

LEGAL UPDATES AND NEWS

Federal Reserve Clarifies Bank Control Rules

The Board of Governors of the Federal Reserve System (the “Federal Reserve”) has adopted new rules regarding when an investor will be *presumed* to have, directly or indirectly, acquired control of a banking organization (banks, savings associations and their holding companies) for purposes of the Bank Holding Company Act (“BHCA”) and the Home Owners’ Loan Act (“HOLA”). Under the BHCA, the definition of control is limited to companies, while under the HOLA control applies to both companies and individuals. As such, the term “investor” means (a) a company, when describing control of a bank or a bank holding company, and (b) a company or an individual, when describing control of a savings association or a savings and loan holding company.

The new rules clarify some of the Federal Reserve’s existing rules and interpretations, relax certain presumptions of control and eliminate, with a few exceptions, the use of passivity agreements. The new rules become effective April 1, 2020. The new rules do not apply to questions of control under the Change in Bank Control Act, which requires that the acquisition, directly or indirectly, of control of a bank by a person individually or acting in concert with others obtain prior regulatory approval.

Current Control Standard

The Federal Reserve’s current regulatory standard for determining whether an investor “controls” a banking organization has generally been based on a three-pronged test. An investor is considered to have control of a banking organization if (a) the investor controls, directly or indirectly, 25% or more of any voting class of the banking organization’s securities, (b) the investor controls in any manner the election of a majority of the directors or trustees of the banking organization, or (c) the Federal Reserve otherwise determines that the investor directly or indirectly controls the banking organization. Furthermore, in any proceeding initiated by the Federal Reserve to determine control under (c) above, the Federal Reserve has maintained a rebuttable presumption of non-control for any investor that directly or indirectly controls less than 5% of any class of the banking organization’s voting securities. This framework creates a gap between 5% and 25% where there have been no bright line rules and little concrete guidance to determine control.

New Control Standard – Tiered Presumptions

The Federal Reserve’s new rules establish a tiered framework that provides additional guidance on when an investor is *presumed* to have control over a banking organization. The new rules maintain the previous 5% and 25% thresholds as bookends of the new tiered structure (in certain situations, the new rules attribute ownership by an investing company’s directors or senior management to the investing company itself). In between are new tier levels of 10% and 15% that, when taken in conjunction with the objective and subjective standards in the new rules, create a new matrix that will be used to determine whether an investor is presumed to have control of a banking organization. While the new framework provides additional clarity and structure, the Federal Reserve retains the discretion to (1) find control based upon the facts and circumstances of a particular case within the share ownership thresholds, and (2) raise safety and soundness or other concerns regarding either controlling or noncontrolling relationships.

Below is a table that describes the different tiers and categories that the Federal Reserve will consider and how they work together within the new framework, followed by a review of the different categories in the framework and how they are applied at each tier level. As a general proposition, the greater the investor’s equity interest in a banking organization, the fewer relationships must exist in other areas to avoid a presumption of control.

Summary of Tiered Presumptions

(presumption triggered if any relationship exceeds the amount listed in the table)

| | Less than 5% of voting stock | 5%-9.99% of voting stock | 10%-14.99% of voting stock | 15%-24.99% of voting stock |
|--------------------------------------|---|---|--|--|
| Directors | Less than 50% of the board | Less than 25% of the board | Less than 25% of the board | Less than 25% of the board |
| Director Service as Board Chair | No restriction | No restriction | No restriction | No director representative is chair of the board |
| Director Service on Board Committees | No restriction | No restriction | 25% or less of a committee with power to bind the company | 25% or less of a committee with power to bind the company |
| Business Relationships | No restriction | Less than 10% of revenues or expenses of the banking organization | Less than 5% of revenues or expenses of the banking organization | Less than 2% of revenues or expenses of the banking organization |
| Business Terms | No restriction | No restriction | Market terms | Market terms |
| Officer/Employee Interlocks | No restriction | No more than one interlock, never CEO | No more than one interlock, never CEO | No interlocks |
| Contractual Powers | No management agreements | No rights that significantly restrict discretion | No rights that significantly restrict discretion | No rights that significantly restrict discretion |
| Proxy Contests (Directors) | No restriction | No restriction | No soliciting proxies to replace more than permitted number of directors | No soliciting proxies to replace more than permitted number of directors |
| Total Equity | Bank Holding Companies – Less than 33.33% Savings and Loan Holding Companies – 25% or less | | | |

Board and Committee Representation

The Federal Reserve has historically limited a noncontrolling investor's representation on a banking organization's board to one or, in limited circumstances, two members. The new rules permit an investor that owns less than 5% of any class of voting securities to be represented by up to 49.99% of the board without a control presumption and an investor that owns between 5% and 24.99% to be represented by up to 24.99% of the board. Furthermore, an investor that controls less than 15% of any class of voting securities will now be allowed to have a representative serve as the board chair without triggering a control presumption. For an investor owning 15% or more, the new rules do not change the prohibition on having any representative serve as the board chair to avoid a control presumption.

For an investor owning less than 10% of any class of voting securities, the new rules also remove the limitation on the investor having representation on a committee that has the power to bind the banking organization. For an investor owning 10% or more of any class of voting securities, the committee representation threshold remains at 25%.

Interlocks

The new rules provide that an investor that owns between 5% and 14.99% of any class of voting securities of a banking organization will be presumed to control the banking organization if the investor has more than one senior management interlock with the banking organization or if any employee or director serves as the chief executive officer of the banking organization. This limitation does not apply to any investor owning less than 5%. An investor owning 15% or more of any class of voting securities cannot have any management interlocks with the banking organization without creating a presumption of control.

Proxy Contests

The Federal Reserve did not adopt a general presumption of control for an investor that solicits proxies from the shareholders of a banking organization. As such, a noncontrolling investor generally may act as a shareholder and engage with the banking organization and other shareholders on issues through proxy solicitations. Nevertheless, the ability of a noncontrolling investor to elect its representatives to the board of a banking organization is limited to the percentages stated above in our discussion under “Board and Committee Representation.”

Contractual Powers

The new rules expressly note that agreements or understandings that allow an investor to exercise significant influence over the core business or policy decisions of a banking organization warrant a presumption of control, regardless of the investment percentage the investor owns in the banking organization. Furthermore, an investor that owns 5% or more of any class of voting securities of a banking organization that wishes to retain its noncontrolling status will not be able to enter into an agreement with the banking organization that restricts the discretion that the organization has over major operational or policy decisions. Examples of provisions that would give rise to a presumption of control include, but are not limited to: limits on the banking organization’s ability to engage in business combinations, enter new lines of business or substantially change or discontinue existing lines of business, imposing significant financial obligations or restrictions on significant investments or expenditures, restrictions on dividends and securities redemptions, restrictions on hiring/firing/compensating senior management, and restrictions on issuing junior debt securities or amending the terms of outstanding equity or debt securities. This presumption is separate from the presumption in the regulations arising from management agreements (including where the investor is a managing member, trustee or general partner of the banking organization), which applies regardless of equity ownership.

Business Relationships

While many restrictions that previously resulted in a presumption of control will be eased as a result of the new rules, the Federal Reserve continues to believe that certain business relationships with a banking organization can raise control concerns. To avoid presumptions of control, business relationships will need to decrease as an investor’s equity ownership in the banking organization increases. In this regard, the Federal Reserve will not presume control if the business relationship is less than 10% (for owners of 5%-9.99% of any class of voting securities), 5% (for 10%-14.99% owners) or 2% (for 15%-24.99% owners) of the total annual revenue or expenses of the banking organization (for purposes of the new rules, “revenue” and “expenses” are to be interpreted as these terms are commonly understood in the context of GAAP with “revenue” being gross income, not income net of expenses).

The new rules also take into consideration whether the terms of the relationship are on market terms. If not, and the investor owns between 10% and 24.99% of any class of voting securities, the Federal Reserve will presume that the investor has control of the banking organization.

Total Equity

The new rules provide a total equity ownership threshold that is uniformly applicable to all levels of the tier framework regardless of the amount of voting securities owned. Under the new rules, an investor will be presumed to have control of a bank or a bank holding company if the investor owns 33.33% or more of the total equity of the entity. An investor will be presumed to have control of a savings association or a savings and loan holding company if the investor owns 25% or more of its total equity due to particular statutory language that is not present in the BHCA.

Passivity Agreements

As a result of the new rules, the Federal Reserve has stated that it will no longer require standard-form passivity commitments from companies that own between 5% and 24.99% of any class of voting securities. Companies that have previously provided a standard-form passivity commitment will be able coordinate with the Federal Reserve to seek relief from those commitments. However, the Federal Reserve will continue to require control-related commitments in specific contexts, such as commitments from employee stock ownership plans, mutual fund complexes and in special situations.

Additional Presumptions

The rules establish a presumption of control where an investor consolidates a banking organization on its financial statements under GAAP. There are also specific presumptions related to an investment advisor's control of an investment fund. A general presumption of non-control is established under the new rules where an investor controls less than 10% of each class of voting securities of a banking organization and none of the rebuttable presumptions of control apply.

Considerations

Financial institutions should note that the new rules apply not only to determinations of whether an investor controls a banking organization, but also govern determinations of whether a banking organization has acquired control of a target in which it has invested. As a result, the rules could benefit banking organizations with an interest in investing in nonbank entities.

The additional transparency provided by the new rules could also make investments in financial institutions and their holding companies more appealing to investors. However, the greater certainty provided by the new rules could also encourage shareholder activism.

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We encourage financial institutions to carefully review the Federal Reserve's new rules. If you need assistance or would like to talk about the new rules, please contact:

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