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Alert

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

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This week, the Federal Reserve Board ("Board") announced proposed rulemaking (to be published in 12 C.F.R. Parts 225 and 238) ("Proposed Rule")[1] that would revise 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]

We expect these changes will make investments in 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.

In part, the Proposed Rule would codify much of the Board's historical practice regarding control determinations, which currently does not appear in the Board's regulations and, therefore, is primarily known only by experienced practitioners. As indicated by the Board:

> The proposed revisions are intended to provide bank holding companies, savings and loan holding companies, depository institutions [referred to herein, collectively, as "Banking Organizations"], investors and the public with a better understanding of the facts and circumstances 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.

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

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.

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[1] The Proposed Rule is available here.

[2] 12 U.S.C. § 1841 *et seq.*

[3] 12 U.S.C. § 1461 *et seq.*

How Would the Proposed 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 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.[4] HOLA contains a substantially similar test for control.[5]

However, under the Board's recent historical practice applying the third prong, an entity possessing as little as 5 percent of any class of a second entity's voting stock or 25 percent 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 Proposed Rule would provide 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, where applicable, the potential changes contained in the Proposed Rule. *It is important to note, however, that most of the lines drawn by the Proposed Rule are merely presumptions. Thus, the Board would retain 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**	**Proposed Rule's Presumptions**
Total Equity	Investments up to 33 percent of total equity generally are viewed as noncontrolling, so long as the investor does not hold 15 percent or more of any class of voting securities (or instruments convertible/exercisable into such voting securities).	No change.
Board Representation 1. Number of Seats 2. Role 3. Committee Service	1. *In theory*, noncontrolling investors with less than 10 percent 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.	1. Noncontrolling investors with less than 5 percent of any class of voting securities would be permitted to have representatives constituting less than 50 percent of the total board seats. Investors with greater voting rights, but less than 25 percent of any class of voting

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

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

Potential Indicia of Control	Recent Historical Practice	Proposed Rule's Presumptions
	(However, *in practice*, such investors have typically been subject to further restrictions). Noncontrolling investors with 10 percent or more, but less than 25 percent, 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 percent of the board's voting members and (c) the two seats would be 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 percent of any committee *and* may not serve on any committee that has the power to bind the board.	securities would be permitted to have representatives constituting less than 25 percent 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 percent 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 Proposed Rule does not explicitly discuss chairing committees). 3. Noncontrolling investors with less than 10 percent 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 constitute more than 25 percent of any committee that has the power to bind the board.
Proxy Solicitations	In general, noncontrolling investors with 10 percent or more of any class of voting securities have not been permitted to solicit	All noncontrolling investors would be permitted to solicit proxies in support of shareholder proposals. Noncontrolling investors with 10

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	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).	percent or more of any class of voting securities would not be permitted to solicit proxies to elect opposition board candidates who would constitute 25 percent 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 percent 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 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.	No material change for noncontrolling investors with 5 percent or more of any class 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	Noncontrolling investors with less than 5 percent of any class of voting securities would not have any explicit limit on their business relationships

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	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.	with a target. Noncontrolling investors with 5 percent or more, but less than 10 percent, of any class of voting securities would be permitted to engage in business that did not represent 10 percent or more of the target's annual revenue or expenses. Noncontrolling investors with 10 percent or more, but less than 15 percent, of any class of voting securities would be permitted to engage in business that was on market terms and did not represent 5 percent or more of the target's annual revenue or expenses. Noncontrolling investors with 15 percent or more, but less than 25 percent, of any class of voting securities would be permitted to engage in business that was on market terms and did not represent 2 percent or more of the target's annual revenue or expenses.
Senior Management Interlocks	Noncontrolling investors with 10 percent 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 percent or more, but less than 15 percent, 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.

Comments on the Proposed Rule will be due within 60 days of its publication in the Federal Register.

Authored by Joseph P. Vitale.

If you have any questions concerning this *Alert* or would like to submit comments on the Proposed Rule, please contact your attorney at Schulte Roth & Zabel or the author.