y that contractual restrictions limiting "in any manner" another person's rights over securities they control create control over those securities (thus causing those securities to be counted by an investor toward the relevant presumptions and control thresholds). However, the Final Rule also expands and elaborates on the previously codified exceptions to this rule.[40]

Prior to the Final Rule, the Regulation Y presumption of control over a security could theoretically be rebutted.[41] Under the Final Rule, control of the securities is generally definitive, rather than presumptive (subject only to the exceptions described below and to the Federal Reserve's reservation of authority to determine the securities are not controlled). As a result, it may be more challenging to conclude that other standard protective rights that are on market terms and reasonably tailored, but that are not included in the Final Rule's list of exceptions, should be permissible.

38 See, e.g., 12 C.F.R. § 225.143(d)(2).

39 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.

40 The former Regulation Y presumption included just three exceptions—for reciprocal rights of first refusal, 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) (pre-Final Rule).

41 See 12 C.F.R. § 225.31(d) (pre-Final Rule).

The Final Rule 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;[42] and

— Anti-dilution provisions and similar rights.

The proposal noted that the Federal Reserve did 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.[43] As examples of disfavored provisions, the proposal cited rights of last refusal priced at a deep discount to market or featuring an unnecessarily long exercise period.[44]

The Final Rule also exempts, consistent with Federal Reserve precedent:

— pledges of securities and other restrictions incidental to bona fide loan transactions;[45]

— 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.

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 in some cases resisted requests for reasonable lock-up and support agreements in M&A transactions.

In an apparent clarification of the existing rules regarding control over securities, but in a potential expansion of such rules, the Federal Reserve inserted into the regulatory text that a company is deemed to control voting securities "that the company has power to vote or to dispose of."[46] This provision is likely to require additional consideration by institutions, and perhaps further clarification from the Federal Reserve. If interpreted too broadly, it could be understood to apply to situations such as an investment advisor's ability to dispose of a fund's securities (even when the advisor does not control the fund, but operates pursuant to authority granted by a GP or independent board). Such a reading would be a significant departure from past practice, and would create seemingly inconsistent approaches to certain issues (e.g., the Final Rule's discussion and provisions regarding when an investment advisor is deemed to control a fund does not allude to an idea that the advisor would nevertheless be viewed as controlling the underlying securities that it has the power to dispose of in the course of its duties as advisor).[47]

The Federal Reserve declined to respond to various questions regarding the meaning of this provision, such as whether it would apply to the ability to rehypothecate securities received as collateral. Other responses to commenters yielded statements inconsistent with existing precedent.[48]

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[42] 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 if the drag-along right was unilateral or class-specific. The Final Rule confirms that an investor may have the benefit of a drag-along right if the agreement provides that a shareholder is dragged along when a majority of shareholders also agree to sell their securities to a third party.

[43] See Proposed Rule, "Control and Divestiture Proceedings," 84 Fed. Reg. 21634, 21649 (May 14, 2019).

[44] Proposed Rule, "Control and Divestiture Proceedings," 84 Fed. Reg. at 21649.

[45] But see discussion below regarding rehypothecation of securities received as collateral.

[46] Final Rule at pp. 60-62 and 91 (new regulatory text at § 225.2(e)(2) (post-Final Rule)).

[47] The investment advisor's role may also be subject to the fiduciary exception discussed below.

[48] See, e.g., Final Rule at pp. 61 and 61, n. 66 (when discussing how underwriters may not be deemed to have

Safety and soundness considerations.

In multiple contexts, the Final Rule 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 are intended to highlight that "contractual covenants and business relationships between a banking organization and a company may raise safety and soundness or other concerns whether or not the relationship raises control concerns."[49]

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

Proxy Contests

The Final Rule adopts the presumptions related to proxy solicitations substantively as proposed, with minor clarifications in language.

The Final Rule expands the ability of investors to solicit proxies with respect to both board representation and other matters without being deemed to control an investee company. This part of the Final Rule 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 Final Rule appears to reflect a recognition that ordinary participation in shareholder democracy generally should not raise controlling influence concerns.

Proxies on director elections. The Final Rule establishes 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 represents a meaningful change from current practice. Prior to the Final Rule, 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 allows 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 under the new presumptions.

The Final Rule does 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 Bank Holding Company Act's definition of control.

control over securities, the Federal Reserve alluded to a "few days" or "5 days" as potential underwriting periods). Compare Regulation K, 12 C.F.R. § 211.10(a)(15)(iv)(C) (securities held under an underwriting commitment become subject to dealing/investment limitations after 90 days); 66 Fed. Reg. 54346, 54351 (Oct. 26, 2001) ("underwriting is a shorter term activity than, e.g., dealing. . . . positions undertaken in connection with an underwriting and unplaced after 90 days must be moved to the dealing account and counted against the dealing limit"); 66 Fed. Reg. at 54356 ("all equity shares held in a single company, including those held in connection with dealing activity (but excluding underwriting commitments and shares held for up to 90 days pursuant to an underwriting), must be combined for purposes of determining compliance with the control limitations of : (i) section 4(c)(6) of the [Bank Holding Company] Act (with respect to U.S. companies); and (ii) the voting and total equity limits for portfolio investments under Regulation K (with respect to foreign companies)").

[49] Final Rule at p. 10, n. 25.

Proxies on other matters. The preamble states that the Federal Reserve is not adopting a presumption of control at any level of voting equity ownership for soliciting proxies on matters other than board representation, thereby permitting a greater degree of latitude for non-controlling investors to exercise shareholder rights, even when in opposition to the board or management.

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

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

Although the Federal Reserve's regulations implementing the CIBC Act have long included a similarly phrased exemption from that Act's prior notice requirements,[50] the Federal Reserve previously had not adopted a general exception for purposes of Bank Holding Company Act control standards.[51] However, the treatment of voting rights acquired in connection with proxy contests arose in the past in connection with hostile acquisitions.[52]

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 revisions are unlikely to meaningfully affect how activist shareholders engage with bank holding companies and savings and loan holding companies.

The prior framework, like the new tiered framework, essentially allowed an activist shareholder to acquire up to 9.9% of a banking organization's voting shares without being required to rebut control or to commit not to solicit proxies, not to propose directors in opposition to management, not to seek a representative on the board or otherwise not to influence management.[53]

The Final Rule's increased flexibility is most significant for an activist investor owning 10% or more of the voting shares of a banking organization. In that zone, the prior framework (including standard Federal Reserve passivity commitments) generally prohibited solicitations of proxies or nominating a slate of directors against the slate proposed by management and the board (among other things). In contrast, the new framework allows solicitation of proxies on matters unrelated to board elections and allows 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

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50 See 12 C.F.R. § 225.42(a)(5).

51 The Bank Holding Company Act and Regulation Y do, however, 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) (post-Final Rule).

52 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).

53 Under the prior and new framework, an activist shareholder at any ownership level is 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 Bank Holding Company 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 Final Rule's increased flexibility at and above 10% voting is not likely to significantly change current strategies employed by activists in agitating for change at banking organizations. Nevertheless, it does signal to less-than-10% voting interest holders that the "question" of whether a proxy solicitation or fight may create control considerations is no longer as important as it may previously have been perceived.

Total Equity Threshold and Calculations

Total equity thresholds for control. The Final Rule affirms and in one respect liberalizes the Federal Reserve's most recent guidance on the total equity threshold for determining control under the Bank Holding Company Act. The 2008 Policy Statement stated 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. Notwithstanding this statement, some market participants remained concerned that the Federal Reserve would only permit total equity over 24.9% in unusual circumstances, and thus the proposal was welcomed as affirming the broad general application of the 33.3% threshold. In addition, in one of the few positive changes from the proposal, the proviso limiting the voting stake to 14.9% has been removed from the total equity standard in the Final Rule. Accordingly, the permitted thresholds are now more straightforward, and investors may hold up to 24.9% of a company's voting equity and 33.3% of its total equity without being presumed to control on that basis.

However, the Federal Reserve declined to apply the 33.3% total equity threshold uniformly in the Final Rule, and a 25%-or-more equity ownership control threshold continues to apply in the case of (i) an investment fund where an investor also serves as an investment advisor to the fund, and (ii) investments in or by savings and loan holding companies under HOLA, as described in greater detail below. The Federal Reserve also declined, at this time, to revise Regulation W's existing 25% of total equity control standard to align with the one-third-or-more standard in the Final Rule. Regulation W therefore continues to provide that an investor holding 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).[54] The Federal Reserve is expected to release a proposal to revise Regulation W before the end of 2020; the preamble states the Federal Reserve "may . . . consider conforming revisions" to Regulation W, while noting that the regulation is intended to address "different concerns."[55]

GAAP-based liquidation value methodology for determining total equity. The Final Rule codifies a methodology for determining total equity based on GAAP balance sheet concepts. The methodology adopted in the Final Rule includes no material changes from the proposal,[56] despite extensive industry comments highlighting the negative impact (and arguably illogical results) of the methodology with respect to investments in fintech and other early stage companies that have negative earnings.,

[54] See 12 C.F.R. § 223.3(g)(5) (rebuttable presumption of control at 25% total equity capital). 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. See Dodd-Frank Act § 608.

[55] See Final Rule at p. 15. As noted in "Application in Other Contexts" above, the Federal Reserve also declined to apply the Final Rule to control concepts under the CIBC Act and Regulation O, indicating that it would potentially consider conforming changes in the future, subject to each regulatory framework's specific purpose.

[56] The preamble notes one "technical correction" has been incorporated to ensure that *pari passu* classes of preferred stock are treated as a single class.

While this GAAP-based methodology has been applied by Federal Reserve staff for many years when evaluating investments, its application was not uniform or transparent. The Federal Reserve had never described the methodology in publicly disclosed guidance or precedents prior to the proposal. Accordingly, some industry participants and practitioners assessed total equity based on a "dollars invested" or "capital contributed" test for total equity in the case of shares acquired directly from an issuer. In some of the relatively small number of fintech investments reviewed by Federal Reserve staff, they did not raise questions about total equity calculations based on capital contributed, without accounting for negative earnings.

Given the uneven application of the Federal Reserve's approach, and also perhaps its seemingly illogical results in some scenarios, publication of the Federal Reserve's methodology in the proposal generated significant industry concern that its adoption would virtually cut off the ability of banking organizations to invest in early-stage fintech companies. The GAAP-based total equity calculation in the Final Rule can significantly overstate a preferred investor's total equity percentage in situations where the investee company has very low or negative retained earnings. Low total equity and/or negative earnings are common situations for early-stage fintech companies and other start-ups.

For example, assume Company X's balance sheet was as follows:

Preferred Stock Series A 200 Shares at $1,000	$200,000
Preferred Stock Series B 1000 Shares at $200	$200,000
Common Stock 10,000 Shares ($1.00 par value)	$10,000
Retained Earnings (reflecting operating losses)	($210,000)
Total Shareholders' Equity	$200,000

In this case, total shareholders' equity would be $200,000, and because the Federal Reserve methodology would require attribution of all negative retained earnings to the common holders, and none to the preferred equity, the Series A holder and the Series B holder would each appear to be deemed to control 100 percent of Company X's total shareholders' equity. Effectively, the negative retained earnings can drastically reduce the denominator for a preferred shareholder's calculation, without any reduction to the numerator, resulting in a distorted picture of an individual preferred shareholder's percentage ownership of the issuer.

Although there was extensive industry comment arguing that this approach overstated the equity percentages in such a scenario (and an investor's related "controlling influence"), the Federal Reserve declined to adopt any changes or to explain why its formula provides an accurate and appropriate measure of an investor's influence.

Under the Final Rule, an investor's percentage of total equity equals the sum of "investor common equity" and "investor preferred equity," divided by total shareholders' equity.

— Investor common equity equals 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.

— Investor preferred equity equals, 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 portion of total shareholders' equity allocated to the preferred stock.

— The Final Rule clarifies that where the target company has multiple classes of common stock outstanding and the different classes have different economic interests on per share basis, the number of shares of common stock must be adjusted for

purposes of the calculation so that each share of common stock has the same economic interest in the target company. The Final Rule requires a similar adjustment where *pari passu* classes of preferred stock have different economic interests on a per share basis.

Shareholders' equity is not defined in the Final Rule, but under GAAP it generally includes 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 primary source of the overstatement of equity holdings arises from the Federal Reserve's position that retained earnings will be allocated solely to common stock, and not to preferred stock, under the Final Rule's methodology.[57] Many non-public start-up companies raise capital through successive rounds of preferred share issuances, while founders and initial management often are the holders of common equity. Therefore, the Federal Reserve's incorporation of this methodology into the Final Rule is likely to impede bank holding company investors from making investments in non-public fintech and start-up companies, even in situations where the investor's voting equity percentage would be less than 5% and its equity percentage in relation to other investors based on paid-in capital may be well short of 33.3%.

Although the proposal included 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, and the Federal Reserve summarized certain of those comments, there is no substantive discussion in the Final Rule of the distortionary impact of this calculation methodology on investments in start-ups.

Frequency of total equity calculation. The Final Rule does helpfully address potential volatility in the total equity percentage calculation by clarifying that the calculation is required only at the time when the investor acquires its equity instruments. The preamble specifically notes that, in contrast to the proposal, an investor is not required to recalculate its total equity percentage when it sells or otherwise disposes of equity in an investee company,[58] nor is it required to recalculate when there are other changes to the company's shareholders' equity over time. It is not yet clear whether this timing clarification could help address investments made prior to adoption of the Final Rule, given this change arguably went beyond codification of broadly known and generally applied Federal Reserve precedent.

Standards for treating debt or other interests as equity. Consistent with the proposal, the Final Rule provides that, for purposes of determining total equity, debt instruments or other interests will be treated as equity if they are functionally equivalent to equity. In contrast to the stated goal of providing increased certainty, the Final Rule's approach to non-equity interests provides no bright line test for determining when a non-equity interest will be safe from the risk of recharacterization as equity and instead establishes a facts-and-circumstances standard.

Equity-like characteristics. The Final Rule incorporates without change the proposal's list of equity-like characteristics that may lead to a determination that a debt instrument is functionally equivalent to equity,[59] 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);

57 See Final Rule at p. 70.

58 See Final Rule at p. 73.

59 12 C.F.R. § 225.34(c)(3) (post-Final Rule).

— Absence or inadequacy of equity capital underneath the instrument;

— Extremely long-dated maturity; and

— Terms that are inconsistent with market terms.

Other interests. The Final Rule also provides that profit-sharing interests that are not debt instruments may be deemed functionally equivalent to equity.[60] Depending on how it is interpreted and applied in practice, this treatment could be inconsistent with published Federal Reserve precedent,[61] and raises the question of whether other instruments never previously deemed equity interests or their equivalents would be captured by the Final Rule. The preamble provides no clarifying guidance on this point, or on other practical considerations, including how such interests would be quantified for purposes of a total equity calculation.

Recharacterization risk for debt. Under the Final Rule, none of the characteristics listed above is intended to result automatically in debt being treated as functionally equivalent to equity. Rather, each instrument will now be subject to a facts-and-circumstances analysis. The preamble to the Final Rule affirms that the Federal Reserve expects that it would be "unusual" for debt (or "other interests") to be considered functionally equivalent to equity. However, the preamble also notes that the list of factors included in the Final Rule is "nonexclusive," which potentially subjects any non-equity interest, including those that have none of the equity-like characteristics identified in the Final Rule, to recharacterization as equity.[62]

— This approach creates 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 Final Rule 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 much equity capital under the debt would be sufficient to prevent recharacterization of an issuer's debt.

— The preamble's assertion that the Federal Reserve "expects to reclassify debt as equity under the rule only under unusual circumstances to prevent evasion" is helpful, but harder to square with the expansive list of equity-like characteristics and the Federal Reserve's refusal to provide even basic clarifications of the listed factors. For example, the preamble does not address commenters' requests that the Final Rule clarify that plain-vanilla subordinated debt will not be recharacterized as equity unless another "equity-like characteristic" is present.[63]

Exclusion of certain equity investments from total equity. In response to requests from commenters, the Final Rule includes a new provision permitting exclusion from total equity of instruments nominally characterized as equity if the instruments are determined to be the functional equivalent of debt. The Final Rule includes a nonexclusive list of characteristics that could indicate functional equivalence to debt, such as protections provided to creditors, a limited term, a fixed rate of return or a variable rate of return linked to a reference interest rate, and classification as debt for tax or accounting purposes. However, the preamble notes that this provision is intended "to provide flexibility for unusual structures and is expected to be used rarely" and directs companies to consult with

60 12 C.F.R. § 225.34(c)(4) (post-Final Rule).

61 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).

62 See Final Rule at p. 70.

63 We note that, absent very rare circumstances, traditional analyses also typically suggested that subordinated debt would be treated as equity only if it were coupled with a true equity interest. See, e.g., Regulation K, 12 C.F.R. § 211.2(m)(4) (subordinated debt deemed a Regulation K "investment" only when the investor also holds at least 5% of the equity of the investee).

Federal Reserve staff in order to determine whether equity instruments with such characteristics should be excluded from the total equity calculation.[64]

The preamble does not provide any examples of equity instruments that could meet this standard for exclusion from the total equity calculation. However, equity investments that carry certain tax credits and that are structured with debt-like features may be one category of investments that could meet this test for exclusion.[65]

The preamble also does not provide guidance on the potential conflict or inconsistencies between the factors that may allow equity to be characterized as debt and the factors that may cause debt to be recharacterized as equity. This may lead to potentially inconsistent results in the characterization of certain instruments. However, as the Federal Reserve indicated that debt is only likely to be recharacterized as equity in unusual circumstances to prevent evasion and equity is only rarely expected to be recharacterized as debt in unusual structures after consultation with the Federal Reserve, the situations in which this conflict may arise could be rare.

Pro rata "look-through" approach for non-controlling investments eliminated. The proposal would have required proportional allocation of equity in an investee based on equity interests held in a parent of an investee company, regardless of whether the investor controlled the parent company.[66] The Final Rule does not incorporate any requirement to include a *pro rata* share of equity securities held by a non-subsidiary. Accordingly, under the Final Rule, a company must include in its total equity calculation only the equity securities it controls directly or indirectly through its subsidiaries.

Helpfully, the Final Rule also appears to definitively retire the "vertical stacking" theory for determining whether an investor'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 Bank Holding Company 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 Final Rule clarifies that a bank or other company generally does not control any voting securities controlled by a company that is not a direct or indirect subsidiary of the bank or other company. However, the Federal Reserve removed the express statement to this effect that appeared in the proposal's regulatory text, noting that it did not want to "create an expectation that a company would never be deemed to control securities held by a non-subsidiary."[67] As an example, the Federal Reserve noted that a company generally would be deemed to control securities held by a non-subsidiary if the company had an option to acquire those securities.

25% Total Equity Threshold Applied to Savings and Loan Holding Companies. The proposal noted that the

[64] See Final Rule at p. 73. This direction to discuss with the Federal Reserve staff is phrased more strongly than other suggestions in the preamble to approach staff, implying that an approval or interpretation is likely necessary before an investor could comfortably exclude certain equity interests from the total equity calculation.

[65] Cf., e.g., OCC Interpretive Letter No. 941 (June 11, 2002) (subject to analysis of appropriate debt-like characteristics, preferred stock may be owned by national banks under authority to own debt securities); OCC Interpretive Letter No. 1048 (Dec. 21, 2005) (equity interest in wind energy project permitted for national bank based on debt-equivalent characteristics and need to purchase equity to obtain renewable electricity production tax credits). Investments in low-income housing, alternative energy and similar tax-advantaged situations may be undertaken by bank holding company investors in reliance on merchant banking authority, but the possibility of receiving approval to treat certain of these equity structures as debt may provide an alternative investment authority.

[66] Specifically, under the proposal, the calculation of an investor's total equity (not voting interest) investment in an investee company would have included 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.

[67] See Final Rule at p. 68.

statutory control frameworks under the Bank Holding Company Act and HOLA are "nearly identical."[68] The proposal recognized, however, that HOLA has an independent control threshold measured by 25% of "contributed capital."[69] Nevertheless, for purposes of the controlling influence analysis, the Federal Reserve proposed that the one-third total equity presumption also apply in the context of control proceedings under HOLA. The proposal stated that the two were distinct concepts (one a statutory control threshold and the other a presumption under a controlling influence analysis) and need not be viewed as inconsistent.[70]

In a sharp reversal from the proposal, the Final Rule collapses that distinction by:

— omitting the one-third-of-total-equity noncontrol presumption from Regulation LL's rebuttable presumption; and

— clarifying, only in the preamble to the Final Rule, that the Federal Reserve generally expects to measure "contributed capital" for purposes of HOLA's 25% of contributed capital control threshold using the Final Rule's Regulation Y GAAP total equity methodology.[71]

Contributed capital is not defined in HOLA or in Regulation LL, and the Regulation Y total equity calculation is not incorporated into Regulation LL under the Final Rule, either directly or through a cross reference.

Calculating Voting Equity

Number-of-Shares and Voting Power. Consistent with the proposal, the Final Rule requires 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 asserted that the bifurcated, "greater of" approach is "consistent with a longstanding Board practice."[72] 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 focused on voting power.

— Applying a number-of-shares test rather than focusing on actual voting power can create seemingly illogical results and may be difficult to apply in certain circumstances. For example, for investments in companies with a high-vote/low-vote share structures (which have become increasingly common), it has the potential to radically overstate an investor's deemed percentage of a class of voting securities in comparison to the investor's actual voting power.

— The Federal Reserve claimed that the dual calculation would "prevent[] evasion through the use of securities with different voting power."[73] However, while this might have been a concern at the time of certain decades-old precedents, any concern about an investor in low-vote shares having a higher economic interest than its proportion of votes is already addressed today by the total equity limitation. Thus, instead of preventing evasion,

[68] See Proposed Rule, "Control and Divestiture Proceedings," 84 Fed. Reg. at 21653.

[69] Under HOLA, a person controls a company if the person has more than 25% of any class of voting securities of the company, rather than 25% or more of any class of voting securities under the Bank Holding Company Act. Unlike the language of the Bank Holding Company Act, HOLA explicitly states that a general partner of a partnership controls the partnership, a trustee of a trust controls the trust, and a person that has contributed more than 25% of the capital of a company controls the company.

[70] The proposal indicated 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.

[71] See Final Rule at p. 84.

[72] Proposed Rule, "Control and Divestiture Proceedings," 84 Fed. Reg. at 21650.

[73] Final Rule at p. 69.

applying a number-of-shares test in connection with measuring voting equity simply creates a metric that does not actually measure an investor's voting power.

— The number-of-shares approach has also raised questions about how it would apply to situations where an investor holds an interest but not a number of shares (e.g., a limited partnership interest), or where the terms of a security cap the voting power of the holder, although it should be possible to resolve these questions within the new framework.

Look-through treatment of options, warrants and contingently convertible instruments. The Final Rule codifies 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 seemingly 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.

- In one exception to this rule, consistent with the proposal and historical practice, the Final Rule confirms that where, by the terms of the instrument, an investor may exercise an option 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.

- The Final Rule also confirmed 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.[74]

— This calculation method is required even when the future contingency that would permit exercise or conversion is remote and when the options are deeply out of the money. The Federal Reserve rejected commenter requests to distinguish between such options, noting that looking through in-the-money options while not looking through out-of-the-money options could result in unpredictable moves from non-control to control of a bank without the ability of the investor to apply for or receive prior approval under Section 3 of the Bank Holding Company Act.[75] The Final Rule also did not incorporate commenter recommendations to limit the scope of the "look-through" approach to options and warrants that that can be freely converted or exercised by the holder within a prescribed, near-term time period.[76]

— The Final Rule also confirmed that preferred securities that have no voting rights unless the issuer fails to pay dividends for six or more quarters are only considered to be voting securities if a sufficient number of dividends are missed and the voting rights are active. This additional narrow exception to the look-through approach is consistent with Federal Reserve precedent and simply reflects a common feature of preferred securities.

— Although overall this calculation approach can significantly overstate an investor's actual control of voting securities (or its related influence), this element of the Final Rule does increase

[74] 12 C.F.R. § 225.9(a)(7)(B) (post-Final Rule). See Final Rule at p. 64.

[75] See Final Rule at p. 65.

[76] Commenters generally suggested a time period that would equate to beneficial ownership under the securities laws and securities law reporting requirements. See 17 C.F.R. § 240.13d-3(d)(1)(i).

transparency by codifying the Federal Reserve's longstanding practice and precedents.

Convertible instruments and "blockers" limiting transfer of non-voting securities. The Final Rule also incorporates 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 that are convertible only in the hands of a transferee under certain specified circumstances. Consistent with the 2008 Policy Statement, the Final Rule does not require application of the look-through approach to a convertible instrument if the terms of the instrument contain a blocker provision, providing that the instrument may convert into voting securities only following a transfer in connection with the following specific circumstances:

— 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.

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.

Additional Presumptions, Exclusions and Implications

Management Agreements

The Final Rule adopts the presumption related to management agreements as proposed.

The Final Rule slightly modifies Regulation Y's existing presumption of control for "management agreements."[77] In its revised form under the Final Rule, the presumption is 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 Final Rule cites examples of 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, investment advisory contracts are explicitly excluded and do 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, would appear more appropriately evaluated as variants of the type of investment advisory agreements excluded from the presumption.

— As the Federal Reserve did not provide specific guidance on when limiting contractual rights may cross the line to become a management contract or similar agreement, which would trigger an automatic presumption of control notwithstanding other factors, there may be gray areas near the margins where the classification is not clear. However, as management agreements are characterized as providing "*significant*" influence or discretion over the "*general*" business of a company, it is unlikely that even significant limiting contractual rights would cross the line to become a management agreement, unless they are so pervasive that the agreement begins to look more like a general partner or managing member role.

[77] See 12 C.F.R. § 225.31(d)(2)(i) (pre-Final Rule).

Presumption of Control Due to GAAP Consolidation

The Final Rule also preserves the proposal's presumption of control for any entity that a company consolidates on its financial statements under U.S. GAAP despite commenter concerns that the presumption is overbroad and inappropriately captures a number of structures, including asset-backed commercial paper ("ABCP") conduits and certain other special purpose vehicles subject to GAAP consolidation as variable interest entities ("VIEs").

The rule does not apply the same presumption to consolidation under different accounting standards, such as the International Financial Reporting Standards. The preamble notes, however, that the Federal Reserve is "likely to have control concerns where a company consolidates another company on its financial statements under another accounting standard, particularly if the other accounting standard has consolidation standards that are similar to the consolidation standards under GAAP."[78]

The impact of this new presumption could be significant, given that consolidation is likely to be transparent to both internal and external parties. While this presumption will certainly be a complicating factor in a review of existing relationships and in future situations, it may be that its effect is decreased by a few understandings:

— If an equity interest is causing consolidation, it is likely a controlling equity interest under another test.

— If the consolidator has no equity interest,[79] the impact may be limited to certain structured transactions and their related VIEs or SPVs, rather than operating companies, although further review of other scenarios would be beneficial.

— Structured transaction VIEs or SPVs often hold assets or conduct activities that are usually permissible for a bank holding company (i.e., receivables, loans, derivatives).[80]

— The preamble clarifies that a foreign bank with an intermediate holding company ("IHC") would not need to transfer a contractual relationship to its IHC, if the contractual relationship were causing the consolidation.[81]

— The Federal Reserve indicated that the presumptions under this Final Rule would not apply to Regulation W situations until the Federal Reserve considered its application in the context of the affiliate transaction rules.

Potential considerations in the context of this presumption also include FR Y-10 entity reporting and any restrictions on acquisitions/expansion, such as under a 4(m) agreement.

Equity Accounting Treatment Not Presumed Control. The proposal requested comment on whether the Federal Reserve should presume that a company controls an investee company if it uses the GAAP

[78] See Final Rule at p. 46.

[79] See FASB Accounting Standards Update No. 2015-02 (Feb. 2015) at 10 ("a controlling financial interest [causing consolidation] may be achieved other than by ownership of shares or voting interests. A controlling financial interest in the VIE model requires both of the following: (a) The power to direct the activities that most significantly impact the VIE's economic performance, (b) 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."). In addition to the difficulties caused by the fact that the GAAP consolidation presumption can be applied in situations where an "investor" has no investment, other ambiguities arise when looking at the Final Rule through the GAAP consolidation lens, including the question of when limiting contractual rights (permitted for an under-5% investor) may rise to the level of causing consolidation of a VIE, but not to the level of a management agreement.

[80] Of course some may hold real property or commodity interests not permissible for bank holding companies or permissible only under merchant banking authority for financial holding companies.

[81] See Final Rule at pp. 46-47; 12 C.F.R. § 252.153.

equity method of accounting (in addition to when a company consolidates a company for GAAP purposes). The preamble acknowledges strong commenter objection to this approach, which would have substantially lowered the threshold for presuming control—the equity method of accounting is generally triggered on ownership of voting securities of 20% or more, while the Bank Holding Company Act's control threshold is 25% of any class of voting securities. Accordingly, the Final Rule does not incorporate any presumption of control related to equity method accounting.[82]

Attribution of Securities Held by Related Parties

General attribution rule; exceptions. The Final Rule largely retains the proposal's general attribution rule for related party holdings, deeming a 5%-or-greater voting equity investor to control any securities of an investee company that are controlled by senior management officials, directors or controlling shareholders of the investor, or their immediate family members.

— The Final Rule also revises the general attribution rule as proposed to provide that it will not apply where an investing company controls less than 15%, and the investor's related parties control 50% or more, of an investee company's voting equity.

— In a request for comment in the proposal's preamble, the Federal Reserve noted that the newly proposed provisions addressing control over securities (e.g., proposed Sections 225.9 of Regulation Y and 238.10 of Regulation LL) would be placed in a general section of the regulations and not limited in their application. Therefore, the provisions would apply for all purposes under those regulations, including regulatory notice requirements under the CIBC Act.[83] Consistent with the proposal, the new provisions addressing control over securities in the Final Rule amend the generally applicable provisions of Regulations Y and LL. Accordingly, the finalized control-over-securities provisions will presumably apply for CIBC Act purposes, despite the Federal Reserve's general statement in the Final Rule preamble that "the [F]inal [R]ule applies to questions of control under the [Bank Holding Company] Act and HOLA; it does not extend to [the CIBC Act] . . . ."[84]

No presumption of control based on related party holdings. The Final Rule eliminates the existing regulatory presumption of control (which the proposal would have revised) that historically applied where a 5%-or-greater voting equity investor, together with certain of its related parties, controlled 25% or more of an investee company's voting equity.

— As a practical matter, the Final Rule's elimination of the existing presumption in favor of a general attribution rule results in broader and more rigid application of the Federal Reserve's traditional view of related party investments in the control context.[85]

— The general attribution rule also differs from the approach taken under the Volcker Rule, where covered fund shares acquired by a related party are attributed to a banking entity for purposes of measuring compliance with the rule's fund ownership limits only where the banking entity provides financing for the related party's acquisition.[86] Adoption of the general attribution

[82] See Final Rule at p. 47.

[83] See Proposed Rule, "Control and Divestiture Proceedings," 84 Fed. Reg. at Q. 40.

[84] See Final Rule at p. 15.

[85] Consistent with the proposal, the Final Rule 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 circumstances presented, which applies by its terms specifically to the general attribution rule for related party holdings.

[86] See 12 C.F.R. § 248.12(b)(1)(iv). See also Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds at pp. 110-111, available at https://www.federalreserve.gov/aboutthefed/boardmeetings/files/volcker-rule-fr-notice-20200130.pdf (Jan. 20, 2020) (the "2020 Volcker Funds Proposal") (proposing to amend 12

rule will likely require adjustments to banking organizations' policies and procedures for monitoring related party holdings, including those of immediate family members, and could prompt increased supervisory scrutiny of such policies and procedures.

Fiduciary Exception

The Final Rule clarifies the proposed fiduciary exception to reflect the different conditions of the Section 3 and Section 4 fiduciary exceptions under the Bank Holding Company Act, consistent with commenters' recommendations. Under the Final Rule, the "sole discretionary [voting] authority" applies only to depository institution and depository institution holding company (i.e., Section 3) securities.[87]

— The preamble also states that the Final Rule "does not provide broader clarity around the scope" of the fiduciary exception, which "is intended to align with the [Federal Reserve's] traditional understanding of the scope of the fiduciary exceptions" in the Bank Holding Company Act and Regulation Y. The preamble goes on to state that the "primary example" of a qualifying fiduciary is a "trust department of a depository institution that is authorized to engage in fiduciary activities."[88] This reference to a bank trust department as the "primary example" (i.e., not the only type) of a qualifying fiduciary would appear to suggest that other types of fiduciary roles should qualify. This would allow for the broader scope of fiduciaries within a bank holding company structure—including investment advisory subsidiaries—that the industry has long viewed as qualifying, consistent with historical Federal Reserve guidance confirming that nonbank subsidiaries of a bank holding company may also rely on the fiduciary exception.[89]

Control Framework as Applied to Investment Funds

Control of advised funds. The Final Rule largely adopts the proposal's approach to control of investment funds,[90] rejecting key commenter recommendations.

— *Investment advisor + ≥ 5% voting equity.* The Final Rule adopts without change the proposal's presumption of control for a company that both serves as investment advisor 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.[91] These

C.F.R. §§ 248.10(d)(6)(C), 248.12(c)(1) to limit attribution of an employee's or director's restricted profit interest in a covered fund organized or offered by a banking entity to only those circumstances in which the banking entity has directly or indirectly financed the acquisition of the restricted profit interest).

87 The clarified fiduciary exception now aligns with other Regulation Y provisions implementing the Section 3 and Section 4 fiduciary exceptions. See 12 C.F.R. §§ 225.12(a), 225.22(d)(3) (pre- and post-Final Rule).

88 See Final Rule at p. 54.

89 See, e.g., Final Rule, "Bank Holding Companies and Change in Bank Control; Revision of Regulation Y," 49 Fed. Reg. 794, 803 (Jan. 5, 1984) ("While the exception contained in section 3 of the [Bank Holding Company] Act for the acquisition of bank or bank holding company securities or assets in a fiduciary capacity is limited to such acquisitions made by a bank, [Regulation Y] extends the exception for fiduciary acquisition of bank and bank holding company securities to those made by a nonbank company. This interpretation recognizes the fact that there are nonbank companies, including nonbank subsidiaries of bank holding companies, that are engaged in fiduciary activities and would receive securities or assets in a fiduciary capacity.").

90 The Federal Reserve appears to confirm in the Final Rule preamble that the term "investment fund" will be interpreted, consistent with statements in the proposal's preamble, to encompass "a wide range of investment vehicles," including investment companies registered under the Investment Company Act of 1940 (the "1940 Act") (such entities, "RICs"), investment companies exempt from registration under the 1940 Act (generally including commodity funds and real estate investment trusts) and foreign equivalents of those funds. See Final Rule at p. 40.

91 This presumption is consistent with the guidance in the merchant banking context for when a financial holding company controls a private equity fund. 12 C.F.R. § 225.173(d)(4) ("When does a financial holding company control a private equity fund? A financial holding company controls a private equity fund for purposes of this subpart if the financial holding company, including any director,

control thresholds apply even in a post-seeding context as an advisor is distributing interests to investors and reducing its stake.

- The Federal Reserve determined not to adopt commenters' recommendations that the presumption's 5% post-seeding voting equity threshold be increased to align with Federal Reserve precedent permitting up to 24.99% voting equity ownership following a permitted seeding period (e.g., the First Union letter and related interpretive precedent).[92] The preamble characterizes the First Union letter as a "single precedent" and an "unusual case based in part on statutory provisions that are no longer in effect."[93] This is an unfortunate and significant development, as the First Union letter—which the Federal Reserve has cited in other contexts as a "long recognized" precedent for Bank Holding Company Act purposes[94]—has long been relied upon by the industry in fund seeding contexts. One possibility for the industry to consider in this new context is whether investments in certain types of funds could be structured as nonvoting equity ownership to allow for a greater percentage of ownership post-seeding.

- The Final Rule also did not adopt the proposed exception from the investment fund presumption for certain RICs. The Federal Reserve notes in the preamble that the proposed RIC exception provided "minimal incremental information beyond the general investment fund presumption" and introduced ambiguity to the proposal's general investment fund control parameters.[95]

— *Seeding period exception*. The Final Rule adopts without change the proposed one-year seeding period exception from the investment fund presumption, rejecting commenters' recommendations that the Final Rule adopt a multi-year seeding period consistent with the Volcker Rule.[96]

- The preamble notes that the Final Rule's one-year seeding period exception "does not alter the rules applicable to hedge fund and private equity fund investments under the Volcker Rule, including the rules addressing permissible seeding periods for such funds."[97] However,

officer, employee or principal shareholder of the financial holding company:

(i) Serves as a general partner, managing member, or trustee of the private equity fund (or serves in a similar role with respect to the private equity fund);

(ii) Owns or controls 25 percent or more of any class of voting shares or similar interests in the private equity fund;

(iii) In any manner selects, controls or constitutes a majority of the directors, trustees or management of the private equity fund; or

(iv) Owns or controls more than 5 percent of any class of voting shares or similar interests in the private equity fund and is the investment [advisor] to the fund.").

92 See First Union Letter. See also 2013 Volcker Rule Release, 79 Fed. Reg. at 5676, 5732; 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).

93 See Final Rule at p. 43.

94 See, e.g., 2013 Volcker Rule Release, 79 Fed. Reg. at 5676 (citing the First Union Letter in stating that the Federal Reserve's "regulations and orders have long recognized that a bank holding company may organize, sponsor, and manage a mutual fund such as a [RIC] . . . without controlling the [RIC] for purposes of the [Bank Holding Company] Act," for example by "permitt[ing] a bank holding company to own less than 25 percent of the voting shares of a [RIC] . . ." without finding that the bank holding company controls the fund, so long as the fund limits its investments to those permissible for the holding company to make itself"), 5732 (citing the First Union Letter again in noting that the Federal Reserve's "regulations and orders have long recognized that the concept of control is different for funds than for operating companies").

95 See Final Rule at p. 43.

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

97 See Final Rule at p. 44, n. 48.

banking entities subject to the Volcker Rule will now be required to structure their seeding and distribution strategies to avoid triggering control of a fund based on lengthier seeding periods, and to consider the interplay between the Volcker Rule's more flexible seeding periods and general triggers for control under the Bank Holding Company Act and Regulation Y.

- The preamble also states that the one-year seeding period exception is available only for a company that "organizes and sponsors" an investment fund, and not to "other early investors in an investment fund."[98]

Definition of "nonvoting securities"; defensive rights common to investment fund interests. Consistent with the proposal, the Final Rule clarifies that certain defensive voting rights commonly found in securities issued by investment funds (e.g., limited partnerships or limited liability companies, among other forms of entities)[99] will not cause such securities to be considered "voting securities" solely by virtue of entitling a holder to vote on (1) removal of a general partner, managing member or similar person for cause, (2) replacing such person due to incapacitation or following removal for cause or (3) continuing or dissolving a company after removal of such person.

— This clarification should ease pressure on banking institutions to scrutinize and waive commonly held and important voting rights in the case of what are fundamentally passive investments in investment funds.

— Although not addressed explicitly in the Final Rule, this revision appears to be consistent with the Volcker Rule agencies' recent proposed amendments to the regulatory definition of an "other similar interest" in a covered fund, designed to address the potentially over-broad inclusion of debt instruments within the scope of "equity, partnership, or other similar interest[s]" in covered funds.[100]

Divesting Control

The Final Rule adopts the proposal's revisions to the Federal Reserve standards for effective divestiture of control of a subsidiary, thus representing 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 simplifies business planning for banking organizations and other investors.

— It also opens up opportunities for banking organizations to be more active in early stage and incubator investments. The 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 divestiture of

98 See Final Rule at p. 44.

99 See Final Rule at p. 60 ("[T]he definitions of voting securities and nonvoting securities in the final rule have been drafted broadly to apply effectively to all forms of legal entities"). The same principle will presumably apply in the case of trust interests that confer limited rights to, for example, remove a 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. See, e.g., 12 C.F.R. § 225.2(e)(1)(i) (post-Final Rule) (defining "control" generally under Regulation Y, except with respect to Subpart E's CIBC Act regulations); cf. 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).

100 See 2020 Volcker Funds Proposal at pp. 103-107 (proposing to amend 12 C.F.R. § 248.10(d)(6)(1)(A) to "specify [for purposes of the definition of "other similar interest"] that creditors' remedies upon the occurrence of an event of default or an acceleration event include the right to participate in the removal of an investment manager for cause or to nominate or vote on a nominated replacement manager upon an investment manager's resignation or removal," such that, for example, "an interest [in a covered fund] that allows its holder to [participate in] remov[al] [of] an investment manager for cause upon the occurrence of an event of default . . . would not be considered an ownership interest for this reason alone.").

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 Final Rule, 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 explained 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.[101] In some cases, the Federal Reserve has required divestment to less than 5% of voting equity.[102]

— The range of Federal Reserve precedents in this area attest to the nuanced, context-specific approach that staff has taken to date.[103] As a result, divesting companies were frequently required to expend significant time and resources negotiating the terms of a bespoke "de-control" determination with Federal Reserve staff.

— Typically, Federal Reserve approval of a de-control transaction was 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 Final Rule adopts the divesture presumption substantially as proposed, providing two paths to achieving "de-control" of a subsidiary at closing of a divestiture transaction.

First, an investor can:

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

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

— 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 can:

— 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.

Longer-term de-control approach. If a divesting investor does not wish to immediately reduce its investment below 15% of each class of voting or there is not a majority shareholder of each class of securities, the Final Rule also permits 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.

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[101] Federal Reserve Staff Memorandum, p. 5 (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%) ("Barclays Africa Letter").

[102] See, e.g., Barclays Africa Letter; 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").

[103] 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.

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. 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.

Application in Other Contexts

The Federal Reserve declined to extend the presumptions in the Final Rule to other contexts that include a similar control analysis, such as the CIBC Act, Regulation W and Regulation O. The Federal Reserve indicated that it may consider changes to these elements of the regulatory framework in the future, noting that "common control standards across the Board's regulatory framework may provide efficiency benefits" but that "each of the regulations identified by commenters arises out of different provisions of law and is intended to address different concerns in specific contexts."[104] This is likely to be an area for future advocacy, especially in the context of the long-awaited Regulation W revisions. Industry will likely suggest that:

— The control presumptions should be used in the context of the CIBC Act to allow an investor to effectively rebut the 10% presumption of control without filing a notice or other biographical/financial information if the investment would not trigger a presumption under the Final Rule. This would allow the Federal Reserve to continue to meet its statutory obligations under the CIBC Act and facilitate increased investment in U.S. banking organizations.

— The Federal Reserve should generally apply the control presumptions to the controlling influence standards in Regulation W and Regulation O, with targeted amendments for areas in the Final Rule that are inconsistent with longstanding industry practice, such as the presumption of control based solely on GAAP consolidation. With respect to Regulation O, the Federal Reserve should consider a different interpretation of controlling influence in the context of the "related interest" definition, which is often applied to those outside the bank regulatory world who are not familiar with the intricacies of the controlling influence guidance.

— Regulation K, Subpart A has a separate standard for control relevant to certain overseas investments by U.S. banking organizations.[105] Control analysis in the context of Regulation K, Subpart A should be a separate analysis that is not subject to the presumptions under the Final Rule. However, a Regulation K control analysis may be informed by certain of the principles described in the Final Rule and its preamble.

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[104] Final Rule at p. 15.

[105] See 12 C.F.R. § 211.2(w).

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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 Final Rule’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)

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**
When a minority investor has a 5%-or-greater voting equity investment in an investee company, the Final Rule 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 Final Rule’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.	
→ 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 or other information 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	→ 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 → Requirements to achieve or maintain a financial target or limit (<u>e.g.</u>, debt-to-equity

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	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 advisor, 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)