Financial Services Management

BHC/Bank Control Criteria

Cite
Federal Reserve Board, Final Rule, Control and Divestiture Proceedings

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CEO, Corporate Development, Policy, Legal, Government Relations

Websites:
https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-rule-fr-notice-20200130.pdf

Impact Assessment

- Bank/fintech alliances and those between banks and other entities will be easier to consummate without triggering control as long as stakes are not large and/or banks do not wish to become a major customer of the fintech firm. Changes sought to the NPR that would have considerably eased control thresholds for start-up businesses were not reflected in the final rule.
- Banks will find it easier to hold interests in tech-platform firms to further alliances, but tech-platform companies will still find it challenging to integrate with all but the biggest banks.
- Proxy fights are now less constrained by control considerations. Banking organizations could be more efficient and/or simple, but activist investors could also lead some to become more highly leveraged or otherwise riskier.
- PE investment in banking organizations is eased due to expanded authority to govern banks without triggering control presumptions and resulting limits on the parent PE firm or fund.
- Community-bank capitalization could be enhanced.
- FBO integration with U.S. banks without resulting control will also be easier.
- Continued reliance on "control" as inferred by the Fed rather than "actual control" will constrain BHC-related investment in comparison to the "actual control" definition ordinarily applied for accounting purposes. Conflict and prudential considerations will thus still drive Fed action.

Overview

After several years of promising to do so, the Federal Reserve has finalized a proposal[1] and revised the standards at which "control" is considered to be held over a banking organization or when a bank controls another entity. The Board continues to

[1] See **TAKEOVER8**, *Financial Services Management*, May 3, 2019.

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state that the rule codifies and clarifies 2008 standards.[2] This it does, but the manner in which "indicia of control" are now defined open numerous avenues for integrating banking and commerce or banking and other financial activities in ways the Federal Reserve in 2016 made clear it then would not countenance.[3] These new standards also facilitate proxy contests that could make it easier for private-equity firms or activist investors to force major changes at large and small banking organizations. Foreign banks will also find it easier to exercise influence over a U.S. banking organization without triggering control under U.S. law that might then subject them to costly safety-and-soundness or resolution requirements.[4]

Impact

The final rule is less assertive than the proposal in stating that changes are principally clarifications, but nonetheless says that the new approach is so aligned with prior requirements as to suggest no substantive impact. The rule thus does not include a regulatory-impact statement in which the FRB indicates how it thinks its proposal affects the structure of the U.S. financial services industry. However, as discussed below, the clarifications may be so substantive as to in fact constitute a new, liberalized framework for inter-relationships between banking and other forms of finance and commerce, some of which the Fed has previously viewed with considerable alarm.

Although the final rule retains numerous subjective standards designed to identify potential control even in the absence of express legal authority to exert control, many modifications – e.g., larger investment stakes eligible under the presumption of non-control – provide considerably more flexibility for non-traditional and cross-sectoral transactions than the Fed to date has been willing to approve. To be sure, there is no official change to the 2016 policy referenced above that would suggest that the Board now intends its new control thresholds to redefine U.S. finance. In the 2016 policy statement – which was an official pronouncement but not a rule, guidance, or other binding pronouncement – the Fed laid out the reasons why it opposed even limited integration of banking and commerce (e.g., concentration risk, conflicts of interest). At the same time, the Board indicated that it had far fewer qualms about integrating banking with securities, insurance, and other financial activities already allowed in connection with banking in one form or another. The rule regarding control does not, however, differentiate between the types of investors or ventures taking stakes in banks or in which banks would take stakes, thus making it at least as easy for retailers, large tech companies, or private-equity firms to acquire stakes in banks as it would be for entities such as insurance companies subject to their own capital and prudential restrictions. Investors able to obtain a sizeable stake and/or exercise considerable influence over a banking organization might thus profit directly or indirectly from the affiliation without the regulatory, capital, and activity restrictions that previously constrained similar positions that triggered a control determination. Similarly, banks investing in otherwise-impermissible activities could have a new direct or indirect profit channel without some of the prohibitions now barring commercial activity.

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2 See **TAKEOVER5**, *Financial Services Management*, September 26, 2008.

3 See **CHARTER23**, *Financial Services Management*, September 14, 2016.

4 See **SIFI35**, *Financial Services Management*, December 18, 2019.

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As noted, a significant implication of the rule is its impact on proxy contests. Historically, banks have been insulated from activist or private-equity challenges because it can be difficult to obtain necessary board influence without also triggering control. Although the rule describes its changes as only modest differences from the current regime, they would eliminate the current restrictions on proxy contests when current, relatively small director-presence thresholds apply. As a result, there could well be considerably more scope for such challenges. This would increase the dynamism of the U.S. banking sector and provide new capital to smaller banks, but also expose banks to still more pressure for quarter-over-quarter earnings that could increase both leverage and risk.

What's Next

This final rule was approved unanimously by the Board on January 30.[5] It is effective on April 1. Because the Board views the rule as generally consistent with current standards, there are no grandfather or transition provisions. Companies are told to petition the Fed from relief from certain terms in existing transactions that now may be liberalized. The rule covers only the definition of "control" in the Bank Holding Company Act; the Fed may at a later date do so for this term as it is elsewhere defined in its regulations (i.e., under the Change in Bank Control Act).

Analysis

A. General Terms and Conditions

1. Scope

The rules described below also apply in similar fashion to S&L holding companies.

2. Framework

As discussed above, the rule addresses control in two contexts: companies seeking a stake in a bank or banks seeking a stake in another company. The control standards apply in either case without distinction. As a result, the rule frames its presumptions with regard to a "first company" – i.e., the investor – and a "second company" – i.e., the target. These terms are used below as appropriate subsidiaries of these companies are treated in accordance with their relationship to each other. Thus, the bank in a BHC is not treated differently than the parent BHC. Relationships with joint ventures are not completely excluded. With the exception of shares held in connection with permissible underwriting, the final rule does not exempt interests held in merchant-banking affiliates or other permissible equity-ownership entities. Look-through treatment is required for options, warrants and other instruments so that ownership stakes are calculated at the maximum possible, albeit with certain exceptions. Numerous anti-evasion standards are also finalized.

[5] See *Client Report* **TAKEOVER9**, January 30, 2020.

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3. Definitions

Numerous definitions key to the provisions discussed below are revised in the final rule. However, the Board largely retained its definition of "total equity," which is key to the presumptions of control discussed below, rejecting recommendations to provide special provisions for start-up companies, change the treatment of retained earnings, or relax conditions in which debt is treated as equity. However, the final rule does clarify when debt is likely to be considered equity and specifies that debt will only be treated as equity in unusual circumstances where this is necessary to prevent evasion.

B. Control Tierings and Presumptions

The following is a guide to key facets of the new standard; clients are referred to the Fed's matrix showing how different relationships and ownership stakes align with specific restrictions. These increase as the potential for a controlling interest rises. Importantly, current requirements related to passivity commitments are withdrawn.

1. Notice

The Board may issue preliminary notices indicating that a transaction appears to provide control. A process for rebutting this is also laid out.

2. Control Criteria

The final rule, like the proposal, establishes tiered presumptions of control that rise with stringency as equity ownership increases, doing so based on the view that control is most likely with a larger ownership stake. Several of the control thresholds are based on voting equity, with tiers of control established for other ownership indicators based on whether the equity stake is below five, ten, or fifteen percent.

The control limit on non-voting equity is no more than one-third of a second company's total equity without regard to voting-share percentages (a change from the NPR).

The rule retains the current rebuttable presumption of control if it appears that the first company has covenants or other limiting rights enabling it to exert control over the second company; an illustrative list of limiting rights is provided. Indicia of control found on a case-by-case basis are included as a non-exclusive list of possible causes for such a control presumption, with these indicia clarified beyond those established in prior cases. Covenants and contractual rights structured to permit the exercise of conventional creditor rights even if a bank is both the first party and a creditor, would not generally lead to a finding of control.

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While the standards impose limits on the ability of a first party that is not a bank to govern a banking organization in which it invests, significant liberalizations apply to how many directors the non-controlling party may have on the bank's board and the active role they may play in governing it. Any provisions that limit discretion of target-company management over major operational or policy decisions would, however, be deemed to be controlling.

Further, business relationships between the first and second company may trigger a control finding based on how many there are, how relationships are structured, and the manner in which the transaction otherwise fits in the tiered-control framework. Business relationships would be measured based on the revenue and expenses of the second company, also judging business relationships by whether or not they are on market terms as measured with regard to certain inter-affiliate transactions between a bank and its parent holding company.

The final rule recognizes that its business-relationship framework could overlook other business relationships (i.e., funding flows, a demand that a company not do business with someone). The Fed has thus reserved the right to declare relationships as controlling even if specific tiered presumptions do not apply or when warranted by safety-and-soundness consideration. As proposed, the business-relationship criteria apply over the life of a business affiliation; no exceptions with regard to relationship criteria or measurement are provided despite comments seeking liberalizations to enhance bank/fintech affiliations.

3. Interlocks

The rule also includes tiered restrictions related to director interlocks. These are more liberal than current restrictions, even allowing a first-company person to serve as chairman of the second-company board if other control limitations are met. However, the definition of "director" is tightened to cover persons recently affiliated with the first company, and certain others.

The rule also addresses senior-management interlocks. A senior management official would be defined as any person who participates or has the authority to participate (other than as a director) in major policymaking functions of the second company. This liberalizes the current interlock ban, which applies to all management interlocks, not just those of senior management. However, a new presumption of control resulting from a first-company interlock with the second company's CEO is established.

4. Corporate Form

The final rule retains the proposed approach and thus does not differentiate tiered presumptions of control based on factors such as whether a company is closely held.

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C. Additional Presumptions of Control

Presumptions of control the Board has long used and now codifies include:

- management agreements;
- serving as an investment adviser to an investment fund controlling five percent or more of any class of the fund's voting securities or more than twenty percent of the fund's total equity. Certain exceptions apply, but one proposed for registered investment companies has been deleted from the final rule; and
- accounting consolidation under GAAP or other standards similar to GAAP.

D. Presumptions of Non-Control

A rebuttable non-control presumption occurs when voting equity is less than ten percent. However, holdings in a fiduciary capacity also create a non-control presumption.

E. Divestiture

The rule also includes new procedures laying out when a controlling influence is divested to the point at which presumptions of control may no longer apply. This generally occurs when voting interests drop below fifteen percent or after divesting to 25 percent and waiting two years.

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