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Alert

Federal Reserve Provides Greater Clarity and Flexibility for Noncontrolling Investments in (and by) Banking Organizations

January 31, 2020

On Jan. 30, 2020, the Federal Reserve Board ("Board") issued a final rule (to be published in 12 C.F.R. Parts 225 and 238) ("Final Rule")[1] revising the Board's regulations governing determinations of whether a company "controls" another company for purposes of the Bank Holding Company Act ("BHCA")[2] or the Home Owners' Loan Act ("HOLA").[3] While the Final Rule is largely consistent with the Notice of Proposed Rulemaking issued by the Board in April 2019 ("Proposed Rule"),[4] it does contain certain modifications as further discussed herein. The Final Rule is effective April 1, 2020.

The Final Rule codifies much of the Board's historical practice regarding control determinations, which did not appear in the Board's regulations and, therefore, was primarily known only by experienced practitioners. As indicated by the Board:

> The Board believes that the final rule, which is largely consistent with the proposal, will increase the transparency and consistency of the Board's control framework. As a result, the final rule should help facilitate permissible investments in banking organizations and by banking organizations.

However, under certain circumstances, the Final Rule also significantly expands the relationships and rights an investor could have while still being deemed noncontrolling.

We expect these changes will make investments in bank holding companies, savings and loan holding companies and depository institutions (collectively, "Banking Organizations") more attractive to investors (including private equity funds, hedge funds and activist investors) and better facilitate joint ventures and minority investments by Banking Organizations.[5]

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[1] The Final Rule is available here.

[2] 12 U.S.C. §§ 1841, *et seq.*

[3] 12 U.S.C. §§ 1461, *et seq.*

[4] The Proposed Rule was published in the Federal Register on May 14, 2019, and the period for public comment ended on July 15, 2019.

[5] We also believe that some of the changes effectuated by the Final Rule will benefit Banking Organizations that sponsor investment funds, which we plan to discuss in a forthcoming *Alert*.

Why Is Being Deemed Noncontrolling Important?

Under U.S. banking law, an entity that is deemed to control a Banking Organization must register as a holding company with the Board. Becoming a holding company subjects the entity to regulatory supervision, capital requirements, "source of strength" obligations and potentially significant activity and investment restrictions. Similarly, if a Banking Organization is deemed to control another entity, that entity will generally become subject to the laws applicable to the Banking Organization.

How Does the Final Rule Change the Level of Investment and/or Involvement Permissible for a Noncontrolling Investor?

Under the BHCA, 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% 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.[6] HOLA contains a substantially similar test for control.[7]

However, under the Board's recent historical practice applying the third prong, an entity possessing as little as 5% of any class of a second entity's voting stock or 25% of its total equity (even if it does not hold any voting rights) could also be deemed a controlling shareholder, depending on its overall relationship with the second entity. The Final Rule provides increased flexibility in several areas that would allow noncontrolling investors to maintain increased total equity stakes and greater relationships without being deemed to be in control of an entity. The chart below provides a brief summary of the Board's historical practice with regard to the major potential indicia of control and the changes contained in the Final Rule. *It is important to note, however, that most of the lines drawn by the Final Rule are merely presumptions. Thus, the Board retains the discretion to find (after notice and opportunity for hearing) that a particular situation amounts to control based on the totality of the circumstances, despite the applicability of one or more presumptions of noncontrol.*

Potential Indicia of Control	Recent Historical Practice	Final Rule's Presumptions
Total Equity	Investments up to 33% of total equity generally are viewed as noncontrolling, so long as the investor does not hold 15% or more of any class of voting securities (or instruments convertible/exercisable into such voting securities).	*Bank Holding Companies ("BHCs").* Investments up to 33% of total equity are viewed as noncontrolling, regardless of the investor's voting interest, unless the investor separately triggers some other conclusive or presumptive indicia of control. *Savings and Loan Holding Companies ("SLHCs").* Investments up to 25% of total equity are viewed as noncontrolling, regardless of the

[6] *See* 12 U.S.C. § 1841(a)(2); 12 CFR 225.2(e).

[7] *See* 12 U.S.C. § 1467a(a)(2); 12 CFR 238.2(e).

Potential Indicia of Control	Recent Historical Practice	Final Rule's Presumptions
		investor's voting interest, unless the investor separately triggers some other conclusive or presumptive indicia of control. The Final Rule is different from the Proposed Rule in that it establishes a single total equity threshold for investors (and differs for BHCs and SLHCs), regardless of their voting interest, while the Proposed Rule provided for no change to historical practice.
Board Representation 1. Number of Seats 2. Role 3. Committee Service	1. *In theory*, noncontrolling investors with less than 10% of any class of voting securities are permitted to have multiple board representatives, so long as they do not constitute a majority of the board. (However, *in practice*, such investors have typically been subject to further restrictions.) Noncontrolling investors with 10% or more, but less than 25%, of any class of voting securities are permitted to have one board representative (and one observer) and still be viewed as noncontrolling. Additionally, *in theory*, the investor may have two board seats without being deemed to control, so long as (a) there is at least one other shareholder with a greater interest and that larger shareholder is a registered holding company; (b) the two seats would not constitute more than 25% of the board's voting members; and (c) the two seats would be	1. Noncontrolling investors with less than 5% of any class of voting securities would be permitted to have representatives constituting less than 50% of the total board seats. Investors with greater voting rights, but less than 25% of any class of voting securities would be permitted to have representatives constituting less than 25% of the board. (Each of the foregoing presumptions assumes that the investor's representatives would not have the power to unilaterally make or block major decisions.) 2. Noncontrolling investors with less than 15% of any class of voting securities would be permitted to have a representative serve as chairman of the board or of any committee. Noncontrolling investors with greater voting rights would not be permitted to have a representative serve as chairman of the board (or presumably any committee that has the power to bind the board (and possibly all committees), although the Final

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	proportionate to the investors total interest. 2. A noncontrolling investor's representative may not serve as the chairman of the board or, in general, of any committee. 3. A noncontrolling investor's representative may not represent more than 25% of any committee *and* may not serve on any committee that has the power to bind the board.	Rule does not explicitly discuss chairing committees). 3. Noncontrolling investors with less than 10% of any class of voting securities would not have any limitations regarding representation on committees. Noncontrolling investors with greater voting rights would not be permitted to have representatives constituting more than 25% of any committee that has the power to bind the board.
Proxy Solicitations	In general, noncontrolling investors with 10% or more of any class of voting securities have not been permitted to solicit proxies. Moreover, noncontrolling investors with smaller voting interest have not been permitted to solicit proxies to elect more than one board representative and one independent nominee (although there have been certain exceptions where an investor has put forth greater number of independent nominees).	All noncontrolling investors would be permitted to solicit proxies in support of shareholder proposals. Noncontrolling investors with 10% or more of any class of voting securities would not be permitted to solicit proxies to elect opposition board candidates who would constitute 25% or more of the total board. Noncontrolling investors with smaller voting interests would not have any explicit limit on their ability to nominate, and solicit proxies in favor of, opposition board candidates.
Consultations with Management	Noncontrolling investors may communicate with management and advocate for changes, so long as there is no explicit or implicit threat to sell shares (or solicit proxies) to influence management's decisions (especially for investors holding 10% or more of any class of voting securities).	Threats to dispose of securities would not necessarily be presumed to be inconsistent with noncontrol.
Covenants	Covenants that substantially limit the discretion of the target over	No material change for noncontrolling investors with 5% or more of any class

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	operational or policy decisions (e.g., regarding hiring, firing, executive compensation, operations, raising debt and equity, merging, consolidating, acquiring assets and companies, etc.) are viewed as suggesting control. In contrast, covenants that were limited to matters that would affect the rights or preference of an investor's interest (e.g., regarding issuing senior securities, borrowing on a senior basis, modifying the terms a security or liquidating the target) were not viewed as indicia of control.	of voting securities. Noncontrolling investors with smaller voting interests would be permitted to substantially limit the discretion of the target over certain operational or policy decisions but would not be permitted to hold rights that enable them to exercise significant influence or discretion over the core operations or general management of the target.
Business Relationships	Business relationships between a noncontrolling investor and the target should remain limited, and the Board reviews such relationships on a case by case basis. Factors of such review include whether the relationship will be on market terms, non-exclusive and terminable without penalty by the target.	Noncontrolling investors with less than 5% of any class of voting securities would not have any explicit limit on their business relationships with a target. Noncontrolling investors with 5% or more, but less than 10%, of any class of voting securities would be permitted to engage in business that did not represent 10% or more of the target's annual revenue or expenses. Noncontrolling investors with 10% or more, but less than 15%, of any class of voting securities would be permitted to engage in business that was on market terms and did not represent 5% or more of the target's annual revenue or expenses. Noncontrolling investors with 15% or more, but less than 25%, of any class of voting securities would be permitted to engage in business that was on market terms and did not represent 2% or more of the target's annual revenue or expenses. The Final Rule differs from the Proposed Rule in that it only takes into

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		account the significance of the business relationship from the perspective of the target, not from the perspective of both the investor and the target.
Senior Management Interlocks	Noncontrolling investors with 10% or more of any class of voting securities are not permitted to have any of their employees or directors serve as a management official of the target. No explicit restriction exists with regard to management interlocks involving investors with lesser voting interests.	Noncontrolling investors with 5% or more, but less than 15%, of any class of voting securities would be permitted to have a single employee/director serve as a senior management official (excluding the CEO) of the target. No explicit management interlock restrictions would apply to noncontrolling investors with lesser voting interests.

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If you have any questions concerning this *Alert,* please contact your attorney at Schulte Roth & Zabel or one of the authors.

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