

FEDERAL RESERVE SYSTEM

12 CFR Parts 225 and 238

Regulations Y and LL; Docket No. R-[--]

RIN [--]

Control and Divestiture Proceedings

AGENCY: Board of Governors of the Federal Reserve System (Board).

ACTION: Notice of proposed rulemaking with request for comment.

SUMMARY: The Board is inviting public comment on a proposal that would revise the Board's regulations related to determinations of whether a company has the ability to exercise a controlling influence over another company for purposes of the Bank Holding Company Act or the Home Owners' Loan Act. The proposal would significantly expand the number of presumptions for use in such determinations. By codifying the presumptions in the Board's Regulation Y and Regulation LL, the Board's rules would provide substantial additional transparency on the types of relationships that the Board would view as supporting a determination that one company controls another company. The proposed presumptions generally would be consistent with the Board's historical practice with respect to the types of relationships that raise, or do not raise, significant controlling influence concerns. Several of the proposed presumptions, however, would represent targeted adjustments relative to the Board's historical practice. Finally, the proposal would include various definitions and ancillary rules to ensure that the application of the proposed presumptions is clear, transparent, and consistent.

DATES: Comments must be received by [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by [Docket No. R-[--]] and RIN [--]] by any of the following methods:

- **Agency Web site:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.aspx>.
- **Email:** regs.comments@federalreserve.gov. Include the docket number and RIN number in the subject line of the message.
- **Fax:** (202) 452–3819 or (202) 452–3102.
- **Mail:** Address to Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.

All public comments will be made available on the Board’s Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.aspx> as submitted, unless modified for technical reasons or to remove sensitive PII at the commenter’s request. Public comments may also be viewed electronically or in paper form in Room 146, 1709 New York Avenue, NW, Washington, DC 20006 between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Laurie Schaffer, Associate General Counsel, (202) 452-2272, Alison Thro, Assistant General Counsel, (202) 452-2036, Greg Frischmann, Senior Counsel, (202) 452-2803, Mark Buresh, Counsel, (202) 452-5270, or Brian Phillips, Attorney, (202) 452-3321, Legal Division; Melissa Clark, Lead Financial Institution Policy Analyst, (202) 452-2277, Division of Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551. Users of Telecommunication Device for Deaf (TDD) only, call (202) 263-4869.

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I. Background and summary of the proposal

The Board is seeking comment on proposed revisions to its rules regarding the definition of control in the Bank Holding Company Act (“BHC Act”),¹ and the Home Owners’ Loan Act (“HOLA”).² Under the BHC Act, control is defined by a three pronged test: a company has control over another company if the first company (i) directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company; (ii) controls in any manner the election of a majority of the directors of the other company; or (iii) directly or indirectly exercises a controlling influence over the management or policies of the other company.³ HOLA includes a substantially similar definition of control.⁴ The proposed revisions are intended to provide bank holding companies, savings and loan holding companies, depository institutions, investors, and the public with a better understanding of the facts and circumstances that the Board generally considers most relevant when assessing controlling influence. The increase in transparency due to the proposed rule should provide greater clarity and ensure consistency of decision-making, thereby reducing regulatory burden for banking organizations and investors.

¹ 12 U.S.C. § 1841 et seq.

² 12 U.S.C. § 1461 et seq.

³ 12 U.S.C. § 1841(a)(2); 12 CFR 225.2(e).

⁴ See 12 U.S.C. § 1467a(a)(2); 12 CFR 238.2(e).

In the Board's experience, investors seeking to avoid the responsibilities and restrictions imposed on bank holding companies and savings and loan holding companies typically structure their investments to avoid the statutory definition of control. Although the first two prongs of the definition of control are bright-line standards that are easily understood by the public, the third prong of the definition of control is a facts and circumstances determination by the Board rather than a bright-line standard. As a result, it is often difficult for an investor seeking to avoid making a controlling investment to ensure that the investment will, in fact, be considered noncontrolling by the Board. Significant minority investors often seek to protect or enhance their investments through multiple forms of engagement with the target company that provide such investors with an opportunity to monitor and influence the target company. Consequently, a significant minority investment can, and often does, raise questions regarding whether the investor will be able to exercise a controlling influence over the management or policies of the target company.

The determination of whether a company has the ability to exercise a controlling influence over another company is a factual determination. The Board's experience generally has shown that the variety of equity investments, negotiated investment terms, and other business arrangements between investors and targets makes it difficult to prescribe a set of rigid rules that determine whether an investor exercises a controlling influence in all situations. As a result, Board determinations regarding the presence or absence of a controlling influence generally have taken into account the specific facts and circumstances of each case.⁵ Nonetheless, the Board has identified a number of factors and thresholds that the Board believes generally would be

⁵ See 12 CFR 225.143; Policy Statement on equity investments in banks and bank holding companies (September 22, 2008), www.federalreserve.gov/newsevents/press/bcreg/20080922c.htm.

indicative of the ability or inability of a company to exercise a controlling influence over another company.

Accordingly, the Board is proposing a tiered framework that would substantially revise and clarify the Board's existing regulatory presumptions of control.⁶ The proposed tiered framework is designed to incorporate the major factors and thresholds that the Board has typically viewed as presenting controlling influence concerns. The proposal is structured so that, as an investor's ownership percentage in the target company increases, the additional relationships and other factors through which the investor could exercise control generally must decrease in order to avoid triggering the application of a presumption of control. The proposal also would include several other presumptions of control, a new presumption of noncontrol, and additional provisions to clarify how the presumptions would apply in particular circumstances.

The Board intends for the proposed presumptions of control to clarify whether certain common fact patterns are likely to give rise to a controlling influence, which should substantially increase the transparency and consistency of the Board's control framework. Adding the proposed control presumptions to the Board's regulations should help to facilitate permissible investments in banking organizations and by banking organizations.

As a whole, the proposal generally would codify a significant portion of the Board's historical practice with respect to controlling influence. However, the proposal also includes certain targeted adjustments that the Board believes are appropriate based on its experience. In particular, compared to past practice, the proposal would permit an investor to have a greater number of director representatives at the target company without triggering a presumption of

⁶ See 12 CFR 225.31 and 238.21.

control, and would allow investors seeking to terminate an existing control relationship to do so while retaining greater levels of ownership.

A. Description of “control” under the Bank Holding Company Act

Control is a foundational concept under the BHC Act and related statutes.⁷ Most notably, control is used to determine the scope of application of the BHC Act. Specifically, a company is a bank holding company if the company directly or indirectly controls a bank. In assessing control, the Board historically has focused on two key purposes of the BHC Act to guide its understanding of the meaning of control and controlling influence. First, the BHC Act was intended to ensure that companies that acquire control of banks have the financial strength and managerial ability to exercise control in a safe and sound manner. Second, the BHC Act was intended to separate banking from commerce by preventing companies with commercial interests from exercising control over banking organizations and by restricting the nonbanking activities of banking organizations.⁸

Under the BHC Act, a company is a bank holding company if it directly or indirectly controls a bank or bank holding company.⁹ Accordingly, a company that controls a bank or bank holding company is subject to the Board’s regulations and supervisory oversight, which includes

⁷ The following discussion is limited to the BHC Act because the Board’s historical experience with control and controlling influence has arisen predominantly in the context of the BHC Act, rather than HOLA. The Board has attempted to apply substantially the same principles in the context of HOLA as it applies in the context of the BHC Act, while also recognizing the limited differences between the statutes with respect to the definition of control. The application of the proposal to savings and loan holding companies is described in greater detail later in this preamble.

⁸ Bank Holding Company Act Amendments: Hearing on H.R. 6778 Before H. Comm. on Banking & Currency, 91st Cong. 85 (1969).

⁹ 12 U.S.C. § 1841(a)(1).

regular examinations,¹⁰ financial reporting obligations,¹¹ capital and liquidity requirements,¹² source of strength obligations,¹³ activities restrictions,¹⁴ and restrictions on certain affiliate transactions.¹⁵

Congress enacted the BHC Act in 1956. In the original BHC Act, Congress defined “bank holding company” to mean any company that (1) “directly or indirectly owns, controls, or holds with power to vote, 25 per centum or more of the voting shares of each of two or more banks or of a company which is or becomes a bank holding company by virtue of this Act, or (2) which controls in any manner the election of a majority of the directors of each of two or more banks.”¹⁶

In 1970, Congress made significant amendments to the BHC Act, including significant revisions to the definition of control. The 1970 amendments retained the same core standards in the first two prongs of control from 1956, but added to the definition of control a new third prong. This third prong provided that a company has control over a bank or other company if the

¹⁰ 12 U.S.C. § 1844(c); 12 CFR 225.5(c).

¹¹ 12 U.S.C. § 1844(c); 12 CFR 225.5(b).

¹² See, e.g., 12 CFR 225 app. C; 12 CFR part 217.

¹³ 12 U.S.C. § 1831o-1.

¹⁴ 12 U.S.C. § 1843; 12 CFR 225 subpart C.

¹⁵ 12 U.S.C. §§ 371c and 371c-1; 12 CFR part 223.

¹⁶ Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (May 9, 1956). The original BHC Act also defined “bank holding company” to include a company that holds 25 percent or more of the voting shares of two or more banks or bank holding companies, if such shares are held by trustees for the benefit of the shareholders or members of the company. to include a company that holds 25 percent or more of the voting shares of two or more banks or bank holding companies, if such shares are held by trustees for the benefit of the shareholders or members of the company. This prong of control was repealed in 1966. See An Act to Amend the Bank Holding Company Act of 1956, Pub. L. No. 89-485, 80 Stat. 236 (July 1, 1966).

“Board determines after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company” (“controlling influence”).¹⁷ Congress included the controlling influence prong to address concerns that a company could structure an investment in a bank below the two bright-line thresholds of control while still having the “power directly or indirectly to direct or cause the direction of the management or policies of any bank.”¹⁸

B. Summary of the Board’s historical interpretation of “control” under the Bank Holding Company Act

Since the 1970 amendments to the BHC Act, the Board has had numerous occasions to interpret and apply the controlling influence prong of the BHC Act. The Board has long held that controlling influence does not require an investor to exercise complete domination or absolute control over all aspects of the management and policies of a company. Instead, the Board has found that a controlling influence is possible even if the first company is not able to

¹⁷ An Act to Amend the Bank Holding Company Act of 1956, Pub. L. No. 91-607, 84 Stat. 1760, 1761 (December 31, 1970). HOLA, originally enacted in 1933, contains substantially similar language for its definition of control. Specifically, HOLA defines control by a person of a savings association or other company to include, among other things, “if the Board determines after reasonable notice and opportunity for hearing, that such person directly or indirectly exercises a controlling influence over the management or policies of such association or other company.” 12 U.S.C. § 1467a(a)(2)(D).

¹⁸ Bank Holding Company Act Amendments: Hearing on H.R. 6778 Before H. Comm. on Banking & Currency, 91st Cong. 87 (1969).

dictate the outcome of a significant matter under consideration.¹⁹ Thus, control requires only “the mere potential for manipulation of a bank.”²⁰

Historically, in assessing the controlling influence prong, the Board has considered a number of factors, including the size of the first company’s voting and total equity investment in the second company; the presence of countervailing shareholders of the second company; the first company’s representation on the board of directors or board committees of the second company; any covenants or other agreements that allow the first company to influence or restrict the management decisions of the second company; and the nature and scope of the business relationships between the companies.²¹

The Board provided initial guidance on the controlling influence prong by issuing a limited set of regulatory presumptions of control in 1971.²² The Board made slight modifications to these presumptions in connection with the comprehensive revisions to Regulation Y in 1984.²³ The Board has not materially modified these regulatory presumptions of control since 1984.

¹⁹ Patagonia Corp., 63 Federal Reserve Bulletin 288 (1977) (citing Detroit Edison Co. v. S.E.C., 119 F.2d 738, 739 (6th Cir. 1941) (interpreting “controlling influence” in the Public Utility Holding Company Act, which has a nearly identical definition of control as in the BHC Act, to not “necessarily [require] those exercising a controlling influence [to] be able to carry their point.” Rather a controlling influence can be effective “without accomplishing the purpose fully”)).

²⁰ Interamericas Investments, Ltd. v. Bd. of Governors of the Fed. Reserve Sys., 111 F.3d 376, 383 (5th Cir. 1997).

²¹ A relationship between two companies may raise supervisory or other concerns whether or not the relationship raises controlling influence concerns.

²² 36 Fed. Reg. 18945 (Sept. 24, 1971).

²³ 49 Fed. Reg. 794, 817, 828–29 (Jan. 5, 1984).

The Board also has issued various public policy statements to provide guidance regarding the controlling influence prong of the BHC Act. In 1982, for example, the Board issued a Policy Statement on Nonvoting Equity Investments by Bank Holding Companies (the “1982 Policy Statement”).²⁴ The 1982 Policy Statement outlined the standards that the Board would consider in reviewing whether an investment in a banking organization would result in the Board determining that the investor was able to exercise a controlling influence over the management or policies of the banking organization. The 1982 Policy Statement focused on issues of particular concern in the 1980s in the context of investments by bank holding companies in out-of-state banking organizations. For example, the 1982 Policy Statement addressed investments that included a long-term merger or stock purchase agreement between the investor and the target banking organization that would be triggered upon a change in the interstate banking laws, as well as so-called “lock-up” arrangements designed to prevent another company from acquiring the target banking organization without the permission of the investor.

The Board recognized in the 1982 Policy Statement that the complexity of minority investments precluded rigid rules designed to cover all situations of control. As a result, the Board noted that decisions regarding the existence of control in any particular case generally should take into account the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board articulated certain factors in the 1982 Policy Statement that provided guidance for bank holding companies to understand the concept of controlling influence. For example, the 1982 Policy Statement noted that certain common contractual covenants substantially limited the discretion of the target company’s management over major policies and decisions, such as restrictions on

²⁴ See 68 Federal Reserve Bulletin 413 (July 1982) (codified at 12 CFR 225.143).

entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters.²⁵ The Board indicated that covenants of this type likely would constitute a controlling influence by the investing company over the target company.²⁶

In 2008, the Board issued another policy statement on equity investments in banks and bank holding companies to clarify its views on controlling influence (the "2008 Policy Statement").²⁷ In the 2008 Policy Statement, the Board stated that it had reviewed its experience with director interlocks, limits on the amount of nonvoting shares that could be held in combination with voting shares, and the scope of discussions that minority investors could have with management of the banking organization. The Board noted that it continued to believe that a determination of whether an investor could exercise a controlling influence over a banking organization depended on the consideration of all the facts and circumstances of each case. The Board, however, provided guidance on certain types of relationships that generally would not raise controlling influence concerns. For example, the Board noted that it generally would not find a controlling influence if a minority investor had a single director representative on the board of directors of a banking organization. In addition, the Board noted that a representative of a noncontrolling investor who serves on the board of directors of the banking organization generally should not serve as the chair of the board of the banking organization or as the chair of

²⁵ 12 CFR 225.143(c)(4).

²⁶ Id.

²⁷ See Policy Statement on equity investments in banks and bank holding companies (September 22, 2008). The Board did not rescind the 1982 Policy Statement, and that statement continues to reflect the Board's views on questions of control to the extent not superseded by the 2008 Policy Statement.

a committee of the board of the banking organization. The 2008 Policy Statement noted that representatives of a noncontrolling investor could serve as members of committees of the board of the banking organization without raising significant control concerns, provided that the director representatives did not occupy more than 25 percent of the seats on any committee and the committee did not have the authority or practical ability to make or block major policy decisions of the banking organization.

Regarding nonvoting equity investments, the Board noted in the 2008 Policy Statement that the overall size of an equity investment, including both voting and nonvoting equity, was an important indicator of the degree of influence an investor could have. Accordingly, the Board noted that, in most circumstances, an investor that owns 25 percent or more of the total equity of a banking organization owns enough of the capital resources of a banking organization to have a controlling influence over the management or policies of the banking organization. However, the Board noted that it would not expect an investor to have a controlling influence over a banking organization if the investor owned a combination of voting shares and nonvoting shares that, when aggregated, represented less than one-third of the total equity of the organization and less than 15 percent of every class of voting securities of the organization.

The Board also extensively discussed business relationships in the 2008 Policy Statement. The Board noted that not all business relationships provided an investor the ability to exercise a controlling influence over the management or policies of a banking organization. The Board explained that it did not have significant control concerns with business relationships that were quantitatively limited and qualitatively nonmaterial, particularly in situations where a noncontrolling investor's percentage of voting securities in the banking organization was closer to 10 percent than 25 percent. As such, the Board noted that it would pay particular attention to

the size of proposed business relationships and to whether the relationships would be on market terms, nonexclusive, and terminable without penalty by the banking organization.

C. Summary of proposal

Based on its historical experience with the controlling influence prong of the BHC Act, the Board is proposing to substantially revise and augment its regulations regarding control.²⁸ The proposed tiered presumptions of control are designed to enhance transparency and improve consistency of outcomes for controlling influence questions under the BHC Act and HOLA. The discussion that follows explains the proposed revisions to the existing presumptions of control, and sets forth and explains the proposed new presumptions of control and noncontrol.

As discussed elsewhere in this proposal, the BHC Act and HOLA provide that control due to controlling influence only arises once the Board determines, based on the facts presented and after notice and opportunity for a hearing, that a company controls another company. The proposed presumptions are intended to assist the Board in conducting such a hearing or other proceeding and to provide additional information to the public regarding the circumstances in which the Board believes that controlling influence is likely to exist. Notwithstanding the presumptions of control or noncontrol, the Board may or may not find there to be a controlling influence based on the facts and circumstances presented by a particular case. However, the Board generally would not expect to find that a company controls another company unless the first company triggers a presumption of control with respect to the second company.

²⁸ The Board has issued two additional policy statements that are relevant to the meaning of control and controlling influence: “Statement of policy concerning divestitures by bank holding companies” (12 CFR 225.138) and “Presumption of continued control under section 2(g)(3) of the Bank Holding Company Act” (12 CFR 225.139). These more targeted policy statements are discussed further below in the context of the proposed presumption related to divestiture of control.

This proposal relates solely to the issue of whether an investment, alone or in combination with other relationships, raises controlling influence concerns. The Board may have safety and soundness or other concerns arising out of either controlling or noncontrolling relationships.²⁹ Thus, that an investment would not be presumed to be controlling would not mean that the investment and all other aspects of the relationship would necessarily be consistent with safe and sound banking practices or other expectations or requirements of the Board. The Board retains the right to examine all banking entities under its jurisdiction for potential safety and soundness or other concerns.

II. Proposed presumptions of control and noncontrol

A. Control hearings and the role of presumptions of control and noncontrol

As noted, the BHC Act provides that control due to controlling influence arises following a Board determination that a company controls another company. The proposed presumptions of control are intended to assist the Board in reaching such a determination and to provide additional public information regarding the Board's views on controlling influence.

Under the procedures currently in Regulation Y and under the proposal, the Board, in its discretion, may issue a preliminary determination of control if it appears that a company has the power to exercise a controlling influence over a bank or other company. A company that receives a preliminary determination of control must respond within 30 days with (i) a plan to terminate the control relationship; (ii) an application for the Board's approval to have control; or

²⁹ Most notably, contractual covenants and business relationships between companies may raise safety and soundness and other concerns where the relationship between the companies does not raise controlling influence concerns. For example, a contractual provision may not allow a company to restrict substantially the discretion of a banking organization, but may impose financial obligations on the second company that are inconsistent with safe and sound operation of the banking organization.

(iii) a response contesting the preliminary determination, setting forth supporting facts and circumstances, and, if desired, requesting a hearing or other proceeding. If a company contests a preliminary determination and requests a hearing or other proceeding, then the Board shall order a hearing or other appropriate proceeding if material facts are in dispute. The proposed presumptions would apply at such a hearing or other proceeding in accordance with the Federal Rules of Evidence and the Board's Rules of Practice for Formal Hearings. After considering all relevant facts and circumstances, including information gathered during any hearing or other proceeding, the Board would issue a final order stating its determination on controlling influence.

B. Description of Indicia of Control

The proposed rule would incorporate some of the Board's common historical considerations for assessing whether a company, typically a minority equity investor, has the power to exercise a controlling influence over the management or policies of another company. The proposal would not cover all facts and circumstances that could potentially relate to controlling influence due to an investor's investment in, and relationship with, another company. Although the proposal generally would be consistent with historical practice, in some instances the proposed rule would adjust the Board's past practices. Overall, the proposed rule would substantially expand on the existing rebuttable presumptions of control in section 225.31 of Regulation Y to include additional rebuttable presumptions of control, and a new rebuttable presumption of noncontrol. Generally, these rebuttable presumptions would be structured based on specified thresholds of voting ownership and the scope of different relationships between companies that the Board believes may justify a determination of control. Absent unusual circumstances, the Board generally would not expect to find that a company controls another

company where the first company is not presumed to control the second company under the proposal.

The rebuttable presumptions of control would be based on the types and levels of relationships that the Board historically has viewed as allowing one company to have the power to exercise a controlling influence over another company, including: (i) the size of the first company's voting equity investment in the second company; (ii) the size of the first company's total equity investment in the second company; (iii) the first company's rights to director representation and committee representation on the board of directors of the second company; (iv) the first company's use of proxy solicitations with respect to the second company; (v) management, employee, or director interlocks between the companies; (vi) covenants or other agreements that allow the first company to influence or restrict management or operational decisions of the second company; and (vii) the scope of the business relationships between the companies.³⁰

Voting and nonvoting equity investments

A company's voting ownership in another company is typically the most direct mechanism through which control is exercised. The greater the first company's voting ownership in the second company, the greater the ability of the first company to exercise significant influence over the management and policy decisions of the second company by voting its shares on issues presented to the shareholders or by voting on director nominees. Thus, a company with significant voting ownership in a second company has a direct and effective lever by which to influence the second company.

³⁰ See 2008 Policy Statement.

Similarly, as a company's economic interest in another company increases, it provides a powerful incentive for the first company to wield its influence over the second company to protect or grow its investment. This incentive to wield influence due to significant economic exposure does not require the first company's shares to be voting shares. An investor with a substantial equity position in a company has a significant amount of money at stake in the enterprise and is among the first to absorb losses if the banking organization has financial difficulties. Moreover, a company is likely to pay heed to its large shareholders (voting or nonvoting) to help ensure it has the ability to raise additional equity capital in the future and to prevent the negative market signal that would be created by the sale of a large block of voting or nonvoting equity by an existing shareholder. Based on these considerations, the Board historically has been concerned with nonvoting equity interests in addition to voting ownership as a potential means of exercising a controlling influence.

Director Representation

Director representatives of an investor also can provide the investor with a mechanism through which to exercise a controlling influence over the management and policies of another company. For example, director representatives allow the investor to access information of the company that might not otherwise be accessible. In addition, director representatives participate in decisions regarding major operations and policies of the company. Accordingly, the Board has historically limited a noncontrolling investor's director representation to one or two director representatives. The Board continues to believe that director representatives are a significant conduit through which an investor could exercise a controlling influence.

Proxy Solicitations

Historically, the Board has taken the position that a significant investor may raise controlling influence concerns by soliciting proxies contrary to the recommendations of the board of directors of a company. By definition, proxy solicitations are related to matters presented to the shareholders of a company for a vote. These matters include regular matters, such as the election of directors, or special matters, such as major transactions. How shareholders vote on these matters can have a significant impact on the management and policies of the company, which is why proxy solicitations may raise controlling influence issues. However, the Board also has recognized that noncontrolling shareholders may exercise certain of their core rights as shareholders and that it is important that the Board's standards balance normal shareholder activities with controlling influence concerns.

Management Interlocks

Management interlocks are another mechanism through which a company may exercise a controlling influence over a second company. A management interlock exists when a management official of a company is also a management official of another company. Management interlocks can permit the first company to gather nonpublic information regarding the second company. In addition, a management official associated with the first company can advocate, or in some cases decide, that the second company adopt policies supported by the first company. Accordingly, the ability of the first company to have management officials at the second company, combined with an equity interest, provides the first company with the ability and incentive to influence the management or policies of the second company.

Contractual rights that influence or restrict management policies or operations

Contractual provisions that provide a company with a right to influence or restrict the management, policies, or operations of another company may present controlling influence concerns. Specifically, contractual provisions may present controlling influence concerns when they give a company veto rights or effective veto rights over management, policies, or operations of a second company. Not all restrictive contractual rights raise significant controlling influence concerns. In particular, the Board is aware that standard debtor-creditor covenants often impose material restrictions; however, the Board does not believe that such restrictions, in the context of a debtor-creditor relationship, by themselves raise controlling influence concerns. Instead, the Board is concerned when material equity ownership is combined with contractual provisions that restrict the management, policies, or operations of the second company because the contractual rights may be used to enhance a company's influence as an equity investor.³¹

Business Relationships

The Board has traditionally raised controlling influence concerns when a company has both a material equity investment and material business transactions or relationships with another company. The Board has historically taken the view that a major supplier, customer, or lender to a company can exercise considerable influence over the company's management and policies, especially when combined with a sizeable voting investment, by threatening to terminate or change the terms of the business relationship. The Board also has noted, however, that not all business relationships provide an investor with a controlling influence over the management and

³¹ Contractual provisions that raise controlling influence concerns may often raise safety and soundness concerns. For example, a contractual provision that restricts the ability of a company to issue additional common stock restricts the discretion of a company and limits the ability of the company to raise additional capital going forward.

policies of their business counterparties. Accordingly, the Board has not viewed business relationships that are quantitatively limited and qualitatively nonmaterial as raising significant controlling influence concerns.³²

The Board continues to believe that certain material business relationships between an investor and a target company raise significant controlling influence concerns. The combination of a material voting stake in a company, combined with material business relationships, frequently provides both a mechanism and incentive to exert a controlling influence over the management and policies of the company.³³

C. Description of the proposed tiered presumptions

As discussed previously, a core consideration for control established by Congress in the BHC Act is the percentage of voting securities that a company controls of a second company. Under the statute, a company that controls 25 percent or more of any class of voting securities of a second company controls the second company.³⁴ Similarly, under the statute, a company that controls less than 5 percent of any class of voting securities of a company is presumed not to control the second company.³⁵ This statutory framework leaves a space between 5 percent and 25 percent of a class of voting securities where a company is neither presumed to control a second company nor presumed not to control a second company. For companies within this

³² See 2008 Policy Statement.

³³ Business relationships may raise safety and soundness concerns whether or not controlling influence concerns are raised. For example, business relationships may present excessive counterparty or compliance risks even if controlling influence is not implicated. Further, changes in business relationships and the companies involved may give rise to control or safety and soundness concerns under future circumstances.

³⁴ 12 U.S.C. § 1841(a)(2)(A).

³⁵ 12 U.S.C. § 1841(a)(3).

range of voting ownership, the Board has considered the full facts and circumstances of the relationship between the two companies when determining whether the first company controls the second company, consistent with the controlling influence prong of the BHC Act.³⁶

The framework established by Congress implies that a company with a level of voting ownership at the higher end of the range—closer to 25 percent—is more likely to control the second company. Similarly, the statutory framework implies that a company with a level of voting ownership at the lower end of the range—closer to 5 percent—is less likely to control the second company. The Board’s experience supports these implications. As a result, where a company’s voting ownership percentage falls within this range is one of the most salient considerations for determining whether the first company controls the second company. Nonetheless, to support a determination of control for a company that controls less than 25 percent of any class of voting securities of a second company, additional factors relating to the ability to exercise a controlling influence generally should be considered.

The proposal would provide a series of presumptions of control for use by the Board in control proceedings and other control determinations. These presumptions are arranged in tiers based on the level of voting ownership of the first company in the second company. Each of these presumptions would apply where the first company has at least a specified level of voting ownership in a second company, and another specified relationship with the second company. The presumptions would be keyed off of three levels of voting ownership: 5 percent, 10 percent, and 15 percent. Five percent is the level of voting ownership at which the statutory presumption of noncontrol ceases to apply.³⁷ Ten percent is a level of voting ownership used by the Board in

³⁶ 12 U.S.C. § 1841(a)(2)(C).

³⁷ 12 U.S.C. § 1841(a)(3).

other circumstances to identify major investors in banking organizations.³⁸ Finally, investors at the level of 15 percent or higher are significant investors closer to statutory control at 25 percent than presumed noncontrol at less than 5 percent.³⁹

Since Congress added the controlling influence prong to the BHC Act in 1970, the Board has had substantial experience analyzing whether the facts and circumstances of a particular relationship between two companies provide one company with the ability to control the other company. From this experience, the Board has been able to identify certain relationships between companies in addition to voting ownership that are important in determining whether the overall relationship provides a company the ability to exercise a controlling influence over the other company.

Many of these control factors vary in magnitude. For example, the level of business relationships between two companies can range from minimal to very significant, and a more significant business relationship provides a greater means of exercising (and a greater incentive to exercise) a controlling influence than a less significant business relationship. In recognition of this, the proposal would generally presume that higher levels of business relationships, combined with higher levels of voting ownership, increase the ability to exercise a controlling influence. Thus, the proposal would essentially aggregate the means by which a company could exercise a controlling influence—including the combination of control over voting securities and the significance of business relationships—to determine if the threshold for exercising a controlling influence is met. Under this approach, the proposal would presume that a company can exercise a controlling influence if it has high levels of voting ownership and business relationships of

³⁸ See, e.g., 12 CFR 225.2(n)(2); 12 CFR 225.41(c)(2).

³⁹ The Board has used 15 percent as a relevant threshold in certain control precedents. See, e.g., 2008 Policy Statement at 10.

lesser magnitude, or, alternatively, lower levels of voting ownership and business relationships of more substantial magnitude.

Director Representation

The Board has long considered a company's level of representation on the board of directors of a second company as an important factor for controlling influence. Traditionally, the board of directors of a company is the body that makes strategic decisions and establishes major policies for the company. Indeed, one of the most important rights of holders of voting securities of a company is the ability to participate in the selection of the members of the board of directors of the company. Under recent precedent, the Board generally has considered a single director representative to be the maximum director representation for a noncontrolling investor with at least 10 percent of a class of voting securities.⁴⁰ The Board, however, has considered a second director representative to be consistent with status as a noncontrolling investor when two director representatives represent a share of the target company's board that is proportional to the investor's voting ownership in the company and when there is another larger shareholder that controls the company.⁴¹

For a company that controls 5 percent or more of any class of voting securities of a second company, the proposal would presume control if the first company controlled a quarter or more of the board of directors of the second company. At over 5 percent of a class of voting securities, the voting power of the first company is substantial and in excess of the threshold under which the first company would be presumed not to control the second company under the BHC Act. When this material level of voting power is combined with control over a quarter or

⁴⁰ 2008 Policy Statement at 6.

⁴¹ 2008 Policy Statement at 7.

more of the board of directors, the influence of the first company is likely to be substantial enough to constitute a controlling influence. However, the proposed presumption is designed to allow a less than 25 percent voting shareholder to vote its shares to elect a proportional share of the members of the board of directors of the second company without triggering a presumption of control. The proposal would provide a more permissive director representation standard for 10 to 24.9 percent investors than current practice.

In addition, the proposal would presume that a company that controls 5 percent or more of any class of voting securities of a second company controls the second company if the first company has director representatives that are able to make or block the making of major operational or policy decisions of the second company. This is intended to account for supermajority voting requirements, individual veto rights, or any similar unusual provision that would allow a minority of the board of directors of the second company to control effectively major operational or policy decisions of the second company.

Furthermore, for a company that controls less than 5 percent of every class of voting securities of a second company, the proposal would not include a presumption of control by the first company based on the level of director representation of the first company. As a result, a company with less than 5 percent of every class of voting securities of a second company would generally only control the second company due to director representation if the first company controls a majority of the board of directors of the second company and thereby controls the second company under the second prong of the definition of control in the BHC Act.

Question 1: Should the proposed presumption instead allow an investor to have director representation that is proportional to its voting percentage without triggering a presumption of

control? Or, should the proposed presumption require an inverse relationship between voting percentage and director representation to avoid triggering a presumption of control?

In addition to the number of director representatives that one company has on the board of directors of a second company, the proposed presumptions would consider certain roles that director representatives may have that increase the ability of a particular director to affect the decisions of a company. For instance, serving as chair of the board of directors is generally a position of heightened influence. The chair of the board of directors is generally recognized as a leader of both the company and the board of directors. The chair often has powers that other directors do not have, such as the ability to set the agenda for meetings of the board of directors.

Similarly, certain committees of the board of directors are granted the power to take certain actions that bind the company without the need for approval by the full board of directors. In the Board's experience, examples of committees that may have these powers include the audit committee, compensation committee, and executive committee. As a result, the Board may have controlling influence concerns if director representatives of a company occupy a substantial proportion of the seats on a committee of the board of directors of a second company that has the power to take action that binds the company.

To recognize the enhanced power wielded by directors in the positions described in the paragraphs above, the proposal would include a presumption of control if the first company controls 15 percent or more of any class of voting securities of a second company and if any director representative of the first company also serves as the chair of the board of directors of the second company.

Regarding committee service, the proposal would include a presumption of control if a company controls 10 percent or more of any class of voting securities of a second company and

the director representatives of the first company occupy more than a quarter of the positions on any board committee of the second company with power to bind the company without the need for additional action by the full board of directors.

These presumptions are similar to, but modestly more permissive than, the Board's historic position with respect to the roles of director representatives. Historically, the Board has raised controlling influence concerns when a company controls 10 percent or more of any class of voting securities of a second company and has a director representative serving as chair of the board of directors of the second company. As noted, however, the proposed chair presumption would apply only if a company controls 15 percent or more of any class of voting securities of a second company. Fifteen percent has been chosen because, as discussed elsewhere in this proposal, 15 percent represents a very significant level of ownership that is closer to statutory control at 25 percent than presumed noncontrol at less than 5 percent.

Regarding committee service, the Board historically has raised controlling influence concerns when a company controls 10 percent or more of a class of voting securities of a second company and has a director representative serving on a committee that has the power to bind the company or serving on a committee with fewer than four members. As noted, the proposal would presume control only if a company controls 10 percent or more of any class of voting securities of a second company and director representatives of the first company occupy more than a quarter of the seats on any committee of the board of directors of the second company that has the power to bind the second company. The power of a director representative serving on such a committee is based to a significant extent on the size of the committee, just as the size of the full board affects the power of an individual director. Accordingly, the presumption for director representation at the committee level is designed to mirror approximately the level of

director representation that would be permitted at the second company's board of directors without triggering a presumption of control.

Question 2: Should the chair of the board presumption include a distinction based on whether the shares of the second company are widely held? Does the chair's role in a public company versus a private company provide a greater or lesser ability to exercise a controlling influence and, if so, how should the proposed presumption recognize this difference?

Question 3: Should the committee presumption be modified to take into account the different scope of authority that may be exercised by different committees? For example, some committees might be empowered to make only very specific decisions on behalf of the company—such as an audit committee selecting the outside auditor—while other committees might be empowered generally to make decisions on behalf of the company—such as some executive committees. Should the presumption take this or any similar considerations into account and, if so, what standard should the Board use to differentiate committees with sufficient powers to raise control concerns from committees with more limited powers?

The proposal also would include a presumption regarding the solicitation of proxies for the election of directors. Historically, the Board has raised control concerns when a company that controls 10 percent or more of a class of voting securities of a second company solicits proxies in opposition to the recommendation of the board of directors of the second company. A significant investor organizing other shareholders to replace members of the board of directors, for example, could be a way for the investor to influence the existing members of the board of directors, even those members of the board of directors that the investor has not targeted for removal.

The proposal would include a more narrow form of this presumption. Specifically, a presumption of control would be triggered if a company that controls 10 percent or more of any class of voting securities of a second company solicits proxies to appoint a number of directors that equals or exceeds a quarter of the total directors on the board of directors of the second company. This would align the presumption for proxy solicitations to elect directors with the proposed presumption for having director representatives. As a result, a company would be able to conduct a proxy solicitation in opposition to the board of directors of a second company without triggering a presumption of control, so long as the number of directors proposed in the proxy, together with any other director representatives of the first company, was not greater than the number of director representatives that the first company could have on the board of directors of the second company. This would allow investors somewhat greater ability to engage in standard shareholder activities without raising significant control concerns.

Business Relationships

The Board has long considered whether a company's business relationships with a second company could provide a mechanism through which the first company could exercise a controlling influence over the second company. The Board has considered both the size and nature of the business relationships between two companies, as well as whether the business relationships are on market terms.

The Board historically has taken the view that a major supplier, customer, or lender to a banking organization could exercise considerable influence over the banking organization's management and policies, especially when coupled with a sizeable voting stock investment. In particular, a business relationship between an investor and another company that accounts for a substantial portion of the revenues or expenses of either company may create a financial

incentive for the first company to attempt to influence the second company. Furthermore, the business relationship may provide a means for the first company to exert influence over the second company, for example by threatening to terminate or alter the business relationship if the second company does or does not take a particular action. This ability to influence is heightened when the business relationship is substantial or if the second company is dependent on the relationship. Thus, a company with an equity investment in a second company could enhance its influence over the second company through significant business relationships with the second company.

Under the proposal, the Board would presume control in the following circumstances:

(i) if a company controls 5 percent or more of any class of voting securities of a second company and has business relationships with the second company that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the first company or the second company;

(ii) if a company controls 10 percent or more of any class of voting securities of a second company and has business relationships that generate in the aggregate 5 percent or more of the total annual revenues or expenses of the first company or the second company; or (iii) if a company controls 15 percent or more of any class of voting securities of a second company and has business relationships that generate in the aggregate 2 percent or more of the total annual revenues or expenses of the first company or the second company.

The Board's control precedents with respect to business relationships have varied significantly based on the facts and circumstances presented. These proposed thresholds would be roughly in line with certain Board precedents, but may be more permissive than certain other precedents. The Board believes that the proposed business relationship presumptions are

appropriate based on its historical experience considering issues of controlling influence arising from a combination of control over voting securities and business relationships.

Question 4: The proposal would quantify business relationships based on the percentage of total annual revenues and expenses of the first company and the second company. What types of business relationships that might raise control concerns would not be captured by these metrics but would be captured by other metrics, such as assets or liabilities? What additional metrics, if any, should the Board consider for purposes of these proposed presumptions?

Question 5: Should the Board permit greater or lesser amounts of business relationships under the proposed presumptions? If so, what levels of greater or lesser business relationships should be permitted without triggering a presumption of control?

Question 6: Are there particular business relationships, such as funding relationships, that raise controlling influence concerns regardless of their quantitative impact on the financial statements of the first company or the second company?

Question 7: Should the presumptions incorporate limits on business relationships in light of the economic significance of such relationships to both the first company and the second company? Would it be appropriate to apply different thresholds in the presumptions to measure the materiality of a business relationship to the first company versus the second company?

Question 8: Is the proposed measurement of business relationships for purposes of the presumptions sufficiently clear? Would companies have any difficulty measuring the economic significance of a business relationship as described in the presumptions? If so, would a shorter measurement period (e.g., quarterly) or a longer measurement period be appropriate? Is the proposed annual measurement period appropriate for all business relationships or should the proposal provide alternative standards for certain relationships?

In addition, if a company is able to enter into a business relationship with a second company on terms that are more favorable than market terms, it is likely that the first company has a significant level of influence over the second company. As such, the Board would presume control if a company controls 10 percent or more of any class of voting securities of a second company and has business relationships with the second company that are not on market terms.

Question 9: Is the proposed market terms presumption necessary or appropriate? What standards should the Board apply in this context to determine whether a business relationship is on market terms?

Senior Management Interlocks

The officers of a company wield significant power over the company because they implement the major policies set by the board of directors, make all the ancillary policy decisions necessary for implementation, and operate the company on a day-to-day basis. In addition, officers often make recommendations to the board of directors regarding major policy decisions. As a result of this substantial degree of influence, the Board historically has viewed situations where an agent of a significant investor company serves as a management official of another company as providing a significant avenue for the first company to exercise a controlling influence over the second company. Specifically, the Board generally has found controlling influence if a company controls 10 percent or more of a class of voting securities of a second company and has any management official interlock with the second company.

The proposal would presume control if a company that controls 5 percent or more of any class of voting securities of a second company has more than one senior management interlock with the second company. In addition, the proposal would include a presumption of control if a company that controls 15 percent or more of any class of voting securities of a second company

has any senior management interlock with the second company. In order to trigger either of these presumptions, the individual would have to serve as an employee or director at the first company and as a senior management official at the second company. Senior management official would be defined 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 definition would help provide clarity around which individuals would be covered by the senior management interlock presumptions and would reflect a slight liberalization of current practice by limiting the presumptions to senior management officials, rather than management officials more generally.

In addition, the proposal would presume control if a company that controls 5 percent or more of any class of voting securities of a second company has an employee or director who serves as the chief executive officer (or an equivalent role) of the second company. The chief executive officer of a company is generally the most powerful executive officer of the company. The proposed chief executive officer presumption would be more conservative than current practice, which does not provide for specific treatment for an interlock involving a chief executive officer and which generally does not raise controlling influence concerns based on interlocks with a company that controls less than 10 percent of a class of voting securities.

Question 10: Should the Board maintain, raise, or lower the proposed voting ownership threshold at which a company would be presumed to control a second company if there is a single senior management official interlock? Other than chief executive officer, are there any other common senior management positions that should be subject to a specific presumption of control? Should the Board expand the senior management interlock presumption to include, for example, all management officials of the second company?

Contractual Limits on Major Operational or Policy Decisions

A company often acquires control over voting securities of a second company under a contractual agreement that includes various covenants between the companies. A company that controls a material amount of voting securities of a second company also may have contractual arrangements with the second company, such as investment agreements, debt relationships, service agreements, or other business relationships. Often, these contractual rights do not raise controlling influence concerns because the rights, for example, are very limited in scope or reinforce the protections provided to the investor under the law. However, the Board has viewed many of these contractual agreements as raising controlling influence concerns when the agreement has the effect of enhancing an investor's influence over the target company. This often arises when investors seek and obtain covenants obligating the target company to act or not act in a particular way.⁴² This can also occur independent of an equity investment agreement, such as restrictive covenants in a loan agreement that benefit a lending company that also controls a material amount of voting securities of the debtor company.

Contractual rights often raise controlling influence concerns when they provide an investor with the ability to direct or block the major operational or policy decisions of the target company. For example, the board of directors of a company generally decides whether to recommend that shareholders accept an offer to sell the company to a third party, and shareholders generally decide whether to accept such an offer by majority vote. If a contract between a company and an investor provides that the company may not accept a takeover offer without the consent of the investor, the contract effectively provides the single investor the

⁴² Contractual covenants also may raise safety and soundness concerns, such as a covenant that impairs the ability of a banking organization to raise additional capital, or a covenant that imposes substantial financial obligations on a banking organization.

ability to override a decision by the board of directors and the shareholders to accept a takeover offer. The ability to veto an important business decision of a company provides an investor with the ability to exercise a controlling influence over a major operational or policy decision of the company.

However, the Board has long recognized that contracts governing business relationships, including many loan agreements, contain restrictive covenants and that the existence of these covenants has not been sufficient, in itself, to constitute a controlling influence. The Board generally has allowed companies to enter into restrictive covenants with each other for purposes of loan transactions or commercial services without raising controlling influence concerns. However, when a company has a material voting ownership interest in another company and has covenants that restrict the target company, the covenants have raised controlling influence concerns. This has been true whether the covenants arise directly from the equity investment (e.g., are contained in a stock purchase agreement or related documents) or arise from some creditor or other business relationship between the companies.

As noted previously, there is a presumption in the BHC Act that a company that controls less than 5 percent of any class of voting securities of a second company does not control the second company. A company with a 5 percent or greater voting interest in a second company has a material voting interest in the second company and, as a result, a core feature of the first company's relationship with the second company is an investor-investee relationship, even if the first company and the second company also have other material relationships.

The proposal would presume a company to control a second company if the first company owns 5 percent or more of any class of voting securities of the second company and if the first company has any contractual right that significantly restricts the discretion of the second

company over major operational or policy decisions. A company with less than 5 percent of each class of voting securities of a second company would not be presumed to control the second company even if the first company has covenants that significantly restrict the discretion of the second company over major operational and policy decisions. As a result, the presumptions would recognize the potentially significant influence that covenants can provide while also recognizing the use of standard restrictive covenants in loan agreements and other market-terms business relationships.

The presumption of control under the proposal would use a new defined term, “limiting contractual right,” which would be defined to mean a contractual right that significantly restricts, directly or indirectly, the discretion of a company over major operational or policy decisions. The proposal would include a nonexclusive list of examples of contractual rights that are considered to be limiting contractual rights, as well as a nonexclusive list of examples of contractual rights that are not considered to be limiting contractual rights. These examples should provide additional transparency and clarity regarding the scope of the presumption. These examples are described in greater detail in the definitions section later in this discussion.

Total equity

The Board has long subscribed to the view that the overall size of an equity investment, including both voting and nonvoting equity, is an important indicator of the degree of influence an investor may have. Investors with large equity investments have a powerful incentive to wield influence over the company in which they have invested. Such investors have a substantial amount of money at stake in the target company, are among the first to absorb losses if the company has financial difficulties, and participate in the profits of the company. Moreover, a company is likely to pay heed to its large shareholders in order to maintain stability in its capital

base, enhance its ability to raise additional equity capital in the future, and to prevent the negative market signal that may be created by the sale of a large block of equity by an unhappy shareholder. These concerns apply to both voting equity and nonvoting equity investments.

Accordingly, the Board traditionally has taken account of the presence and size of nonvoting equity investments in its controlling influence analysis. For example, in the 1982 Policy Statement, the Board set forth a guideline that nonvoting equity investments that exceed 25 percent of the total equity of a company generally raise control concerns under the BHC Act. In the 2008 Policy Statement, the Board reaffirmed the position that a nonvoting equity investment in excess of 25 percent generally raises control concerns under the BHC Act. However, the Board also noted that a company with voting and nonvoting securities that, when aggregated, represent less than one-third of the total equity of a second company generally would not have a controlling influence over the second company if the first company controlled less than 15 percent of any class of voting securities of the second company.

The Board has recognized that nonvoting equity does not provide the holder with the same ability to exercise a controlling influence as voting equity, because nonvoting equity generally does not participate in the selection of directors or decisions on certain other matters that require shareholder approval. Moreover, as noted previously, the BHC Act defines control in terms of ownership of 25 percent or more of a class of voting securities but does not impose an express limit on ownership of nonvoting securities.

The Board continues to believe that, in most circumstances, an investor that owns 25 percent or more of the total equity of a company owns enough of the capital resources of the company to have a controlling influence over the management or policies of the company. The Board continues to recognize, however, that the ability of an investor to exercise a controlling

influence through nonvoting equity instruments depends significantly on the nature and extent of the investor's overall relationship with the company.

Accordingly, under the proposal and consistent with the 2008 Policy Statement, the Board would presume control if an investor had less than 15 percent of the voting shares of the second company but more than one-third of the total equity of the second company. The Board also would presume control if an investor had 15 percent or more of the voting shares of the second company and 25 percent or more of the second company's total equity.

Question 11: The proposal incorporates the Board's historical practice with respect to total equity, as discussed in the 2008 Policy Statement. Should the Board permit an investor to have a greater ownership of total equity without triggering a presumption of control?

Proxies on Issues

The Board historically has raised controlling influence concerns if a company with control over 10 percent or more of a class of voting securities of a second company solicits proxies from the shareholders of the second company on any issue. The Board is not proposing a presumption that a company that controls 10 percent or more of a class of voting securities of a second company, and solicits proxies from the shareholders of the second company on any issue, controls the second company. Thus, the proposal would provide a noncontrolling investor greater latitude to exercise its shareholder rights and engage with the target company and other shareholders on certain issues.

Question 12: Should the Board include a presumption that a company controls a second company if the first company controls 10 percent or more of any class of voting securities of the second company and solicits proxies on any issue presented to the shareholders of the second company for a vote?

Threats to Dispose

Historically, the Board has viewed threats to dispose of large blocks of voting or nonvoting securities in an effort to try to affect the policy and management decisions of the second company as presenting potential controlling influence concerns. As a result, the Board traditionally has raised controlling influence concerns if a company with control over 10 percent or more or a class of securities of a second company threatens to dispose of its investment if the second company refuses to take some action desired by the first company. However, the Board also recognizes that an investor who is unhappy or disagrees with the business decisions of the company in which it invests should be able to exit its investment, and the possibility of investor exit imposes important discipline on management. The Board is not proposing a presumption of control based on threats to dispose of securities.

Question 13: Should the Board include a presumption that a company is presumed to control a second company when the first company has a significant voting stake in the second company, such as 10 percent or more, and threatens the second company with disposing its shares in order to induce action or inaction by the second company?

D. Description of additional proposed presumptions and exclusions

In addition to the tiered presumption framework described previously, the proposal would include several additional presumptions of control. Several of these presumptions are currently in Regulation Y and would be retained in substantially the same form, with clarifications. The remaining new presumptions relate to standards that the Board has historically used to make control decisions, but has not before included in a regulation. These proposed presumptions are described in detail in this section.

Management agreements

Management agreements have long raised controlling influence concerns for the Board. In 1971, when the Board promulgated its first presumptions of control, the Board included a presumption that a company would control another company if the first company had an agreement or understanding to exercise significant influence or discretion regarding the general management or core operations of the second company. The Board continues to believe that agreements under which a company can direct or exercise significant influence over the management or operations of another company raise significant controlling influence concerns.

The proposal would expand slightly the existing presumption to also include other types of agreements or understandings that allow a company to direct or exercise significant influence over the core business or policy decisions of the second company. The Board believes that the ability to direct the core business or policy decisions of a company also evidences the ability to exercise a controlling influence over the company. The Board does not intend for routine outsourcing agreements, such as IT services agreements, to qualify as management agreements.

The proposed revised presumption also would clarify that a management agreement includes an agreement where a company is a managing member, trustee, or general partner of a second company, or exercises similar functions. The Board has long considered companies in these positions to have the power to exercise control over the second company.

Question 14: Should the Board expressly incorporate the concepts of routine management and operation under the Board's merchant banking rules into the management agreement presumption (see 12 CFR 225.170 et seq.)?

Question 15: What other common types of agreements constitute management agreements and should such agreements be listed in the Board's regulation?

Question 16: What other types of arrangements generally provide one company the ability to exercise a controlling influence over another company similar to serving as trustee of a trust or general partner of a partnership? Should the presumption include any such other arrangements?

Investment advice

The proposal would include a presumption of control where a first company serves as investment adviser to a second company that is an investment fund and where the first company controls 5 percent or more of any class of voting securities of the second company or 25 percent or more of the total equity capital of the second company. For purposes of this presumption, the proposal would define “investment adviser” to include any person registered as an investment adviser under the Investment Advisers Act of 1940 (“Advisers Act”), any person registered as a commodity trading advisor under the Commodity Exchange Act, or a foreign equivalent of such a registered adviser.⁴³ Similarly, “investment fund” would include a wide range of investment vehicles, including investment companies registered under the Investment Company Act of 1940, companies that are exempt from registration under the Investment Company Act, and foreign equivalents of either registered investment companies or exempt companies.⁴⁴ Other investment entities, such as commodity funds and real estate investment trusts, generally also would be included as investment funds.

However, the proposed presumption of control would not apply if the company organized and sponsored the investment fund within the preceding twelve months. This would allow the

⁴³ 15 U.S.C. § 80b-1 et seq.; 7 U.S.C. § 1 et seq.

⁴⁴ 15 U.S.C. § 80a et seq.

company to avoid triggering the presumption of control over the investment fund during the initial seeding period of the fund.

The proposed presumption of control for service as an investment advisor to an investment fund is intended to be consistent with the Board's precedents regarding when an investment advisor controls an advised investment fund under the BHC Act and the Glass-Steagall Act.⁴⁵

Question 17: How could the Board further clarify the proposed investment advisor presumption, particularly with respect to the meaning of "investment advisor" and "investment fund?" Should the proposed presumption differentiate between different types of investment advisory roles or different types of investment funds?

Question 18: Should the proposed presumption use different voting security or total equity thresholds?

Question 19: Should the proposed presumption provide a longer seeding period? If the proposed presumption should adopt a longer seeding period, what would be an appropriate length of time for such a seeding period?

Question 20: Would the presumption have any adverse or unintended consequences on investment advisory activities?

Accounting consolidation

Under the proposal, the Board would presume that a company that consolidates a second company under U.S. generally accepted accounting principles ("GAAP") would be presumed to control the second company for purposes of the BHC Act. The Board believes that this

⁴⁵ See, e.g., Letter to H. Rodgin Cohen, Esq., dated June 24, 1999, https://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/1999/19990624/.

presumption is appropriate because consolidation is generally called for under GAAP under circumstances where the consolidating entity has a controlling financial interest over the consolidated entity. For example, a company generally consolidates another company when the first company owns a majority of the voting securities of the second company. GAAP also permits consolidation in situations (i) where a company has the power to direct the activities of a second company that most significantly impact that company's economic performance and has the right to receive a considerable portion of the economic benefits of the second company or (ii) where a company controls a second company by contract.⁴⁶ The proposed presumption is not intended to suggest that the absence of consolidation under GAAP indicates that a company does not control another company.

Question 21: Should this presumption be expanded to presume that for purposes of the BHC Act, a company controls any other company that the first company consolidates for accounting purposes (regardless of whether the company uses GAAP)?

Question 22: Should the Board presume that a company controls a second company for purposes of the BHC Act when the first company accounts for the second company using the GAAP equity method of accounting (in addition to when the first company consolidates the second company for purposes of GAAP)?

Divestiture

The Board is proposing to substantially revise its existing standards regarding divestiture of control. The Board historically has taken the position that a company that has controlled another company for a significant period of time may be able to exert a controlling influence

⁴⁶ See, e.g., ASC 810-10.

over that company even after a substantial divestiture.⁴⁷ As a result, the Board typically has applied a stricter standard for determining noncontrol in divestiture cases than cases where a company seeks to establish a new noncontrolling investment.⁴⁸ In determining whether a reduction in ownership would be effective to terminate an existing control relationship, the Board has placed significant weight on the percentage of voting securities retained by the divesting company and the ongoing relationships between the divesting company and the company being divested.

The Board has examined its practice in this area and believes that a revision of its past practice would be appropriate. The Board continues to believe that a company that has long controlled another company might be capable of controlling that company even after a substantial divestiture.⁴⁹ However, the Board believes that the passage of time diminishes the

⁴⁷ See, e.g., “Statement of policy concerning divestitures by bank holding companies” (divestiture policy statement). 12 CFR 225.138. In the divestiture policy statement, the Board describes general procedures and considerations for purposes of concluding that a company has successfully divested a particular asset. The divestiture policy statement includes divestitures of control over another company, but also applies more broadly to divestitures of impermissible assets. The divestiture policy statement indicates that divestiture is a special consideration for purposes of control and that the Board’s normal rules and presumptions regarding control may not always be appropriate in the context of divestiture.

⁴⁸ See, e.g., 12 CFR 225.139 (“2(g)(3) policy statement”). The 2(g)(3) policy statement describes the implementation of section 2(g)(3) of the BHC Act. Section 2(g)(3) created a rebuttable presumption that a transferor continued to control shares of a company transferred to a transferee if the transferee was indebted to the transferor or if there were certain director or officer interlocks between the transferor and transferee. The presumption could be rebutted if the Board determined that there was no ability to control. Although Congress removed section 2(g)(3) from the BHC Act in 1996, the 2(g)(3) policy statement remains relevant because it illustrates the special considerations raised by the context of divestiture and the longstanding position of the Board that terminating control requires reducing relationships to lower levels than would be consistent with a new noncontrolling relationship.

⁴⁹ See *Am. Gas & Elec. Co. v. SEC*, 134 F.2d 633, 643 (D.C. Cir. 1943) (holding that “controls and influences exercised for so long and so extensively [under the Public Utilities Holding Company Act] are not severed instantaneously, sharply and completely, especially when powers of voting, consultation and influence such as have been retained remain”).

likelihood that a formerly controlling company would be able to leverage its past relationship to continue to exert a controlling influence over the management and policies of the formerly controlled company. In addition, while the Board believes that a history of control provides some influence, the Board also recognizes that a company that has reduced its voting ownership significantly below 25 percent has materially reduced its ability to exercise a controlling influence. Thus, the proposal would state that a company that previously controlled a second company during the preceding two years would be presumed to continue to control the second company if the first company owns 15 percent or more of any class of voting securities of the second company. The other presumptions of control, such as business relationships and interlocks, would continue to apply in evaluating whether a divesting company exercises a controlling influence over a partially divested company.

The practical effect of the proposed presumption would be that a company generally would not be presumed to control a former subsidiary (e.g., a subsidiary that was previously wholly owned, but in which the company is selling some of its ownership stake) by divesting below 15 percent of any class of voting securities.⁵⁰ However, in order to avoid the presumption of control the first company also would be required to remain below 15 percent for two years. If the first company's ownership increased to 15 percent or more during the two year period, the first company would be presumed to control the second company.

In addition to the option of divesting below 15 percent, in practice the proposed divestiture presumption would allow a company to divest to between 15 percent and less than 25 percent and wait for two years to pass. After two years have passed since the company

⁵⁰ This discussion assumes that the divesting company does not trigger any other presumption of control.

owned 25 percent or more, the proposed presumption of control would no longer apply even though the company's ownership remained at 15 percent or more. Thus, a divesting company could choose between (i) divesting to below 15 percent and (ii) divesting to between 15 percent and less than 25 percent for a period in excess of two years, to avoid the presumption of control applicable to divestitures.

In addition, the divestiture presumption would not apply if a majority of each class of voting securities of the company that is being sold is controlled by a single unaffiliated individual or company. For example, if a company sells 80 percent of the voting common stock of its subsidiary bank to another company and retains 20 percent of the common stock, the first company would not trigger the divestiture presumption of control with respect to the bank being sold, despite its previous control of the bank, because a single, unaffiliated company would own a majority of the shares of the bank.

Under the proposal, the divestiture presumption also generally would not apply in cases where a company sells a subsidiary to a third company and receives stock of the third company as some or all of the consideration for the sale.⁵¹ For example, if a company sells 100 percent of the voting common stock of its subsidiary bank to another company for consideration that includes 20 percent of the voting common stock of the acquiring company, the divestiture presumption would not apply (so long as the selling company does not control the acquiring company).

Question 23: Should the Board use different percentages for voting securities or total equity for purposes of the proposed presumptions for divestitures? What voting and total equity

⁵¹ See, e.g., Letter to Mark Menting, Esq., dated February 14, 2012, https://www.federalreserve.gov/bankinforeg/LegalInterpretations/bhc_changeincontrol20120214.pdf.

percentages would be more appropriate? Should the Board use a time period other than two years and, if so, what time period should be used?

Question 24: Is a special divestiture presumption necessary or appropriate?

Presumption of Control for the Combined Ownership of a Company and its Senior Management Officials and Directors (5-25 Presumption)

The proposal would include a presumption that a company controls a second company when the first company controls at least 5 percent of a class of voting securities of the second company and the senior management officials and directors of the first company, together with their immediate family members and the first company, own 25 percent or more of a class of voting securities of the second company. This presumption corresponds to a longstanding presumption of control over a company in Regulation Y.⁵² However, under the proposal, the presumption would be revised not to apply if the first company controls less than 15 percent of each class of voting securities of the second company and the senior management officials and directors of the first company, together with their immediate family members, control 50 percent or more of each class of voting securities of the second company.

The proposed presumption reflects the Board's position that it is generally appropriate to attribute shares held by management officials of a company to the company for purposes of measuring control by the company under the BHC Act.⁵³ The management officials of a company are well positioned to coordinate their actions with each other and the company to act as a single voting bloc to advance the interests of the company.

⁵² 12 CFR 225.31(d)(2)(ii).

⁵³ This principle is also reflected in the proposal in the rules for calculating the percentage of a class of voting securities controlled by a company.

The proposed new exclusion to the presumption reflects the Board’s understanding that, when individuals control an outright majority of a class of voting securities of a second company, it is the individuals who are truly exercising control over the second company, rather than any company that employs the individuals. Under these circumstances, the first company is generally not a significant conduit for control over the second company. This exclusion has a basis in the *Vickars-Henry* precedent.⁵⁴

Question 25: Should the Board revise the proposed 5-25 presumption so that it applies only when the first company controls 10 percent or more of the voting securities of the second company (rather than 5 percent or more)?

Investment company exception

Under the proposal, there would be a limited exception from all of the presumptions that one company controls another company if the second company is an investment company registered with the Securities and Exchange Commission (“SEC”) under the Investment Company Act of 1940 and certain other criteria are satisfied.⁵⁵ In order to qualify for this exception, the relationship between the companies would have to be limited such that:

- The only business relationships between the first company and the investment company are investment advisory, custodian, transfer agent, registrar, administrative, distributor, and securities brokerage services provided by the first company to the investment company;
- Representatives of the first company occupy 25 percent or less of the board of directors or trustees of the investment company; and

⁵⁴ *Vickars-Henry Corp. v. Fed. Reserve Sys.*, 629 F.2d 629 (9th Cir. 1980).

⁵⁵ 15 U.S.C. § 80a *et seq.*

- The first company controls less than 5 percent of each class of voting securities of the investment company and less than 25 percent of the total equity of the investment company.

In addition, the last criterion would be waived if the first company organized and sponsored the second company within the preceding twelve months. This would allow the first company to control greater percentages of securities of the second company during the initial seeding period of the investment company.

This proposed limited exception for SEC-registered investment companies is intended to preserve the Board's precedents related to control over registered investment companies, not to create a looser standard for relationships with such companies.⁵⁶ Consistent with this intention and unlike the investment adviser presumption, the exception for registered investment companies would be limited to companies that are registered with the SEC as investment companies under the Investment Company Act. A first company that does not satisfy the criteria in the registered investment company exception would not necessarily be presumed to control the second company. Instead, the first company may or may not be presumed to control the second company depending on the applicability of the other proposed presumptions of control.

Question 26: Is it necessary or appropriate to have an exception to the control presumptions for registered investment companies? Should the proposed presumption provide a different standard than the Board's investment company precedents contain, such as a longer seeding period, different business relationships, or different levels of ownership?

⁵⁶ See, e.g., Mellon Bank Corporation, 79 Federal Reserve Bulletin 626 (1993); The Chase Manhattan Corporation, 81 Federal Reserve Bulletin 883 (1995); Commerzbank AG, 83 Federal Reserve Bulletin 678 (1997).

Question 27: Should the proposed registered investment company exception be expanded to apply to other types of investment funds?

Closely held companies and widely held companies

In developing this proposal, the Board considered whether the proposed presumptions should vary depending on differences in the ownership structure of the second company. In particular, the Board considered whether there should be different presumptions or different presumption thresholds for (i) companies that are widely held relative to companies that are closely held or (ii) companies that are majority owned by a third party.⁵⁷ In many cases, it could be reasonable to assume that a major investor in a company that is otherwise widely held by dispersed shareholders would have outsized influence compared to a situation where the major investor is one of several major investors in a closely held company. Similarly, in many cases, it could be reasonable to assume that a major investor has limited influence when there is another investor with outright majority ownership.

The proposal, however, does not include different presumptions for widely held companies versus closely held companies. Incorporating these distinctions in the presumptions could greatly increase the complexity of the proposal, and could make the presumptions more difficult to apply in practice. The Board believes that the proposed presumptions would provide appropriate standards for controlling influence in most cases. However, as noted previously, the Board would retain its ability to determine that a company does or does not control a second company based on the facts and circumstances presented, and the Board recognizes that the

⁵⁷ As discussed above, the proposal recognizes this concept in a relatively limited way in the exception to the 5-25 presumptions.

composition of the other shareholders of the second company could be an important consideration in making such a determination.

Question 28: Should the Board create different presumptions for widely held companies and closely held companies? Should the Board create different presumptions for companies that are majority owned by a third party? If so, which of the proposed presumptions should include this differentiation, and how should the presumptions be changed?

Question 29: If the Board were to differentiate between widely held and closely held companies, what should the standards be for a company to be widely held and closely held? Would having publically traded securities or registered securities be an effective means to identify widely held companies?

Fiduciary exception

The presumptions described above would not apply to the extent that a company controls voting or nonvoting securities of a second company in a fiduciary capacity without sole discretionary authority to exercise the voting rights. This exception for holding securities in a fiduciary capacity is currently in the control provisions of Regulation Y and would be retained in full.⁵⁸ The exception implements the treatment of such holdings provided by the BHC Act.⁵⁹

Rebuttable presumption of noncontrol

Under the proposal, a company would be presumed not to control a second company if the first company controls less than 10 percent of every class of voting securities of the second company and if the first company is not presumed to control the second company under any of

⁵⁸ See 12 CFR 225.31(d)(2)(iv).

⁵⁹ See 12 U.S.C. § 1841(a)(5)(A).

the proposed presumptions of control.⁶⁰ This would modestly expand the existing statutory and regulatory presumption of noncontrol where the first company controls less than 5 percent of any class of voting securities of the second company.⁶¹

Question 30: Should the proposed presumption of noncontrol use a different threshold than 10 percent of the voting securities of the second company?

Question 31: Should the Board presume noncontrol in all cases where neither a statutory standard nor a regulatory presumption of control applies?

Question 32: Should the Board create an exception from any of the presumptions of control when there is a larger shareholder that controls 50 percent or more of each class of voting securities of the second company?

Question 33: Should the Board revise any of the other proposed presumptions to allow a company to control a greater percentage of voting securities and/or have more substantial other relationships with a second company when there is a dominant shareholder or dominant shareholder group that is unaffiliated with the first company? Including this type of exception would make the proposed presumptions more complicated, but also more sensitive to particular

⁶⁰ The filing requirements applicable to bank holding companies and savings and loan holding companies for investment of 5 percent or more of the voting securities of a company would not be altered as a result of the presumption of noncontrol.

⁶¹ 12 U.S.C. § 1841(a)(3); 12 CFR 225.31(e) and 238.21(e).

facts. Which presumptions should the Board consider revising to include this treatment or does the Board’s proposal balance complexity and sensitivity appropriately?

III. Proposed definitions related to the proposed presumptions

In connection with the proposed presumptions described previously, the proposal would amend Regulation Y and Regulation LL to update and clarify definitions of terms used in the proposed presumptions. This section discusses in detail each of these proposed revisions.

A. First company and second company

As discussed above, the core of the proposal is the addition of a series of presumptions of control that would apply in the context of the Board making a determination that a first company has the ability to exercise a controlling influence over a second company. To clarify the application of these presumptions, the proposal includes definitions of “first company” and “second company.”

“First company” would be defined as the company whose control over the second company is the subject of a determination of control by the Board. “Second company” would be defined as the company the control of which by the first company is the subject of a determination of control by the Board.⁶²

For many of the proposed presumptions, the first company would be presumed to control the second company if the first company, together with its subsidiaries, has particular relationships with the second company, together with its subsidiaries. Although the relationship between the first company and its subsidiaries, on the one hand, and the second company and its

⁶² First company and second company must meet the definition of “company” under the BHC Act or HOLA, as applicable, but could take a variety of legal entity forms, including a stock corporation, limited liability corporation, partnership, business trust, or foreign equivalents of such legal entities. See 12 U.S.C. §§ 1467a(a)(1)(C) and 1841(b).

subsidiaries, on the other hand, is usually the appropriate scope of the controlling influence inquiry, the result of the inquiry is necessarily specific to whether the first company itself controls the second company itself. As a result, the defined terms “first company” and “second company” do not include subsidiaries of the first company or second company.

In addition, the proposal provides that, for purposes of the proposed presumptions, any company that is both a subsidiary of the first company and the second company should be treated as a subsidiary of the first company but not as a subsidiary of the second company. This would prevent the second company’s relationships with a joint venture subsidiary with the first company from being considered relationships with the first company for purposes of the presumptions of control. The Board believes this treatment is appropriate to allow companies to have joint ventures that are controlled by each company without the control over the joint venture necessarily causing the joint venture partners to be presumed to control each other.

Question 34: Should the Board revise the definition of “first company” or “second company” to incorporate subsidiaries or affiliates of the first company or second company?

B. Voting securities and nonvoting securities

The BHC Act defines control to include a company owning, controlling, or having power to vote 25 percent or more of any class of voting securities of another company.⁶³ In addition, several of the proposed presumptions require identifying the percentage of a class of voting securities controlled by a company in another company.

Currently, Regulation Y includes a definition of “voting securities” and a definition of “nonvoting shares.”⁶⁴ The proposal would change the defined term “nonvoting shares” to

⁶³ 12 U.S.C. § 1841(a)(2)(A).

⁶⁴ 12 CFR 225.2(q).

“nonvoting securities” and would include in the definition of “nonvoting securities” equity instruments issued by companies other than stock corporations, such as limited liability companies and partnerships. This would be consistent with the Board’s historical practice.

In addition, the proposal would revise the existing definition of “nonvoting shares” to clarify the regulation in a manner consistent with the Board’s interpretations. In the current definition of “nonvoting shares,” equity instruments are nonvoting if any voting rights associated with the instruments are limited solely to the type customarily provided by statute with regard to matters that would significantly and adversely affect the rights or preferences of the instruments.⁶⁵ The proposal would be revise the definition to make it clear that common stock can be nonvoting securities.⁶⁶

Regulation Y also provides a nonexclusive list of examples of the types of voting rights that the Board has considered to be within the scope of the defensive voting rights that nonvoting shares may contain. The proposal would revise the definition of “nonvoting shares” to expressly permit defensive voting rights that are commonly found in investment funds that are organized as limited liability companies and limited partnerships. Specifically, the proposal would state that the defensive voting rights of a nonvoting share include the right to vote to remove a general partner or managing member for cause, the right to vote to replace a general partner or managing member that has been removed for cause or has become incapacitated, and the right to vote to dissolve the company or to continue operations following the removal of the general partner or managing member.

⁶⁵ 12 CFR 225.2(q)(2)(i).

⁶⁶ For safety and soundness reasons, the Board generally believes that voting common stockholders’ equity should be the dominant form of equity. See e.g., 78 FR 62018, 62044 (Oct. 11, 2013).

Question 35: What other revisions to the definition of nonvoting securities would be appropriate, such as additional clarifications to permitted defensive rights?

Question 36: Would it be clearer if Regulation Y referred simply to “company” where it currently refers to “bank or other company”?

C. Calculation of voting percentage

As noted above, the BHC Act defines control in part based on a company owning, controlling, or having power to vote 25 percent or more of a class of voting securities of another company.⁶⁷ In addition, many of the proposed presumptions of control would require determining the percentage of a class of a company’s voting securities owned, controlled, or held with power to vote by another company. The proposed rule would reflect the Board’s current practice for determining whether a company’s voting securities are owned, controlled, or held with power to vote by an investor and would provide rules for determining the percentage of a class of a company’s voting securities attributed to an investor.

Ownership, Control, and Holding with Power to Vote

The proposal would provide standards for determining whether a person “controls” a security.⁶⁸ A person would control a security if the person owns the security or has the power to sell, transfer, pledge, or otherwise dispose of the security. In addition, a person would control a security if the person has the power to vote the security, other than due to holding a short-term,

⁶⁷ 12 U.S.C. § 1841(a)(2)(A).

⁶⁸ These proposed standards would effectively replace the presumptions for control over voting securities currently in 12 CFR 225.31(d)(1). In this discussion, “person” has the meaning provided in 12 CFR 225.2(l) and 12 CFR 238.2(j).

revocable proxy. This proposed definition of control over securities would be consistent with Board precedent and with the language of the BHC Act.⁶⁹

Options, Warrants, and Convertible Instruments

The proposal would provide standards for deeming a person to control a security through control of an option or warrant to acquire the security or through control of a convertible instrument that may be converted into or exchanged for the security. Under the proposal's "look-through" approach, a person would control all securities that the person could control upon exercise of any options or warrants. In addition, a person would control all securities that the person could control as a result of the conversion or exchange of a convertible instrument controlled by the person. This approach would be consistent with the Board's longstanding precedent of considering a person to control any securities (i) that the person has a contractual right to acquire now or in the future; and (ii) that the person would automatically acquire upon occurrence of a future event.⁷⁰ The look-through approach would apply even if there were an unsatisfied condition precedent to the exercise of the options or if the options were significantly out of the money.

In addition, the proposal would provide that a person would control the maximum number of securities that could be obtained under the terms of the option, warrant, or convertible instrument. Accordingly, if the number of shares that could be acquired upon exercise of an option varies based on some metric, such as the market price or book value of the shares, the person would be considered to control the highest possible percentage of the class of securities that could ever be acquired under the terms of the option.

⁶⁹ See, e.g., 12 U.S.C. §§ 1841(a)(2)–(3) and 1842(a).

⁷⁰ See, e.g., 2008 Policy Statement.

Moreover, for purposes of calculating a person's percentage of a class of voting securities or total equity, the person generally would be deemed to control the percentage resulting from the exercise of the person's options, assuming that no other parties elected to exercise their options. However, if, for example, a person may exercise an option only when all outstanding options in a class are simultaneously exercised, the percentage controlled by the person would reflect the exercise of all the outstanding options in the class, not just those options held by the person.

The proposal would provide several limited exceptions to the general look-through approach. Consistent with the 2008 Policy Statement, the proposal would incorporate a limited exception for financial instruments that may convert into voting securities but, by their terms or as required by law, may not become voting securities in the hands of the current holder or any affiliate of the current holder and may only convert to voting securities upon transfer to (i) the issuer or an affiliate of the transferor, (ii) in a widespread public distribution, (iii) in transfers where no transferee or group of associated transferees would receive 2 percent or more of any class of voting securities of the issuer, or (iv) to a transferee that controls 50 percent or more of every class of voting securities before the transfer.

The proposal also would exempt from the general look-through approach a purchase agreement to acquire securities that has not yet closed. This would allow parties to enter into securities purchase agreements pending regulatory approval, due diligence, and satisfaction of other conditions to closing. In order to be eligible for this exemption, the securities purchase agreement should only be in effect for the time necessary to satisfy the closing condition. Thus, for example, a company would be able to enter into a securities purchase agreement to acquire shares in bank without being considered to control the shares until the closing, when the

company actually took ownership of the shares. This would allow the company to file any necessary notice or application with an appropriate federal banking authority, conduct due diligence, and prepare funds for the purchase. However, the company would be expected to file any required notice or application promptly and to work actively to satisfy any other closing conditions.⁷¹

In addition, the proposal would exempt from the general look-through approach any options, warrants, or convertible instruments that would permit an investor to acquire additional voting securities only to maintain the investor's percentage of voting securities in the event the company increases the number of its outstanding voting securities.

Question 37: How could the Board more clearly define the scope of the look-through approach to options, warrants, and convertible instruments? Should the Board consider adding or removing any of the proposed exceptions or limitations to the look-through approach? If so, which exceptions or limitations should be added and which should be removed and why?

Question 38: How could the Board more clearly describe the principle that options, warrants, and convertible instruments would be looked through to the maximum percentage of voting securities that the person could control upon exercise or conversion? Should the Board limit this principle in any way?

Question 39: What additional clarification should be included to define a securities purchase agreement? Should the Board define securities purchase agreement by reference to standard characteristics, such as a limited term intended to allow for the preparation of funds

⁷¹ Even if a notice or application is filed promptly, if the filing remains pending for an unusually long period of time, control concerns and supervisory concerns may arise. In general, periods of less than a year would not raise such concerns.

for transfer and completion of due diligence, inability to transfer or assign to a third party, and an expectation among the parties that the sale will in fact occur as agreed?

Control Over Securities

Consistent with current Regulation Y, the proposal would provide that a person controls securities if the person is a party to an agreement or understanding under which the rights of the owner or holder of securities are restricted in any manner, unless the restriction falls under the exceptions specified under the rule. Thus, for example, a person holding a long-term irrevocable proxy to vote shares owned by another party would control the securities subject to the proxy. Under the proposal and consistent with current practice, multiple persons could control the same securities by different means. For example, one person could own securities that another person has the power to vote. In such circumstances, the Board would treat each person as controlling the securities in question.

The proposal would provide six exceptions to this general rule. The first exception is for rights of first refusal, rights of last refusal, tag-along rights, drag-along rights, or similar rights that are on market terms and that do not impose significant restrictions, including significant delay, on the transfer of the securities. For this purpose, a right of first refusal is an arrangement whereby a person seeking to sell or otherwise transfer a security must first offer the security to one or more other persons before making a transfer. Similarly, a right of last refusal is an arrangement whereby a person that has tentatively agreed to sell or otherwise transfer a security must then offer one or more other persons the opportunity to acquire the security on the agreed terms. A tag-along right is an arrangement whereby a person is permitted to participate in a sale or other transfer of securities that has been negotiated by another shareholder on the same terms obtained by the other shareholder. A drag-along right is an arrangement whereby a person can

be obligated to join in a sale or other transfer of securities on the same terms agreed by one or more other shareholders. The Board recognizes that these types of relationships are commonly used to govern transfers of securities of companies, particularly companies with securities that are not publicly traded. The Board does not intend for standard, market-terms arrangements of this type to result in the parties to such agreements controlling the securities subject to the arrangement.

The Board believes, however, that some rights of first refusal, rights of last refusal, tag-along rights, drag-along rights, and similar arrangements serve to impose significant, non-market-standard constraints on the transfer of securities. Under the proposal, these arrangements would convey control of the underlying securities. For example, a right of last refusal that allows an investor to acquire shares at market price within 30 days' notice from a selling shareholder generally would not provide the investor with control over the seller's shares. However, a right of last refusal that allows an investor to acquire shares at a steep discount from market price, or allows the investor an unnecessarily long period of time to decide whether or not to acquire the shares, provides the investor with control over the seller's shares because the restrictions are significant, beyond standard market terms, and unnecessary to provide the investor a reasonable opportunity to buy the shares.

Second, the proposal would provide an exception for arrangements that restrict the rights of an owner or holder of securities when the restrictions are incidental to a bona fide loan transaction. Thus, if a creditor obtains a lien on the shares of a subsidiary of a debtor in connection with a bona fide loan transaction that prevents the debtor from selling the shares to a third party or pledging the shares as collateral to another creditor, the creditor would not be considered to control the shares of the subsidiary of the debtor.

Third, the proposal would provide that an arrangement that restricts the ability of a shareholder to transfer shares pending the consummation of an acquisition does not provide the restricting party control over the shares of the restricted party. For example, if a person agrees to acquire shares of a banking organization from the current owner and the person is required to receive the approval of the Board before acquiring the shares, the parties could agree that the current owner would not sell the shares to a third party, pending Board approval and subsequent prompt consummation of the sale. In this fact pattern, the Board would not deem the person to control the shares because of the agreement.

Fourth, the proposal generally would provide that an arrangement that requires a current shareholder of a company to vote in favor of a proposed acquisition of the company would not result in the proposed acquirer controlling the shares of the current shareholder. In order to qualify for this exception, the restriction may only continue for the time necessary to obtain governmental and shareholder approval and to consummate the transaction promptly.

Fifth, the proposal would exempt arrangements among the shareholders of a company designed to preserve the tax status or tax benefits of a company, such as qualifying as a Subchapter S Corporation⁷² or to preserve tax assets (such as net operating losses) against impairment.⁷³ However, in order to qualify for this exemption, the arrangement must not impose restrictions on securities beyond what is reasonably necessary to achieve the goal of preserving tax status, tax benefits, or tax assets.⁷⁴

⁷² See 26 U.S.C. § 1361.

⁷³ See 26 U.S.C. § 382.

⁷⁴ Independent of whether controlling influence concerns are raised, agreements of this type may raise significant safety and soundness concerns under certain circumstances.

Sixth, the proposal would provide that a short-term revocable proxy would not provide the holder of the proxy with control over the securities governed by the proxy.⁷⁵ This would not interfere with the common practice of voting by proxy on matters presented for a shareholder vote, so long as the proxy is short in duration (i.e., is only valid for the next shareholder vote) and may be rescinded by the shareholder after being granted.

The proposal also would provide that a company that owns, controls, or holds with power to vote 5 percent or more of any class of voting securities of a second company controls any securities issued by the second company that are owned, controlled, or held with power to vote by the senior management officials, directors, or controlling shareholders of the first company, or by the immediate family members of such individuals. The Board has long recognized that a company and the individuals who own or operate the company may be expected to coordinate their actions with respect to common investments in a second company.⁷⁶ This portion of the proposal would provide a clear rule to apply to such circumstances in all cases.

Question 40: The proposal would add a new section to Regulation Y and Regulation LL that would define control over securities for all purposes in Regulation Y or Regulation LL (including, for example, in the context of notices pursuant to the Change in Bank Control Act of 1978), as applicable. Should the proposed new section apply for all purposes under the regulations or should it only apply for purposes of determining control due to controlling influence?

⁷⁵ The proposed treatment of short-term revocable proxies would be consistent with the Board's current regulations regarding notices under the Change in Bank Control Act. See 12 CFR 225.41(d)(4); 12 CFR 225.42(a)(5).

⁷⁶ See, e.g., 12 CFR 225.31(d)(2)(ii).

Question 41: Are there any additional common arrangements that limit the ability of shareholders to control their shares that the Board should exclude from the general rule that limitations on securities provide control over the securities?

Question 42: Should the Board remove or limit any of the proposed exclusions? If so, which ones and why?

Question 43: Should the senior management/director/controlling shareholder share attribution rule only attribute shares if (i) the first company financed the acquisition by the individuals, (ii) there is an agreement between the first company and the individuals regarding the vote or transfer of the securities, or (iii) the first company agreed to indemnify the individuals against losses on the securities?

Reservation of Authority

The proposal would include a reservation of authority to allow the Board to determine that securities that would otherwise be considered controlled by a person under the proposal are not controlled by the person. Similarly, the proposed reservation of authority would allow the Board to determine that securities that are not considered controlled by a person under the proposal are controlled by the person.

Percentage of a Class of Voting Securities

The proposal would provide a rule for calculating the percentage of a class of voting securities controlled by a person that takes into account both the number of shares and the voting power of those shares. Specifically, the percentage of a class of voting securities controlled by a person would be the greater of (i) the number of voting securities of the class controlled by the person divided by the number of issued and outstanding shares of the class of voting securities (expressed as a percentage) and (ii) the number of votes that the person could cast divided by the

total number of votes that may be cast under the terms of all the voting securities of the class that are issued and outstanding (expressed as a percentage). This would be consistent with a longstanding Board practice of recognizing both the proportion of shares of a class controlled by an investor and the proportion of voting power within the class controlled by the investor. This approach is appropriate because the Board has defined a class of voting securities for purposes of the BHC Act to include all shares that vote on the same matters, even if some shares have outsized voting power compared to other shares in the same class.⁷⁷

In addition, the proposal would provide that a person controls all voting securities controlled by the person and any subsidiaries of the person, and that a person generally does not control any voting securities controlled by any non-subsidiary. Regulation Y currently provides that a company controls securities that are controlled by subsidiaries of the company.⁷⁸ The proposal would clarify the existing provision in Regulation Y by providing that all voting securities held by controlled, but less than wholly owned, companies would be controlled by the controlling person. Similarly, if a person has a less than controlling interest in a company, the person generally would not control any voting securities controlled by the noncontrolled company.

Question 44: Should the Board attribute voting securities held by a subsidiary to a person based on the person's percentage of voting securities in the subsidiary rather than attributing all voting securities held by a subsidiary to the person?

Question 45: Should a company with a noncontrolling investment in another company be attributed its pro rata ownership of shares of a second company owned by the noncontrolled

⁷⁷ 12 CFR 225.2(q)(3).

⁷⁸ 12 CFR 225.2(e)(2)(i).

company, for purposes of calculating the first company's voting percentage in the second company?

D. Calculation of total equity percentage

The proposal would provide a standard for calculating a company's total equity percentage in a second company that is a stock corporation that prepares financial statements according to GAAP. Under GAAP, the balance sheet of a corporation reflects a dollar amount of equity for each class of stock that a corporation has issued. For example, a class of preferred stock with a liquidation preference of \$1000 per share is generally attributed \$1000 per share on the equity portion of the balance sheet of the issuing corporation.

The first step to calculate a company's total equity in a second company would be to determine the percentage of each class of voting and nonvoting common or preferred stock issued by the second company that the first company controls.⁷⁹ Second, the percentage of each class of such stock controlled would be multiplied by the value of shareholders' equity allocated to the class of stock under GAAP. For this purpose, the value of shareholders' equity allocated to common stock would be all shareholders' equity not allocated to preferred stock. Most significantly, this would mean that retained earnings would be allocated to common stock. Third, the first company's dollars of shareholders' equity determined under the second step

⁷⁹ For this purpose, all classes of common stock—whether voting or nonvoting—would be treated as a single class. If certain classes of common stock have different economic interests per share in the issuing company, the number of shares of common stock would be adjusted to equalize the economic interest per share. For example, if a company has Class A common stock and Class B common stock outstanding, and each share of Class B common stock has twice the economic interest in the company as each share of Class A common stock, each share of Class B common stock would be treated as two shares of common stock when aggregated with the Class A common stock.

would be divided by the total shareholders' equity of the second company, as determined under GAAP, to arrive at the total equity percentage of the first company in the second company.

For example, assume that a first company owned 10 shares out of 100 of the common equity of second company, and 5 shares out of 100 of the preferred shares of the second company. In calculating total equity, first company would determine the percentage of shares owned in each class of securities of the second company (10 percent and 5 percent, respectively, in the example above). Second, the first company would multiply its percentage by the GAAP shareholders' equity attributed to each class. For example, assume the common shares were worth \$10,000,000; the first company would be attributed \$1,000,000 of equity based on its ownership of common shares. Further assume that the preferred shares as a class had a liquidation preference of \$1,000,000; the first company would be attributed \$50,000 of equity based on its ownership of preferred shares. Following through on this example, the first company's total equity in the second company would equal:

$$\frac{\$1,000,000 \text{ (common equity)} + \$50,000 \text{ (preferred equity)}}{\$10,000,000 \text{ (total common equity)} + \$1,000,000 \text{ (total preferred equity)}} = 9.5 \text{ percent total equity}$$

The proposal would provide for adjustments to this general standard for more complex structures. For example, a first company would be considered to control all equity securities controlled by its subsidiaries and, as a result, equity securities issued by the second company that are controlled by subsidiaries of the first company would be included in the calculation of total equity of the second company owned by the first company. The proposal also would provide that, to the extent that the first company controls equity instruments issued by a parent company that controls the second company, the calculation of total equity of the second company owned by the first company would include both the direct total equity of the second company controlled by the first company, and the indirect total equity of the second company controlled by the first

company through the parent company of the second company, weighted by the total equity percentage of the second company's parent company in the second company. For example, assume that (i) the first company has direct control over 10 percent of the total equity of the second company, (ii) the first company has 10 percent of the total equity of a third company that controls the second company, and (iii) the third company has 50 percent of the total equity of the second company. Under these circumstances, the total equity of the first company in the second company would be 15 percent—the 10 percent direct total equity interest plus a 5 percent indirect total equity interest (i.e., 10 percent of the 50 percent total equity interest that the third company has in the second company).

Under the proposal, the general standard would apply only to stock corporations that prepare financials under GAAP. However, these standards would be applied in other circumstances to the maximum extent possible consistent with the principles underlying the general standard. The Board recognizes that the standard may not function well for companies that are not stock corporations or that do not prepare GAAP financial statements, and therefore this standard cannot be applied to all companies by default.

In addition to the general standard, the proposal would provide for certain adjustments to prevent evasion that the Board has encountered in prior cases. If a company controls debt of a second company that is functionally equivalent to equity, that debt would count as equity and would be measured based on principal amount. Such debt would be included in the first company's total equity ownership of the second company to the extent the debt is controlled by the first company and the total amount of such debt outstanding would be included in the total shareholders' equity of the second company.

The proposal would include a list of features of debt that could cause the debt to be considered functionally equivalent to equity. These features would include that the debt is treated as equity under accounting, regulatory, or tax standards, or that the debt is very long dated or subordinated. In addition, debt issued by a company that has minimal equity to support the debt and debt that is not issued on market terms may be deemed functionally equivalent to equity. None of the listed features is intended to automatically result in debt being treated as functionally equivalent to equity. Instead, each instrument would have to be considered based on the facts and circumstances presented. The Board expects that it would be unusual for debt to be considered functionally equivalent to equity.

Similarly, the proposal would provide that other interests in a company may be treated as equity if they are functionally equivalent to equity. This is intended to capture arrangements other than debt or equity, such as contractual profit sharing rights, that provide the beneficiary with an economic interest that is equivalent to an equity interest but that often is classified as neither equity nor debt. As with debt that is functionally equivalent to equity, the Board expects that considering these other arrangements to be functionally equivalent to equity would be unusual.

In addition to describing how to calculate total equity, the proposal would provide a standard for when to calculate total equity for purposes of applying the presumptions of control. Under the proposal, an investing company must calculate its total equity in a second company each the time the investing company acquires control over additional interests of the second company or ceases to control interests of the second company.

Question 46: How could the Board further clarify the proposed general standard for calculating total equity percentages? Should any portion of the proposed general standard be revised and, if so, how and why?

Question 47: How could the Board further clarify or refine the proposed standards for considering debt or other interests to be functionally equivalent to total equity for purposes of determining an investor's total equity percentage? Should debt that is functionally equivalent to equity only be considered to the extent that it increases a company's total equity percentage?

Question 48: Should a first company be required to calculate its total equity percentage in a second company on a continuous basis or more frequently than under the proposal, or instead should a first company only be required to calculate its total equity at the time of its investment in a second company? For example, should a first company be required to calculate its total equity percentage in a second company upon any transaction by the second company that increases or decreases the shareholders equity of the second company by at least 5 percent, 10 percent, 25 percent, etc.? What are the benefits and consequences of more or less frequent recalculation of total equity percentages?

Question 49: Is the methodology for calculating total equity sufficiently clear? What additional guidance would improve the operation of the proposed methodology? For example, should the proposed methodology to calculate total equity be expanded to account for the treatment of options or warrants to acquire voting or nonvoting shares, and if so, how?

Question 50: Should the proposed methodology be modified in the circumstance where a company has negative retained earnings, and if so, how? Should the proposed methodology require the attribution of accumulated other comprehensive income to the equity of the company for purposes of calculating a company's total equity investment in another company?

E. Contractual provisions

Under one of the proposed presumptions of control, a company would be presumed to control a second company if the first company has a contractual right that significantly restricts, or allows the first company to significantly restrict, the discretion of the second company over major operational or policy decisions. The proposal would provide examples of contractual provisions that generally would significantly limit a company's discretion over major operational or policy decisions, as well as examples of contractual provisions that generally would not significantly limit discretion over such decisions. The examples are based on the Board's experience reviewing control fact patterns. The proposal would reflect the principle that a noncontrolling equity investor may benefit from certain defensive rights and may participate in most standard types of shareholders agreements, but a noncontrolling equity investor with a more than minimal percentage of voting securities may not have a contractual right to prevent a company from making major business decisions in the ordinary course.

As discussed previously, the presumption of control due to limiting contractual rights does not apply to investors with less than 5 percent of any class of voting securities. In part, this recognizes that creditors often impose significant limitations on borrowers and that the Board generally has not considered standard debtor-creditor relationships to provide the creditor with control over a debtor. However, when a creditor is also a significant equity investor in a debtor, the Board historically has been much more concerned with an investor leveraging its dual relationship as investor and creditor to exercise control over the debtor. The proposal would

apply more broadly than debtor-creditor contracts to cover all contractual arrangements between an equity investor and an investee.⁸⁰

The examples included in the proposal are not intended to provide a complete list of provisions that would or would not raise controlling influence concerns, but rather to offer non-exclusive examples to provide greater transparency into the types of contractual provisions that the Board generally would or would not consider to rise to the level of significantly restricting major operational or policy decisions.

Listed below are the examples included in the proposal for contractual provisions that would provide an investor company the ability to restrict significantly the discretion of a second company:

- Restrictions on activities in which a company may engage, including a prohibition on (i) entering into new lines of business, (ii) making substantial changes to or discontinuing existing lines of business, (iii) entering into a contractual arrangement with a third party that imposes significant financial obligations on the second company, or (iv) materially altering the policies or procedures of the company;
- Requirements that a company direct the proceeds of the investment to effect any action, including to redeem the company's outstanding voting shares;
- Restrictions on hiring, firing, or compensating senior management officials of a company, or restrictions on significantly modifying a company's policies concerning the salary, compensation, employment, or benefits plan for employees of the company;

⁸⁰ For purposes of this restriction, a contractual arrangement between the first company and a subsidiary of the second company, or between a subsidiary of the first company and the second company, could constitute a limiting contractual right of the first company over the second company.

- Restrictions on a company's ability to merge or consolidate, or on its ability to acquire, sell, lease, transfer, spin-off, recapitalize, liquidate, dissolve, or dispose of subsidiaries or major assets;
- Restrictions on a company's ability to make significant investments or expenditures;
- Requirements that a company achieve or maintain certain fundamental financial targets, such as a debt-to-equity ratio, a net worth requirement, a liquidity target, or a working capital requirement;
- Requirements that a company not exceed a specified percentage of classified assets or non-performing loans;
- Restrictions on a company's ability to pay or not pay dividends, change its dividend payment rate on any class of securities, redeem senior instruments, or make voluntary prepayment of indebtedness;
- Restrictions on a company's ability to authorize or issue additional junior equity or debt securities, or amend the terms of any equity or debt securities issued by the company;
- Restrictions on a company's ability to engage in a public offering or to list or de-list securities on an exchange;
- Restrictions on a company's ability to amend its articles of incorporation or by-laws, other than limited restrictions that are solely defensive for the investor;
- Restrictions on the removal or selection of any independent accountant, auditor, or investment banker;
- Restrictions on a company's ability to alter significantly accounting methods and policies, or its regulatory, tax, or corporate status, such as converting from a stock corporation to a limited liability company.

Each of these examples would impose significant restrictions on fundamental business decisions of a company. A significant noncontrolling equity investor should not have a contractual right that provides outsized influence or veto power over these types of decisions.

Although contracts that significantly limit discretion are most often found directly in agreements between an investing company and a target company, the Board has encountered such contractual provisions in other types of documents and in other contexts. For example, arrangements between an investing company and the officers, directors, or principal shareholders of a target company may include contractual provisions that significantly limit the discretion of the individuals who make the major operational or policy decisions of the company. The Board may view such arrangements as limiting the target company's discretion over major decisions.

The proposal also would include a set of examples of rights that generally would not be considered to restrict significantly the discretion of a company over its major operational or policy decisions.⁸¹ In most cases, the Board has not considered contractual provisions that are purely defensive for an investor, or that allow an investor reasonable access to information about a company, to constitute significant restrictions over the discretion of a company. Covenants that require a company to comply with applicable law are also generally not viewed as raising controlling influence concerns. Similarly, standard provisions of investment agreements and shareholders agreements, such as "most-favored nation" clauses, market standard transfer and sale restrictions, and arrangements to preserve tax benefits have not been considered to raise controlling influence concerns for investors.

⁸¹ Provisions that generally would not raise controlling influence concerns could nonetheless raise safety and soundness concerns depending on the facts and circumstances.

Provided below are the proposed rule's examples of contractual provisions that generally would not raise significant controlling influence concerns:

- A restriction on a company's ability to issue securities senior to the non-common stock securities owned by the investor;
- A requirement that a company provide the investor with financial reports of the type ordinarily available to common stockholders;
- A requirement that a company maintain its corporate existence;
- A requirement that a company consult with the investor on a reasonable periodic basis;
- A requirement that a company comply with applicable statutory and regulatory requirements;
- A requirement that a company provide the investor with notice of the occurrence of material events affecting the company or its significant assets;
- A market standard "most-favored nation" requirement that the investor receive similar contractual rights as those held by other investors in a company; or
- Drag-along rights, tag-along rights, rights of first or last refusal, or stock transfer restrictions related to preservation of tax benefits of a company, such as S-corporation status and tax carry forwards, or other similar rights.

The Board generally has not considered these types of rights to provide a company with a significant degree of control over another company.

Question 51: Should the scope of "limiting contractual right" be expanded or reduced? If so, what types of contractual provisions should be covered or not covered? Are there additional examples of contractual rights that should be included in either list of examples?

Question 52: What other common types of contractual provisions generally provide a company with the ability to exercise a controlling influence over another company and should such contractual provisions be listed in the Board's regulation as another example?

F. Director representatives

As discussed previously, the Board has long taken the position that director representatives of a company serving on the board of directors of a second company are an avenue through which the first company may exercise a controlling influence over the second company. Questions often have arisen, however, about whether an individual on the board of directors of the second company should be considered a director representative of the first company.

To provide more clarity on this question, the proposal would provide that a director is a director representative of a company if the director (i) is a current director, employee, or agent of the company; (ii) was a director, employee, or agent of the company within the preceding two years; or (iii) is an immediate family member of an individual who is a current director, employee, or agent of the company, or was a director, employee, or agent of the company within the preceding two years. In addition, the proposal would state that a director is a director representative of a company if the director was proposed to serve as a director by the company, whether by exercise of a contractual right or otherwise. The proposal further would specify that a nonvoting observer would not be a director representative. These standards are not intended to provide an exhaustive definition of a director representative, but would provide significant clarity regarding whether a director qualifies as a director representative of a particular investing company.

Question 53: Does the proposal provide sufficient clarity on the standards for determining whether a director of a company is a director representative of another company?

Question 54: How and why should the proposal be revised to limit or expand the scope of directors who are considered director representatives of a company? Are there any classes of directors that should be treated differently than the proposal would provide?

G. Investment advisers

The proposal would define investment adviser for purposes of the proposed presumptions to mean a company that is registered as an investment adviser with the SEC under the Advisers Act,⁸² a company registered with the Commodity Futures Trading Commission (“CFTC”) as a commodity trading advisor under the Commodity Exchange Act,⁸³ a company that is a foreign equivalent of an investment adviser or commodity trading advisor registered with the SEC or CFTC, respectively, or a company that engages in any of the activities set forth in section 225.28(b)(6)(i) through (iv) of the Board’s Regulation Y. This definition is intended to cover a broad range of activities that are generally considered to be included in the general category of investment advisory services.

Question 52: Should the definition of investment adviser be expanded to cover additional activities or types of registrations or should the definition be narrowed in any way?

IV. Application to savings and loan holding companies

As noted above, the Board would apply the proposal to savings and loan holding companies to the maximum extent permitted by law. HOLA defines control in a substantially

⁸² 15 U.S.C. § 80b-1 et seq.

⁸³ 7 U.S.C. § 1 et seq.

similar manner as the BHC Act.⁸⁴ With respect to controlling influence, HOLA provides that a person controls a savings association or other company “if the Board determines, after reasonable notice and opportunity for hearing, that such person directly or indirectly exercises a controlling influence over the management or policies of such savings association or other company.”⁸⁵ This is a substantially similar standard for controlling influence as provided in the BHC Act.⁸⁶ The Board previously recognized that the statutory control framework under the BHC Act and HOLA are nearly identical when the Board originally promulgated Regulation LL and determined to apply identical procedures for reviewing control determinations to savings and loan holding companies as applied to bank holding companies under Regulation Y.⁸⁷ The Board stated that it would review investments and relationships with savings and loan holding companies using the current practices and policies applicable to bank holding companies to the extent possible.⁸⁸ Following this principle, the proposal would incorporate the proposed control presumptions and related revisions into the Board’s Regulation LL for savings and loan holding companies in essentially the same manner as into the Board’s Regulation Y for bank holding companies.

A. Control under HOLA compared to the BHC Act

Although controlling influence is defined similarly under HOLA and the BHC Act, there are several differences between the “control” definitions used in each statute. First, under

⁸⁴ Compare 12 U.S.C. § 1467a(a)(2) (HOLA) with 12 U.S.C. § 1841(a)(2) (BHC Act).

⁸⁵ 12 U.S.C. § 1467a(a)(2)(D).

⁸⁶ See 12 U.S.C. § 1841(a)(2)(C).

⁸⁷ 76 Fed. Reg. 56508, 56509 (Sept. 13, 2011).

⁸⁸ Id.

HOLA, the definition of control applies to both individuals and companies controlling other companies.⁸⁹ Under the BHC Act, control is limited to companies controlling other companies.⁹⁰ Second, under HOLA, a person controls a company if the person has more than 25 percent of the voting securities of the company, rather than 25 percent or more under the BHC Act.⁹¹ Third, unlike the BHC Act, HOLA specifies 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 percent of the capital of a company controls the company.⁹² Finally, HOLA does not include the BHC Act's presumption of noncontrol for a company with less than 5 percent voting in another company.⁹³ Despite these differences, the Board believes that the statutory construct for controlling influence under HOLA is sufficiently similar to the BHC Act that it is appropriate to apply the same presumptions and related provisions to determinations of controlling influence under each statute.

Under the proposal, the same presumption of control based on total equity ownership would apply for purposes of the BHC Act and HOLA. This element of the proposal could be viewed as inconsistent with the 25 percent of contributed capital standard under HOLA. However, the Board's proposed definition of total equity would rely on GAAP shareholders' equity, not contributed capital. The Board believes that it is appropriate to view total equity and contributed capital as different concepts. Regulation LL would continue to provide that a person

⁸⁹ 12 U.S.C. § 1467a(a)(2).

⁹⁰ Id.

⁹¹ 12 U.S.C. §§ 1467a(2)(A)–(B) and 1841(a)(2)(A).

⁹² 12 U.S.C. § 1467a(2)(B)–(C).

⁹³ 12 U.S.C. § 1841(a)(3).

who has contributed more than 25 percent of the capital of a company has control of the company.⁹⁴

Question 55: Should the Board provide for any different presumptions of control under Regulation LL? If so, what different presumptions and why?

B. Proposed revisions to Regulation LL

Under the proposal, the proposed presumptions and the related amendments to Regulation Y also would be added to Regulation LL, with limited changes to reflect the relevant differences between control under the BHC Act and HOLA. The proposed revisions to defined terms would be located in section 238.2 of Regulation LL. The proposed revisions to the calculation of the percentage of a class of securities controlled by a person would be located in section 238.10 of Regulation LL. The proposed revisions related to control proceedings, including the proposed presumptions of control and noncontrol, would be located in subpart C of Regulation LL.

Question 56: What additional changes to the proposal, if any, should the Board make to account for differences between the BHC Act and HOLA?

V. Administrative Law Matters

A. Paperwork Reduction Act

In accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3521) (PRA), the Board may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The Board reviewed the proposed rule and determined that

⁹⁴ 12 CFR 238.2(e)(2). Contributed capital has generally been understood to mean paid-in capital.

it does not create any new or revise any existing collection of information under section 3504(h) of title 44.

B. Regulatory Flexibility Act

The Board is providing an initial regulatory flexibility analysis with respect to this proposed rule. The Regulatory Flexibility Act, 5 U.S.C. 601 et seq. (RFA), requires an agency to consider whether the rules it proposes will have a significant economic impact on a substantial number of small entities. In connection with a proposed rule, the RFA requires an agency to prepare an Initial Regulatory Flexibility Analysis describing the impact of the rule on small entities or to certify that the proposed rule would not have a significant economic impact on a substantial number of small entities. An initial regulatory flexibility analysis must contain (1) a description of the reasons why action by the agency is being considered; (2) a succinct statement of the objectives of, and legal basis for, the proposed rule; (3) a description of, and, where feasible, an estimate of the number of small entities to which the proposed rule will apply; (4) a description of the projected reporting, recordkeeping, and other compliance requirements of the proposed rule, including an estimate of the classes of small entities that will be subject to the requirement and the type of professional skills necessary for preparation of the report or record; (5) an identification, to the extent practicable, of all relevant federal rules which may duplicate, overlap with, or conflict with the proposed rule; and (6) a description of any significant alternatives to the proposed rule which accomplish its stated objectives.

The Board has considered the potential impact of the proposed rule on small entities in accordance with the RFA. Under regulations issued by the Small Business Administration, a small entity includes a depository institution, bank holding company, or savings and loan holding company with total assets of \$550 million or less and trust companies with total assets of \$38.5

million or less. As of June 30, 2018, there were approximately 3,053 small bank holding companies, 184 small savings and loan holding companies, and 541 small state member banks. The proposed rule may also have implications for additional entities that have material relationships with banking organizations; however, the scope of potentially affected entities and thus the extent to which affected entities are small entities under the regulations of the Small Business Administration, is not known. Based on its analysis and for the reasons stated below, the Board believes that this proposed rule will not have a significant economic impact on a substantial number of small entities. Nevertheless, the Board is publishing and inviting comment on this initial regulatory flexibility analysis. A final regulatory flexibility analysis will be conducted after comments received during the public comment period have been considered.

As discussed in detail above, the proposed rule would revise the Board's regulations for purposes of determining whether a company controls another company under the BHC Act or HOLA, as applicable, by virtue of the first company having a controlling influence over the second company. The proposal consists of a series of rebuttable presumptions of control, a rebuttable presumption of noncontrol, and various ancillary items such as definitions of terms used in the proposed presumptions. The proposed presumptions of control generally would be consistent with the Board's current practice with respect to controlling influence, with certain targeted adjustments. In addition, although the proposed presumptions would provide the public with greater transparency into the Board's views on controlling influence, the proposed presumptions would only apply in the context of a proceeding before the Board to determine whether one company has a controlling influence over another company.

A main impact of the proposal would be to enhance transparency to the public around the Board's views on controlling influence. This should enhance the efficiency of investments into

and by banking organizations by providing greater clarity and certainty on the Board's views. This could result in a material reduction in burden for certain banking organizations or other companies. However, the impact would be realized in the context of discretionary transactions, rather than as a continuous benefit. In addition, the reduction in burden would be concentrated in companies engaged in the particular types of investments where controlling influence is a concern for the parties involved, rather a reduction in burden applicable to all transactions.

The Board does not expect that the proposal would impose a significant cost on small banking organizations due to compliance, recordkeeping, and reporting updates from this proposal. The proposal generally would not impact banking organizations in the ordinary course; there would be no regular compliance, recordkeeping, or reporting costs associated with the proposal. In addition, the Board is aware of no other federal rules that duplicate, overlap, or conflict with the proposed changes to the proposed control rules. Therefore, the Board believes that the proposed rule will not have a significant economic impact on small banking organizations supervised by the Board and therefore believes that there are no significant alternatives to the proposed rule that would reduce the economic impact on small banking organizations supervised by the Board.

The Board welcomes comment on all aspects of its analysis. In particular, the Board requests that commenters describe the nature of any impact on small entities and provide empirical data to illustrate and support the extent of the impact.

C. Solicitation of Comments of Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Board has

sought to present the proposed rule in a simple and straightforward manner, and invite comment on the use of plain language. For example:

- Has the Board organized the material to suit your needs? If not, how could they present the rule more clearly?
- Are the requirements in the rule clearly stated? If not, how could the rule be more clearly stated?
- Do the regulations contain technical language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes would achieve that?
- Is this section format adequate? If not, which of the sections should be changed and how?
- What other changes can the Board incorporate to make the regulation easier to understand?

List of Subjects

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Capital planning, Holding companies, Reporting and recordkeeping requirements Securities, Stress testing.

12 CFR Part 238

Administrative practice and procedure, Banks, Banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Holding companies, Securities.

Authority and Issuance

For the reasons stated in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to amend 12 CFR chapter II as follows:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 continues to read as follows:

AUTHORITY: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3906, 3907, and 3909; 15 U.S.C. 1681s, 1681w, 6801 and 6805.

2. Section 225, paragraph (e)(2) and (q)(2) are revised, and paragraph (u) is added, to read as follows:

§ 225.2 Definitions.

* * * * *

(e) * * *

(2) A bank or other company is deemed to control voting securities or assets owned, controlled, or held, directly or indirectly:

(i) By the bank or other company, or by any subsidiary of the bank or other company;

(ii) That the bank or other company has power to vote or to dispose of;

(iii) In a fiduciary capacity (including by pension and profit-sharing trusts) for the benefit of the shareholders, members, or employees (or individuals serving in similar capacities) of the bank or other company or any of its subsidiaries;

(iv) In a fiduciary capacity for the benefit of the bank or other company or any of its subsidiaries; or

(v) According to the standards under section 225.9 of this part.

(vi) Notwithstanding paragraph (e)(2)(i) through (v), a bank or other company does not control any voting securities that are controlled by a company that is not a direct or indirect subsidiary of the bank or other company as a result of an investment by the bank or other company in the company that controls the voting securities.

* * * * *

(q) * * *

(2) *Nonvoting securities.* Common shares, preferred shares, limited partnership interests, limited liability company interests, or similar interests are not *voting securities* if:

(i) Any voting rights associated with the securities are limited solely to the type customarily provided by statute with regard 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;

(ii) The securities represent an essentially passive investment or financing device and do not otherwise provide the holder with control over the issuing company; and

(iii) The securities do not entitle the holder, by statute, charter, or in any manner, to select or to vote for the selection of directors, trustees, or partners (or persons exercising similar functions) of the issuing company; except that limited partnership interests or membership interests in limited liability companies are not voting securities due to voting rights that are limited solely to voting for the removal of a general partner or managing member (or persons exercising similar functions at the company) for cause, to replace a general partner or managing member (or persons exercising similar functions at the company) due to incapacitation or following the removal of such person, or to continue or dissolve the company after removal of the general partner or managing member (or persons exercising similar functions at the company).

* * * * *

(u) Voting percentage. For purposes of this part, the percentage of a class of a company's voting securities controlled by a person is the greater of:

(1) The quotient, expressed as a percentage, of the number of shares of the class of voting securities controlled by the person, divided by the number of shares of the class of voting securities that are issued and outstanding, both as determined under section 225.9 of this part; and

(2) The quotient, expressed as a percentage, of the number of votes that may be cast by the person on the voting securities controlled by the person, divided by the total votes that are legally entitled to be cast by the issued and outstanding shares of the class of voting securities, both as determined under section 225.9 of this part.

* * * * *

3. Section 225.9 is added to read as follows:

§ 225.9 Control over securities.

(a) Contingent rights, convertible securities, options, and warrants. (1) A person that controls a voting security, nonvoting security, option, warrant, or other financial instrument that is convertible into, exercisable for, exchangeable for, or otherwise may become a voting security or a nonvoting security controls each voting security or nonvoting security that could be acquired as a result of such conversion, exercise, exchange, or similar occurrence.

(2) If a financial instrument of the type described in paragraph (a)(1) is convertible into, exercisable for, exchangeable for, or otherwise may become a number of voting securities or nonvoting securities that varies according to a formula, rate, or other variable metric, the number of voting securities or nonvoting securities controlled under paragraph (a)(1) is the maximum number of voting securities or nonvoting securities that the financial instrument could be converted into, be exercised for, be exchanged for, or otherwise become under the formula, rate, or other variable metric.

(3) Notwithstanding paragraph (a)(1), a person does not control voting securities due to controlling a financial instrument if the financial instrument:

(i) By its terms is not convertible into, is not exercisable for, is not exchangeable for, and may not otherwise become voting securities in the hands of the person or an affiliate of the person; and

(ii) By its terms the financial instrument is only transferable:

(A) In a widespread public distribution;

(B) To an affiliate of the person or to the issuing company;

(C) In transfers in which no transferee (or group of associated transferees) would receive 2 percent or more of the outstanding securities of any class of voting securities of the issuing company; or

(D) To a transferee that would control more than 50 percent of every class of the voting securities of the issuing company without any transfer from the person.

(4) Notwithstanding any other paragraph of this section, a person that has agreed to acquire voting securities, nonvoting securities, or other financial instruments pursuant to a securities purchase agreement does not control such voting securities, nonvoting securities, or financial instruments until the person acquires the voting securities, nonvoting shares or other financial instruments.

(5) Notwithstanding any other paragraph of this section, a right that provides a person the ability to acquire securities in future issuances or to convert nonvoting securities into voting securities does not cause the person to control the voting securities or nonvoting securities that could be acquired under the right, so long as the right does 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.

(6) For purposes of determining the percentage of a class of voting securities or the total equity percentage of a company controlled by a person that controls a financial instrument of the type described in paragraph (a)(1):

(A) The voting securities or nonvoting securities controlled by the person under paragraphs (a)(1)-(5) are deemed to be issued and outstanding, and

(B) Any voting securities or nonvoting securities controlled by anyone other than the person under paragraph (a)(1)-(5) are not deemed to be issued and outstanding, unless by the

terms of the financial instruments the voting securities or nonvoting securities controlled by the other persons must be issued and outstanding in order for the voting securities or nonvoting securities of the person to be issued and outstanding.

(b) Restriction on securities. A person that enters into an agreement or understanding with a second person under which the rights of the second person are restricted in any manner with respect to securities that are controlled by the second person, controls the securities of the second person, unless the restriction is:

(1) A requirement that the second person offer the securities for sale to the first person for a reasonable period of time prior to transferring the securities to a third party;

(2) A requirement that, if the second person agrees to sell the securities, the second person provide the first person with the opportunity to participate in the sale of securities by the second person;

(3) A requirement under which the second person agrees to sell its securities to a third party if a majority of shareholders agree to sell their shares to the third party;

(4) Incident to a bona fide loan transaction in which the securities serve as collateral;

(5) A short-term and revocable proxy;

(6) A restriction on transferability that continues only for a reasonable amount of time necessary to complete a transaction to transfer the shares, including the time necessary to obtain required approval from an appropriate government authority with respect to acquisition by the first person of the securities of the second person;

(7) A requirement that the second person vote the securities in favor of a specific acquisition of control of the issuing company, or against competing transactions, if the restriction continues only for a reasonable amount of time necessary to complete the transaction, including

the time necessary to obtain required approval from an appropriate government authority with respect to an acquisition or merger; or

(8) An agreement among shareholders of the issuing company intended to preserve the tax status or tax benefits of the company, such as qualification of the issuing company as a Subchapter S corporation, as defined in 26 U.S.C. § 1361(a)(1) or any successor statute, or prevention of events that could impair deferred tax assets, such as net operating loss carryforwards, as described in 26 U.S.C. § 382 or any successor statute.

(c) Securities held by senior management officials or controlling equity holders of a company. A company that controls 5 percent or more of the voting securities of another company controls all securities issued by the second company that are controlled by senior management officials, directors, or controlling shareholders of the first company, or by immediate family members of such persons.

(d) Reservation of authority. Notwithstanding paragraphs (a) through (c) of this section, the Board may determine that securities are or are not controlled by a company based on the facts and circumstances presented.

* * * * *

4. Section 225.31 is revised to read as follows:

§ 225.31 Control proceedings.

(a) Preliminary determination of control. (1) The Board in its sole discretion may issue a preliminary determination of control under the procedures set forth in this section in any case in which the Board determines, based on consideration of the facts and circumstances presented,

that a first company has the power to exercise a controlling influence over the management or policies of a second company.

(2) If the Board makes a preliminary determination of control under this section, the Board shall send notice to the first company containing a statement of the facts upon which the preliminary determination is based.

(b) Response to preliminary determination of control. (1) Within 30 calendar days after issuance by the Board of a preliminary determination of control or such longer period permitted by the Board in its discretion, the first company against whom the preliminary determination has been made shall:

(i) Consent to the preliminary determination of control and either:

(A) Submit for the Board's approval a specific plan for the prompt termination of the control relationship; or

(B) File an application or notice under this part, as applicable; or

(ii) Contest the preliminary determination by filing a response, setting forth the facts and circumstances in support of its position that no control exists, and, if desired, requesting a hearing or other proceeding.

(2) If the first company fails to respond to the preliminary determination of control within 30 days, the first company will be deemed to have waived its right to present additional information to the Board or to request a hearing or other proceeding regarding the preliminary determination of control.

(c) Hearing and final determination. (1) The Board shall order a hearing or other appropriate proceeding upon the petition of a first company that contests a preliminary determination of control if the Board finds that material facts are in dispute. The Board may, in

its discretion, order a hearing or other appropriate proceeding without a petition for such a proceeding by the first company.

(2) At a hearing or other proceeding, any applicable presumptions established under this subpart shall be considered in accordance with the Federal Rules of Evidence and the Board's Rules of Practice for Formal Hearings (12 CFR part 263).

(3) After considering the submissions of the first company and other evidence, including the record of any hearing or other proceeding, the Board will issue a final order determining whether the first company has the power to exercise a controlling influence over the management or policies of the second company. If a controlling influence is found, the Board may direct the first company to terminate the control relationship or to file an application or notice for the Board's approval to retain the control relationship.

(d) Rebuttal of presumptions of control of a company. (1) In connection with contesting a preliminary determination of control under paragraph (b)(1)(ii) of this section, a first company may submit to the Board evidence or any other relevant information related to its control of a second company.

(2) Evidence or other relevant information submitted to the Board pursuant to paragraph (d)(1) must be in writing and may include a description of all current and proposed relationships between the first company and the second company, including relationships of the type that are identified under any of the rebuttable presumptions in sections 225.32 and 225.33 of this part, copies of any formal agreements related to such relationships, and a discussion regarding why the Board should not determine the first company to control the second company.

(e) Definitions. For purposes of this subpart:

(1) Board of directors means the board of directors of a company or a set of individuals exercising similar functions at a company.

(2) Director representative means, with respect to a first company,

(i) Any individual that serves on the board of directors of a second company and:

(A) Was nominated or proposed to serve by the first company;

(B) Is a current employee, director, or agent of the first company;

(C) Served as an employee, director, or agent of the first company during the immediately preceding two years; or

(D) Is a member of the immediate family of any employee, director, or agent of the first company.

(ii) A director representative does not include a nonvoting observer.

(3) First company means the company whose potential control of a second company is the subject of determination by the Board under this subpart.

(4) Investment adviser means a company that:

(i) Is registered as an investment adviser with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 et seq.);

(ii) Is registered as a commodity trading advisor with the Commodity Futures Trading Commission under the Commodity Exchange Act (7 U.S.C. § 1 et seq.);

(iii) Is a foreign equivalent of an investment adviser or commodity trading advisor, as described in paragraph (e)(4)(i) and (ii) above; or

(iv) Engages in any of the activities set forth in section 225.28(b)(6)(i)-(iv) of this part.

(5) Limiting contractual right means a contractual right of the first company that would allow the first company to restrict significantly, directly or indirectly, the discretion of the second

company, including its senior management officials and directors, over operational and policy decisions of the second company.

(i) A limiting contractual right includes, but is not limited to, a right that allows the first company to restrict or to exert significant influence over decisions related to:

(A) Activities in which the second 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 second company;

(B) How the second company directs the proceeds of the first company's investment;

(C) Hiring, firing, or compensating one or more senior management officials of the second company, or modifying the second company's policies or budget concerning the salary, compensation, employment, or benefits plan for its employees;

(D) The second company's ability to merge or consolidate, or on its ability to acquire, sell, lease, transfer, spin-off, recapitalize, liquidate, dissolve, or dispose of subsidiaries or assets;

(E) The second company's ability to make investments or expenditures;

(F) The second company achieving or maintaining a financial target or limit, including, for example, a debt-to-equity ratio, a fixed charges ratio, a net worth requirement, a liquidity target, a working capital target, or a classified assets or nonperforming loans limit;

(G) The second company's payment of dividends on any class of securities, redemption of senior instruments, or voluntary prepayment of indebtedness;

(H) The second company's ability to authorize or issue additional junior equity or debt securities, or amend the terms of any equity or debt securities issued by the second company;

(I) The second company's 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 first company to have the same status as other securities of the same class;

(J) The second company's ability to amend its articles of incorporation or by-laws, other than in a way that is solely defensive for the first company;

(K) The removal or selection of any independent accountant, auditor, investment adviser, or investment banker employed by the second company;

(L) The second company's ability to significantly alter accounting methods and policies, or its regulatory, tax, or liability status (e.g., converting from a stock corporation to a limited liability company); and

(ii) A limiting contractual right does not include a contractual right that would not allow the first company to significantly restrict, directly or indirectly, the discretion of the second company over operational and policy decisions of the second company, such as:

(A) A right that allows the first company to restrict or to exert significant influence over decisions relating to the second company's ability to issue securities senior to securities owned by the first company;

(B) A requirement that the first company receive financial reports of the type ordinarily available to common stockholders;

(C) A requirement that the second company maintain its corporate existence;

(D) A requirement that the second company consult with the first company on a reasonable periodic basis;

(E) A requirement that the second company provide notices of the occurrence of material events affecting the second company;

(F) A requirement that the second company comply with applicable statutory and regulatory requirements;

(G) A market standard requirement that the first company receive similar contractual rights as those held by other investors in the second company;

(H) A requirement that the first company be able to purchase additional shares issued by the second company in order to maintain the first company's percentage ownership in the second company;

(I) A requirement that the second company ensure that any shareholder who intends to sell its shares of the second company provide other shareholders of the second company or the second company itself the opportunity to purchase the shares before the shares can be sold to a third party; or

(J) A requirement that the second company take reasonable steps to ensure the preservation of tax status or tax benefits, such as status of the second company as a Subchapter S corporation or the protection of the value of net operating loss carry-forwards.

(6) Second company means the company whose potential control by a first company is the subject of determination by the Board under this subpart.

(7) Senior management official means any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of a company.

(f) Reservation of authority. Nothing in this subpart shall limit the authority of the Federal Reserve to take any supervisory or enforcement action otherwise permitted by law, including an action to address unsafe or unsound practices or conditions, or violations of law.

* * * * *

5. Sections 225.32, 225.34, and 225.35 are added to read as follows:

§ 225.32 Rebuttable presumptions of control of a company.

(a) General. (1) In any proceeding under section 225.31(b)(2) or (c) of this part, a first company is presumed to control a second company in the situations described in subsections (b) through (i) of this section. The Board also may find that a first company controls a second company based on other facts and circumstances.

(2) For purposes of the presumptions in this section, any company that is a subsidiary of the first company and also a subsidiary of the second company is considered to be a subsidiary of the first company and not a subsidiary of the second company.

(b) Management contract or similar agreement. The first company enters into any agreement, understanding, or management contract (other than to serve as investment adviser) with the second company, under which the first company directs or exercises significant influence or discretion over the general management, overall operations, or core business or policy decisions of the second company. Examples of such agreements include where the first company is a managing member, trustee, or general partner of the second company, or exercises similar powers and functions.

(c) Total equity. The first company controls one third or more of the total equity of the second company.

(d) Ownership or control of 5 percent or more of voting securities. The first company controls 5 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) (i) Director representatives of the first company or any of its subsidiaries comprise 25 percent or more of the board of directors of the second company or any of its subsidiaries; or

(ii) Director representatives of the first company or any of its subsidiaries are able to make or block the making of major operational or policy decisions of the second company or any of its subsidiaries;

(2) Two or more employees or directors of the first company or any of its subsidiaries serve as senior management officials of the second company or any of its subsidiaries;

(3) An employee or director of the first company or any of its subsidiaries serves as the chief executive officer, or serves in a similar capacity, of the second company or any of its subsidiaries;

(4) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the first company or the second company, each on a consolidated basis;

(5) The first company or any of its subsidiaries has any limiting contractual right with respect to the second company or any of its subsidiaries, unless such limiting contractual right is part of an agreement to merge with or make a controlling investment in the second company that is reasonably expected to close within one year and such limiting contractual right is designed to ensure that the second company continues to operate in the ordinary course until the merger or investment is consummated or such limiting contractual right requires the second company to take an action necessary for the merger or investment to be consummated; or

(6) Senior management officials and directors of the first company and its subsidiaries, together with their immediate family members and the first company and its subsidiaries, own,

control, or have power to vote 25 percent or more of any class of voting securities of the second company, unless the first company and its subsidiaries control less than 15 percent of each class of voting securities of the second company and the senior management officials and directors of the first company and its subsidiaries, together with their immediate family members, own, control, or have power to vote 50 percent or more of each class of voting securities of the second company.

(e) Ownership or control of 10 percent or more of voting securities. The first company controls 10 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) The first company or any of its subsidiaries propose a number of director representatives to the board of directors of the second company or any of its subsidiaries in opposition to the nominees proposed by the management or board of directors of the second company or any of its subsidiaries that, together with any director representatives of the first company or any of its subsidiaries on the board of directors of the second company or any of its subsidiaries, exceed the number of director representatives that the first company could have without being presumed to control the second company under section 225.32(d)(1)(i) of this part;

(2) Director representatives of the first company and its subsidiaries comprise more than 25 percent of any committee of the board of directors of the second company or any of its subsidiaries that can take actions that bind the second company or any of its subsidiaries; or

(3) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that:

(i) Are not on market terms; or

(ii) Generate in the aggregate 5 percent or more of the total annual revenues or expenses of the first company or the second company, each on a consolidated basis.

(f) Ownership or control of 15 percent or more of voting securities. The first company controls 15 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) The first company controls 25 percent or more of the total equity of the second company;

(2) A director representative of the first company or of any of its subsidiaries serves as the chair of the board of directors of the second company or any of its subsidiaries;

(3) One or more employees or directors of the first company or any of its subsidiaries serves as a senior management official of the second company or any of its subsidiaries; or

(4) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that generate in the aggregate 2 percent or more of the total annual revenues or expenses of the first company or the second company, each on a consolidated basis.

(g) Accounting consolidation. The first company consolidates the second company on its financial statements prepared under U.S. generally accepted accounting principles.

(h) Control of an investment fund. (1) The first company serves as an investment adviser to the second company, the second company is an investment fund, and the first company, directly or indirectly, or acting through one or more other persons:

(i) Controls 5 percent or more of the outstanding securities of any class of voting securities of the second company; or

(ii) Controls 25 percent or more of the total equity of the second company.

(2) The presumption of control in paragraph (h)(1) of this section does not apply if the first company organized and sponsored the second company within the preceding 12 months.

(i) Divestiture of control. (1) The first company controlled the second company under paragraph (e)(1)(i) or (ii) of section 225.2 of this part at any time during the prior two years and the first company controls 15 percent or more of any class of voting securities of the second company.

(2) Notwithstanding paragraph (i)(1), a first company will not be presumed to control a second company under this paragraph if 50 percent or more of the outstanding securities of each class of voting securities of the second company is controlled by a person that is not a senior management official or director of the first company, or by a company that is not an affiliate of the first company.

(j) Registered investment company. The presumptions of control in this section do not apply if:

(1) The second company is an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. § 80a et seq.);

(2) The business relationships between the first company and the second company are limited to investment advisory, custodian, transfer agent, registrar, administrative, distributor, and securities brokerage services provided by the first company to the second company;

(3) Director representatives of the first company or any of its subsidiaries comprise 25 percent or less of the board of directors or trustees of the second company; and

(4) (i) The first company controls less than 5 percent of the outstanding securities of each class of voting securities of the second company and less than 25 percent of the total equity of the second company, or

(ii) The first company organized and sponsored the second company within the preceding 12 months.

(k) Shares held in a fiduciary capacity. The presumptions of control in this section do not apply to the extent that the first company or any of its subsidiaries control the securities of the second company or any of its subsidiaries in a fiduciary capacity without sole discretionary authority to exercise the voting rights.

§ 225.33 Rebuttable presumption of noncontrol of a company.

(a) In any proceeding under section 225.31(b)(2) or (c) of this part, a first company is presumed not to control a second company if:

(1) The first company controls less than 10 percent of the outstanding securities of each class of voting securities of the second company, and

(2) The first company is not presumed to control the second company under section 225.32 of this part.

(b) In any proceeding under this subpart, or judicial proceeding under the Bank Holding Company Act, other than a proceeding in which the Board has made a preliminary determination that a first company has the power to exercise a controlling influence over the management or policies of a second company, a first company may not be held to have had control over a second company at any given time, unless the first company, at the time in question, controlled 5 percent or more of the outstanding securities of any class of voting securities of the second company, or had already been found to have control on the basis of the existence of a controlling influence relationship.

§ 225.34 Total Equity.

(a) General. For purposes of this subpart, the total equity controlled by a first company in a second company that is organized as a stock corporation and prepares financial statements pursuant to U.S. generally accepted accounting principles is calculated as described in paragraph (b) of this section. With respect to a second company that is not organized as a stock corporation or that does not prepare financial statements pursuant to U.S. generally accepted accounting principles, the first company's total equity in the second company will be calculated so as to be reasonably consistent with the methodology described in paragraph (b) of this section, while taking into account the legal form of the second company and the accounting system used by the second company to prepare financial statements.

(b) Calculation of total equity. (1) Total Equity. The first company's total equity in the second company, expressed as a percentage, is equal to:

(i) The sum of Investor Common Equity and, for each class of preferred stock issued by the second company, Investor Preferred Equity, divided by

(ii) Issuer Shareholders' Equity.

(2) Investor Common Equity equals the greater of:

(i) Zero, and

(ii) The quotient of the number of shares of common stock of the second company that are controlled by the first company divided by the total number of shares of common stock of the second company that are issued and outstanding, multiplied by the amount of shareholders'

equity of the second company not allocated to preferred stock under U.S. generally accepted accounting principles.⁹⁵

(3) Investor Preferred Equity equals, for each class of preferred stock issued by the second company, the greater of:

(i) Zero, and

(ii) The quotient of the number of shares of the class of preferred stock of the second company that are controlled by the first company divided by the total number of shares of the class of preferred stock that are issued and outstanding, multiplied by the amount of shareholders' equity of the second company allocated to the class of preferred stock under U.S. generally accepted accounting principles.

(c) Consideration of debt instruments and other interests in total equity. (1) For purposes of the total equity calculation in paragraph (b) of this section, a debt instrument or other interest issued by the second company that is held by the first company may be treated as an equity instrument if that debt instrument or other interest is functionally equivalent to equity.

(2) For purposes of paragraph (b)(1) of this section, the principal amount of all debt instruments and the market value of all other interests that are functionally equivalent to equity that are owned or controlled by the first company are added to the sum under paragraph (b)(1)(i), and the principal amount of all debt instruments and the market value of all other interests that are functionally equivalent to equity that are outstanding are added to Issuer Shareholders' Equity.

⁹⁵ If the second company has multiple classes of common stock outstanding and different classes of common stock have different economic interests in the second company on a per share basis, the number of shares of common stock must be adjusted for purposes of this calculation so that each share of common stock has the same economic interest in the second company.

(3) For purposes of paragraph (b)(1), a debt instrument issued by the second company may be considered functionally equivalent to equity if it has equity-like characteristics, such as:

- (i) Extremely long-dated maturity;
- (ii) Subordination to other debt instruments issued by the second company;
- (ii) Qualification as regulatory capital under any regulatory capital rules applicable to the second company;
- (iii) Qualification as equity under applicable tax law;
- (iv) Qualification as equity under U.S. generally accepted accounting principles or other applicable accounting standards;
- (v) Inadequacy of the equity capital underlying the debt at the time of the issuance of the debt; and
- (vi) Issuance not on market terms.

(4) For purposes of paragraph (b)(1), an interest that is not a debt instrument issued by the second company may be considered functionally equivalent to equity if it has equity-like characteristics, such as entitling its owner to a share of the profits of the second company.

(d) Investments in parent companies of a second company. If a first company controls equity interests of one or more companies that directly or indirectly control the second company (parent company), the total equity of the first company in the second company is equal to:

(1) The first company's total equity of the second company as calculated under paragraph (b) of this section, plus

(2) The product of the first company's total equity of each parent company, calculated in accordance with paragraph (b) of this section, multiplied by the parent company's total equity in the second company, as calculated under paragraph (b) of this section.

(e) Frequency of total equity calculation. The total equity of a first company in a second company is calculated each time the first company acquires control over or ceases to control equity instruments of the second company, including any debt instruments or other interests that are functionally equivalent to equity in accordance with paragraph (c) of this section.

* * * * *

PART 238—SAVINGS AND LOAN HOLDING COMPANIES (REGULATION LL)

6. The authority citation for part 238 continues to read as follows:

AUTHORITY: 5 U.S.C. 552, 559; 12 U.S.C. 1462, 1462a, 1464, 1467, 1467a, 1468, 1813, 1817, 1829e, 1831i, 1972; 12 U.S.C. 781.

7. Section 238, paragraph (e) and (r)(2) are revised, and paragraph (v) is added, to read as follows:

§ 238.2 Definitions.

* * * * *

(e) A person shall be deemed to have *control* of:

(1) A savings association if the person directly or indirectly or acting in concert with one or more other persons, or through one or more subsidiaries, owns, controls, or holds with power to vote, or holds proxies representing, more than 25 percent of the voting shares of such savings association, or controls in any manner the election of a majority of the directors of such association;

(2) Any other company if the person directly or indirectly or acting in concert with one or more other persons, or through one or more subsidiaries, owns, controls, or holds with power to

vote, or holds proxies representing, more than 25 percent of the voting shares or rights of such other company, or controls in any manner the election or appointment of a majority of the directors or trustees of such other company, or is a general partner in or has contributed more than 25 percent of the capital of such other company;

(3) A trust if the person is a trustee thereof;

(4) A savings association or any other company if the Board determines, after reasonable notice and opportunity for hearing, that such person directly or indirectly exercises a controlling influence over the management or policies of such association or other company; or

(5) Voting securities or assets owned, controlled, or held, directly or indirectly:

(i) By the savings association or other company, or by any subsidiary of the savings association or other company;

(ii) That the savings association or other company has power to vote or to dispose of;

(iii) In a fiduciary capacity (including by pension and profit-sharing trusts) for the benefit of the shareholders, members, or employees (or individuals serving in similar capacities) of the savings association or other company or any of its subsidiaries;

(iv) In a fiduciary capacity for the benefit of the bank or other company or any of its subsidiaries; or

(v) According to the standards under section 238.10 of this part.

(vi) Notwithstanding paragraph (e)(5)(i) through (v), a savings association or other company does not control any voting securities that are controlled by a company that is not a direct or indirect subsidiary of the savings association or other company as a result of an investment by the savings association or other company in the company that controls the voting securities.

* * * * *

(r) * * *

(2) *Nonvoting securities.* Common shares, preferred shares, limited partnership interests, limited liability company interests, or similar interests are not *voting securities* if:

(i) Any voting rights associated with the securities are limited solely to the type customarily provided by statute with regard 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;

(ii) The securities represent an essentially passive investment or financing device and do not otherwise provide the holder with control over the issuing company; and

(iii) The securities do not entitle the holder, by statute, charter, or in any manner, to select or to vote for the selection of directors, trustees, or partners (or persons exercising similar functions) of the issuing company; except that limited partnership interests or membership interests in limited liability companies are not voting securities due to voting rights that are limited solely to voting for the removal of a general partner or managing member (or persons exercising similar functions at the company) for cause, to replace a general partner or managing member (or persons exercising similar functions at the company) due to incapacitation or following the removal of such person, or to continue or dissolve the company after removal of the general partner or managing member (or persons exercising similar functions at the company).

* * * * *

(v) Voting percentage. For purposes of this part, the percentage of a class of a company's voting securities controlled by a person is the greater of:

(1) The quotient, expressed as a percentage, of the number of shares of the class of voting securities controlled by the person, divided by the number of shares of the class of voting securities that are issued and outstanding, both as determined under section 238.10 of this part; and

(2) The quotient, expressed as a percentage, of the number of votes that may be cast by the person on the voting securities controlled by the person, divided by the total votes that are legally entitled to be cast by the issued and outstanding shares of the class of voting securities, both as determined under section 238.10 of this part.

* * * * *

8. Section 238.10 is added to read as follows:

Subpart A—General Provisions * * *

§ 238.10 Control over securities.

(a) Contingent rights, convertible securities, options, and warrants. (1) A person that controls a voting security, nonvoting security, option, warrant, or other financial instrument that is convertible into, exercisable for, exchangeable for, or otherwise may become a voting security or a nonvoting security controls each voting security or nonvoting security that could be acquired as a result of such conversion, exercise, exchange, or similar occurrence.

(2) If a financial instrument of the type described in paragraph (a)(1) is convertible into, exercisable for, exchangeable for, or otherwise may become a number of voting securities or nonvoting securities that varies according to a formula, rate, or other variable metric, the number

of voting securities or nonvoting securities controlled under paragraph (a)(1) is the maximum number of voting securities or nonvoting securities that the financial instrument could be converted into, be exercised for, be exchanged for, or otherwise become under the formula, rate, or other variable metric.

(3) Notwithstanding paragraph (a)(1), a person does not control voting securities due to controlling a financial instrument if the financial instrument:

(i) By its terms is not convertible into, is not exercisable for, is not exchangeable for, and may not otherwise become voting securities in the hands of the person or an affiliate of the person; and

(ii) By its terms the financial instrument is only transferable:

(A) In a widespread public distribution;

(B) To an affiliate of the person or to the issuing company;

(C) In transfers in which no transferee (or group of associated transferees) would receive 2 percent or more of the outstanding securities of any class of voting securities of the issuing company; or

(D) To a transferee that would control more than 50 percent of every class of the voting securities of the issuing company without any transfer from the person.

(4) Notwithstanding any other paragraph of this section, a person that has agreed to acquire voting securities, nonvoting securities, or other financial instruments pursuant to a securities purchase agreement does not control such voting securities, nonvoting securities, or financial instruments until the person acquires the voting securities, nonvoting shares or other financial instruments.

(5) Notwithstanding any other paragraph of this section, a right that provides a person the ability to acquire securities in future issuances or to convert nonvoting securities into voting securities does not cause the person to control the voting securities or nonvoting securities that could be acquired under the right, so long as the right does 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.

(6) For purposes of determining the percentage of a class of voting securities or the total equity percentage of a company controlled by a person that controls a financial instrument of the type described in paragraph (a)(1):

(A) The voting securities or nonvoting securities controlled by the person under paragraphs (a)(1)-(5) are deemed to be issued and outstanding, and

(B) Any voting securities or nonvoting securities controlled by anyone other than the person under paragraph (a)(1)-(5) are not deemed to be issued and outstanding, unless by the terms of the financial instruments the voting securities or nonvoting securities controlled by the other persons must be issued and outstanding in order for the voting securities or nonvoting securities of the person to be issued and outstanding.

(b) Restriction on securities. A person that enters into an agreement or understanding with a second person under which the rights of the second person are restricted in any manner with respect to securities that are controlled by the second person, controls the securities of the second person, unless the restriction is:

(1) A requirement that the second person offer the securities for sale to the first person for a reasonable period of time prior to transferring the securities to a third party;

(2) A requirement that, if the second person agrees to sell the securities, the second person provide the first person with the opportunity to participate in the sale of securities by the second person;

(3) A requirement under which the second person agrees to sell its securities to a third party if a majority of shareholders agree to sell their shares to the third party;

(4) Incident to a bona fide loan transaction in which the securities serve as collateral;

(5) A short-term and revocable proxy;

(6) A restriction on transferability that continues only for a reasonable amount of time necessary to complete a transaction to transfer the shares, including the time necessary to obtain required approval from an appropriate government authority with respect to acquisition by the first person of the securities of the second person;

(7) A requirement that the second person vote the securities in favor of a specific acquisition of control of the issuing company, or against competing transactions, if the restriction continues only for a reasonable amount of time necessary to complete the transaction, including the time necessary to obtain required approval from an appropriate government authority with respect to an acquisition or merger; or

(8) An agreement among shareholders of the issuing company intended to preserve the tax status or tax benefits of the company, such as qualification of the issuing company as a Subchapter S corporation, as defined in 26 U.S.C. § 1361(a)(1) or any successor statute, or prevention of events that could impair deferred tax assets, such as net operating loss carryforwards, as described in 26 U.S.C. § 382 or any successor statute.

(c) Securities held by senior management officials or controlling equity holders of a company. A company that controls 5 percent or more of the voting securities of another

company controls all securities issued by the second company that are controlled by senior management officials, directors, or controlling shareholders of the first company, or by immediate family members of such persons.

(d) Reservation of authority. Notwithstanding paragraphs (a) through (c) of this section, the Board may determine that securities are or are not controlled by a company based on the facts and circumstances presented.

* * * * *

9. Section 238.21 is revised to read as follows:

§ 238.21 Control proceedings.

(a) Preliminary determination of control. (1) The Board in its sole discretion may issue a preliminary determination of control under the procedures set forth in this section in any case in which the Board determines, based on consideration of the facts and circumstances presented, that a first company has the power to exercise a controlling influence over the management or policies of a second company.

(2) If the Board makes a preliminary determination of control under this section, the Board shall send notice to the first company containing a statement of the facts upon which the preliminary determination is based.

(b) Response to preliminary determination of control. (1) Within 30 calendar days after issuance by the Board of a preliminary determination of control or such longer period permitted by the Board in its discretion, the first company against whom the preliminary determination has been made shall:

(i) Consent to the preliminary determination of control and either:

(A) Submit for the Board's approval a specific plan for the prompt termination of the control relationship; or

(B) File an application or notice under this part, as applicable; or

(ii) Contest the preliminary determination by filing a response, setting forth the facts and circumstances in support of its position that no control exists, and, if desired, requesting a hearing or other proceeding.

(2) If the first company fails to respond to the preliminary determination of control within 30 days, the first company will be deemed to have waived its right to present additional information to the Board or to request a hearing or other proceeding regarding the preliminary determination of control.

(c) Hearing and final determination. (1) The Board shall order a hearing or other appropriate proceeding upon the petition of a first company that contests a preliminary determination of control if the Board finds that material facts are in dispute. The Board may, in its discretion, order a hearing or other appropriate proceeding without a petition for such a proceeding by the first company.

(2) At a hearing or other proceeding, any applicable presumptions established under this subpart shall be considered in accordance with the Federal Rules of Evidence and the Board's Rules of Practice for Formal Hearings (12 CFR part 263).

(3) After considering the submissions of the first company and other evidence, including the record of any hearing or other proceeding, the Board will issue a final order determining whether the first company has the power to exercise a controlling influence over the management or policies of the second company. If a controlling influence is found, the Board may direct the

first company to terminate the control relationship or to file an application or notice for the Board's approval to retain the control relationship.

(d) Rebuttal of presumptions of control of a company.

(1) In connection with contesting a preliminary determination of control under paragraph (b)(1)(ii) of this section, a first company may submit to the Board evidence or any other relevant information related to its control of a second company.

(2) Evidence or other relevant information submitted to the Board pursuant to paragraph (d)(1) must be in writing and may include a description of all current and proposed relationships between the first company and the second company, including relationships of the type that are identified under any of the rebuttable presumptions in sections 238.22 and 238.23 of this part, copies of any formal agreements related to such relationships, and a discussion regarding why the Board should not determine the first company to control the second company.

(e) Definitions. For purposes of this subpart:

(1) Board of directors means the board of directors of a company or a set of individuals exercising similar functions at a company.

(2) Director representative means, with respect to a first company,

(i) Any individual that serves on the board of directors of a second company and:

(A) Was nominated or proposed to serve by the first company;

(B) Is a current employee, director, or agent of the first company;

(C) Served as an employee, director, or agent of the first company during the immediately preceding two years; or

(D) Is a member of the immediate family of any employee, director, or agent of the first company.

(ii) A director representative does not include a nonvoting observer.

(3) First company means the company whose potential control of a second company is the subject of determination by the Board under this subpart.

(4) Investment adviser means a company that:

(i) Is registered as an investment adviser with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 et seq.);

(ii) Is registered as a commodity trading advisor with the Commodity Futures Trading Commission under the Commodity Exchange Act (7 U.S.C. § 1 et seq.);

(iii) Is a foreign equivalent of an investment adviser or commodity trading advisor, as described in paragraph (e)(4)(i) and (ii) above; or

(iv) Engages in any of the activities set forth in 12 CFR 225.28(b)(6)(i)-(iv).

(5) Limiting contractual right means a contractual right of the first company that would allow the first company to restrict significantly, directly or indirectly, the discretion of the second company, including its senior management officials and directors, over operational and policy decisions of the second company.

(i) A limiting contractual right includes, but is not limited to, a right that allows the first company to restrict or to exert significant influence over decisions related to:

(A) Activities in which the second 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 second company;

(B) How the second company directs the proceeds of the first company's investment;

(C) Hiring, firing, or compensating one or more senior management officials of the second company, or modifying the second company's policies or budget concerning the salary, compensation, employment, or benefits plan for its employees;

(D) The second company's ability to merge or consolidate, or on its ability to acquire, sell, lease, transfer, spin-off, recapitalize, liquidate, dissolve, or dispose of subsidiaries or assets;

(E) The second company's ability to make investments or expenditures;

(F) The second company achieving or maintaining a financial target or limit, including, for example, a debt-to-equity ratio, a fixed charges ratio, a net worth requirement, a liquidity target, a working capital target, or a classified assets or nonperforming loans limit;

(G) The second company's payment of dividends on any class of securities, redemption of senior instruments, or voluntary prepayment of indebtedness;

(H) The second company's ability to authorize or issue additional junior equity or debt securities, or amend the terms of any equity or debt securities issued by the second company;

(I) The second company's 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 first company to have the same status as other securities of the same class;

(J) The second company's ability to amend its articles of incorporation or by-laws, other than in a way that is solely defensive for the first company;

(K) The removal or selection of any independent accountant, auditor, investment adviser, or investment banker employed by the second company;

(L) The second company's ability to significantly alter accounting methods and policies, or its regulatory, tax, or liability status (e.g., converting from a stock corporation to a limited liability company); and

(ii) A limiting contractual right does not include a contractual right that would not allow the first company to significantly restrict, directly or indirectly, the discretion of the second company over operational and policy decisions of the second company, such as:

(A) A right that allows the first company to restrict or to exert significant influence over decisions relating to the second company's ability to issue securities senior to securities owned by the first company;

(B) A requirement that the first company receive financial reports of the type ordinarily available to common stockholders;

(C) A requirement that the second company maintain its corporate existence;

(D) A requirement that the second company consult with the first company on a reasonable periodic basis;

(E) A requirement that the second company provide notices of the occurrence of material events affecting the second company;

(F) A requirement that the second company comply with applicable statutory and regulatory requirements;

(G) A market standard requirement that the first company receive similar contractual rights as those held by other investors in the second company;

(H) A requirement that the first company be able to purchase additional shares issued by the second company in order to maintain the first company's percentage ownership in the second company;

(I) A requirement that the second company ensure that any shareholder who intends to sell its shares of the second company provide other shareholders of the second company or the

second company itself the opportunity to purchase the shares before the shares can be sold to a third party; or

(J) A requirement that the second company take reasonable steps to ensure the preservation of tax status or tax benefits, such as status of the second company as a Subchapter S corporation or the protection of the value of net operating loss carry-forwards.

(6) Second company means the company whose potential control by a first company is the subject of determination by the Board under this subpart.

(7) Senior management official means any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of a company.

(f) Reservation of authority. Nothing in this subpart shall limit the authority of the Federal Reserve to take any supervisory or enforcement action otherwise permitted by law, including an action to address unsafe or unsound practices or conditions, or violations of law.

* * * * *

10. Sections 238.22, 238.23, and 238.24 are added to read as follows:

§ 238.22 Rebuttable presumptions of control of a company.

(a) General. (1) In any proceeding under section 238.21(b)(2) or (c) of this part, a first company is presumed to control a second company in the situations described in subsections (b) through (i) of this section. The Board also may find that a first company controls a second company based on other facts and circumstances.

(2) For purposes of the presumptions in this section, any company that is a subsidiary of the first company and also a subsidiary of the second company is considered to be a subsidiary of the first company and not a subsidiary of the second company.

(b) Management contract or similar agreement. The first company enters into any agreement, understanding, or management contract (other than to serve as investment adviser) with the second company, under which the first company directs or exercises significant influence or discretion over the general management, overall operations, or core business or policy decisions of the second company. Examples of such agreements include where the first company is a managing member, trustee, or general partner of the second company, or exercises similar powers and functions.

(c) Total equity. The first company controls one third or more of the total equity of the second company.

(d) Ownership or control of 5 percent or more of voting securities. The first company controls 5 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) (i) Director representatives of the first company or any of its subsidiaries comprise 25 percent or more of the board of directors of the second company or any of its subsidiaries; or

(ii) Director representatives of the first company or any of its subsidiaries are able to make or block the making of major operational or policy decisions of the second company or any of its subsidiaries;

(2) Two or more employees or directors of the first company or any of its subsidiaries serve as senior management officials of the second company or any of its subsidiaries;

(3) An employee or director of the first company or any of its subsidiaries serves as the chief executive officer, or serves in a similar capacity, of the second company or any of its subsidiaries;

(4) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the first company or the second company, each on a consolidated basis;

(5) The first company or any of its subsidiaries has any limiting contractual right with respect to the second company or any of its subsidiaries, unless such limiting contractual right is part of an agreement to merge with or make a controlling investment in the second company that is reasonably expected to close within one year and such limiting contractual right is designed to ensure that the second company continues to operate in the ordinary course until the merger or investment is consummated or such limiting contractual right requires the second company to take an action necessary for the merger or investment to be consummated; or

(6) Senior management officials and directors of the first company and its subsidiaries, together with their immediate family members and the first company and its subsidiaries, own, control, or have power to vote 25 percent or more of any class of voting securities of the second company, unless the first company and its subsidiaries control less than 15 percent of each class of voting securities of the second company and the senior management officials and directors of the first company and its subsidiaries, together with their immediate family members, own, control, or have power to vote 50 percent or more of each class of voting securities of the second company.

(e) Ownership or control of 10 percent or more of voting securities. The first company controls 10 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) The first company or any of its subsidiaries propose a number of director representatives to the board of directors of the second company or any of its subsidiaries in opposition to the nominees proposed by the management or board of directors of the second company or any of its subsidiaries that, together with any director representatives of the first company or any of its subsidiaries on the board of directors of the second company or any of its subsidiaries, exceed the number of director representatives that the first company could have without being presumed to control the second company under section 238.22(d)(1)(i) of this part;

(2) Director representatives of the first company and its subsidiaries comprise more than 25 percent of any committee of the board of directors of the second company or any of its subsidiaries that can take actions that bind the second company or any of its subsidiaries; or

(3) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that:

(i) Are not on market terms; or

(ii) Generate in the aggregate 5 percent or more of the total annual revenues or expenses of the first company or the second company, each on a consolidated basis.

(f) Ownership or control of 15 percent or more of voting securities. The first company controls 15 percent or more of the outstanding securities of any class of voting securities of the second company, and:

(1) The first company controls 25 percent or more of the total equity of the second company;

(2) A director representative of the first company or of any of its subsidiaries serves as the chair of the board of directors of the second company or any of its subsidiaries;

(3) One or more employees or directors of the first company or any of its subsidiaries serves as a senior management official of the second company or any of its subsidiaries; or

(4) The first company or any of its subsidiaries enters into transactions or has business relationships with the second company or any of its subsidiaries that generate in the aggregate 2 percent or more of the total annual revenues or expenses of the first company or the second company, each on a consolidated basis.

(g) Accounting consolidation. The first company consolidates the second company on its financial statements prepared under U.S. generally accepted accounting principles.

(h) Control of an investment fund. (1) The first company serves as an investment adviser to the second company, the second company is an investment fund, and the first company, directly or indirectly, or acting through one or more other persons:

(i) Controls 5 percent or more of the outstanding securities of any class of voting securities of the second company; or

(ii) Controls twenty-five percent or more of the total equity of the second company.

(2) The presumption of control in paragraph (h)(1) of this section does not apply if the first company organized and sponsored the second company within the preceding twelve months.

(i) Divestiture of control. (1) The first company controlled the second company under paragraph (e)(1) or (2) of section 238.2 of this part at any time during the prior two years and the first company controls 15 percent or more of any class of voting securities of the second company.

(2) Notwithstanding paragraph (i)(1), a first company will not be presumed to control a second company under this paragraph if 50 percent or more of the outstanding securities of each class of voting securities of the second company is controlled by a person that is not a senior management official or director of the first company, or by a company that is not an affiliate of the first company.

(j) Registered investment company. The presumptions of control in this section do not apply if:

(1) The second company is an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. § 80a et seq.);

(2) The business relationships between the first company and the second company are limited to investment advisory, custodian, transfer agent, registrar, administrative, distributor, and securities brokerage services provided by the first company to the second company;

(3) Director representatives of the first company or any of its subsidiaries comprise 25 percent or less of the board of directors or trustees of the second company; and

(4) (i) The first company controls less than 5 percent of the outstanding securities of each class of voting securities of the second company and less than 25 percent of the total equity of the second company, or

(ii) The first company organized and sponsored the second company within the preceding 12 months.

(k) Shares held in a fiduciary capacity. The presumptions of control in this section do not apply to the extent that the first company or any of its subsidiaries control the securities of the second company or any of its subsidiaries in a fiduciary capacity without sole discretionary authority to exercise the voting rights.

§ 238.23 Rebuttable presumption of noncontrol of a company.

(a) In any proceeding under section 238.21(b)(2) or (c) of this part, a first company is presumed not to control a second company if:

(1) The first company controls less than 10 percent of the outstanding securities of each class of voting securities of the second company, and

(2) The first company is not presumed to control the second company under section 238.22 of this part.

(b) In any proceeding under this subpart, or judicial proceeding under the Home Owners' Loan Act, other than a proceeding in which the Board has made a preliminary determination that a first company has the power to exercise a controlling influence over the management or policies of a second company, a first company may not be held to have had control over a second company at any given time, unless the first company, at the time in question, controlled 5 percent or more of the outstanding securities of any class of voting securities of the second company, or had already been found to have control on the basis of the existence of a controlling influence relationship.

§ 238.24 Total Equity.

(a) General. For purposes of this subpart, the total equity controlled by a first company in a second company that is organized as a stock corporation and prepares financial statements pursuant to U.S. generally accepted accounting principles is calculated as described in paragraph (b) of this section. With respect to a second company that is not organized as a stock corporation or that does not prepare financial statements pursuant to U.S. generally accepted accounting

principles, the first company's total equity in the second company will be calculated so as to be reasonably consistent with the methodology described in paragraph (b) of this section, while taking into account the legal form of the second company and the accounting system used by the second company to prepare financial statements.

(b) Calculation of total equity. (1) Total Equity. The first company's total equity in the second company, expressed as a percentage, is equal to:

(i) The sum of Investor Common Equity and, for each class of preferred stock issued by the second company, Investor Preferred Equity, divided by

(ii) Issuer Shareholders' Equity.

(2) Investor Common Equity equals the greater of:

(i) Zero, and

(ii) The quotient of the number of shares of common stock of the second company that are controlled by the first company divided by the total number of shares of common stock of the second company that are issued and outstanding, multiplied by the amount of shareholders' equity of the second company not allocated to preferred stock under U.S. generally accepted accounting principles.⁹⁶

(3) Investor Preferred Equity equals, for each class of preferred stock issued by the second company, the greater of:

(i) Zero, and

⁹⁶ If the second company has multiple classes of common stock outstanding and different classes of common stock have different economic interests in the second company on a per share basis, the number of shares of common stock must be adjusted for purposes of this calculation so that each share of common stock has the same economic interest in the second company.

(ii) The quotient of the number of shares of the class of preferred stock of the second company that are controlled by the first company divided by the total number of shares of the class of preferred stock that are issued and outstanding, multiplied by the amount of shareholders' equity of the second company allocated to the class of preferred stock under U.S. generally accepted accounting principles.

(c) Consideration of debt instruments and other interests in total equity. (1) For purposes of the total equity calculation in paragraph (b) of this section, a debt instrument or other interest issued by the second company that is held by the first company may be treated as an equity instrument if that debt instrument or other interest is functionally equivalent to equity.

(2) For purposes of paragraph (b)(1) of this section, the principal amount of all debt instruments and the market value of all other interests that are functionally equivalent to equity that are owned or controlled by the first company are added to the sum under paragraph (b)(1)(i), and the principal amount of all debt instruments and the market value of all other interests that are functionally equivalent to equity that are outstanding are added to Issuer Shareholders' Equity.

(3) For purposes of paragraph (b)(1), a debt instrument issued by the second company may be considered functionally equivalent to equity if it has equity-like characteristics, such as:

- (i) Extremely long-dated maturity;
- (ii) Subordination to other debt instruments issued by the second company;
- (ii) Qualification as regulatory capital under any regulatory capital rules applicable to the second company;
- (iii) Qualification as equity under applicable tax law;

(iv) Qualification as equity under U.S. generally accepted accounting principles or other applicable accounting standards;

(v) Inadequacy of the equity capital underlying the debt at the time of the issuance of the debt; and

(vi) Issuance not on market terms.

(4) For purposes of paragraph (b)(1), an interest that is not a debt instrument issued by the second company may be considered functionally equivalent to equity if it has equity-like characteristics, such as entitling its owner to a share of the profits of the second company.

(d) Investments in parent companies of a second company. If a first company controls equity interests of one or more companies that directly or indirectly control the second company (parent company), the total equity of the first company in the second company is equal to:

(1) The first company's total equity of the second company as calculated under paragraph (b) of this section, plus

(2) The product of the first company's total equity of each parent company, calculated in accordance with paragraph (b) of this section, multiplied by the parent company's total equity in the second company, as calculated under paragraph (b) of this section.

(e) Frequency of total equity calculation. The total equity of a first company in a second company is calculated each time the first company acquires control over or ceases to control equity instruments of the second company, including any debt instruments or other interests that are functionally equivalent to equity in accordance with paragraph (c) of this section.

* * * * *

By order of the Board of Governors of the Federal Reserve System, [DATE].

**Ann Misback,
Secretary of the Board.**