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DODD-FRANK 2.0: POTENTIAL REFORM TO THE FEDERAL RESERVE BOARD'S "CONTROL RULES" – WHAT IS AT STAKE AND WHO MAY BENEFIT

To Our Clients and Friends:

2018 has seen significant but pragmatic developments in the implementation of bank regulation by the Board of Governors of the Federal Reserve System (Federal Reserve) under its new Vice Chairman for Bank Supervision, Randal Quarles. Vice Chairman Quarles has frequently touted transparency in regulation as a significant virtue, and has himself frequently adopted such transparency in his public speeches, by signaling areas that he considers a priority.

One area where the Federal Reserve has not yet published a reform is in the area of "control" under the Bank Holding Company Act of 1956, as amended (BHC Act). In January, Vice Chairman Quarles suggested that it would be on his to-do list:

> Under the Board's control framework – built up piecemeal over many decades – the practical determinants of when one company is deemed to control another are now quite a bit more ornate than the basic standards set forth in the statute and in some cases cannot be discovered except through supplication to someone who has spent a long apprenticeship in the art of Fed interpretation . . . . We are taking a serious look at rationalizing and recalibrating this framework.[1]

This description would be an understatement. The control rules have become challenging for corporate lawyers and clients alike – one may be greeted with "That can't be right!" when explaining the likely Federal Reserve view of control. As such, "rationalization and recalibration" in this area would be highly welcome.

This Client Alert describes the most important aspects of the Federal Reserve's control rules as of today's date, and suggests certain areas of potential reform.

Reform of the control rules would be important for quite a few constituencies. It would certainly benefit private investors that wish to commit capital to banks but that do not wish to become regulated as BHCs.[2] It would benefit nonbanking companies that might wish to partner with banks and acquire bank equity at the same time. And it has the potential to affect certain rules applicable to bank holding companies (BHCs) themselves, particularly in the area of so-called 4(c)(6) investments and the Volcker Rule.

The Statutory Language

The BHC Act defines "control" as follows:

> Any company has control over a bank or over any company if—
>
> > (A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;
> >
> > (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or
> >
> > the [Federal Reserve] 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.[3]

The Principal Federal Reserve Control Positions

For over forty years, the Federal Reserve has issued interpretations of the "controlling influence" prong of the statutory definition to erect a detailed common law of control, and one that is more focused on "influence" than the statutory "controlling influence." Although some of the Federal Reserve's positions are in its Regulation Y and some in policy statements,[4] many are set forth in interpretations granted to individual banks, and some are unwritten lore. The Federal Reserve's current principal positions may be described as follows:

Voting Securities. This definition is critical for purposes of the 25 percent control test that is the first part of the statutory definition. Regulation Y defines "voting securities" as "shares of common or preferred stock, general or limited partnership shares or interests, or similar interests if the shares or interests, . . . in any manner, entitle the holder:

i. To vote for or to select directors, trustees, or partners (or persons exercising similar functions) . . . or

ii. To vote on or to direct the conduct of the operations or other significant policies of the issuing company."[5]

The Federal Reserve takes the position that if a holder of a limited partnership interest has the right to vote on replacing a general partner or who the replacement general partner will be, the interest is a "voting security."

Class of Voting Securities. The 25 percent control test applies to any "class" of voting securities. Under Federal Reserve regulation, a class of voting securities is determined by considering whether the shares are voted together as a single class on all matters for which the shares have voting rights, other than certain very limited fundamental matters described immediately below (Fundamental Matters).[6]

This approach makes it virtually impossible to give particular investors special voting rights outside of Fundamental Matters, because such rights will almost certainly make the investors own more than 25 percent of a separate class of voting securities and thus be in control. Moreover, approval of a new line of business or a merger or acquisition that does not affect the rights of an investor's security is ***not*** considered a Fundamental Matter for these purposes, and therefore cannot be subject to a separate class vote.

The Federal Reserve considers the general partner of a partnership or a managing member of a limited liability company to hold 100% of a class of voting securities, and for that reason, a general partner or managing member always is deemed to control an entity.

Nonvoting Securities. One way of permitting an investor additional economic rights in a deal is to issue nonvoting securities. The Federal Reserve, however, has placed substantial limitations on such securities. Under Regulation Y, preferred shares, limited partnership shares or interests, or similar interests are not voting securities if:

i. Any voting rights associated with the shares or interest are limited solely to the type customarily provided by statute with regard to Fundamental Matters;

ii. The shares or interest represent an essentially passive investment or financing device and do not otherwise provide the holder with control over the issuing company; and

iii. The shares or interest do not entitle the holder, . . . in any manner, to select or to vote for the selection of directors, trustees, or partners (or persons exercising similar functions).[7]

Under Federal Reserve regulation and practice, Fundamental Matters are matters that "significantly and adversely affect the rights or preferences of the security," and are generally limited to:

- the issuance of additional amounts or classes of senior securities;
- the modification of the terms of the security or interest;
- the dissolution of the issuing company; or
- the payment of dividends by the issuing company when preferred dividends are in arrears.[8]

If a security is subject to a restriction on its voting rights, that restriction will be effective only if it is contained in the constitutive documents of the issuing entity – it cannot be in a side agreement. The rationale for this position is that if contained in an agreement alone, the parties to the agreement could breach it and waive any consequences; such a breach is not possible when the restriction is contained in, for example, a corporate charter.

Amount of Nonvoting Securities That May Be Held. The Federal Reserve generally permits an investor to own one-third of the total equity of a company before finding control, as long as no more than 14.9 percent of that equity is voting.[9]

<u>Restrictions on Nonvoting Securities Becoming Voting Securities.</u> The Federal Reserve's traditional position is that a security remains a voting or nonvoting security throughout its life – it cannot switch back and forth. There is a long-standing exception designed to permit a degree of liquidity for nonvoting securities. Such securities may become voting in a limited set of transfers:

- A transfer back to the issuer
- A transfer in a public offering
- A transfer in a private offering in which no transferee acquires more than 2% of the issuer's voting securities
- A transfer in a change-of-control, where more than 50 percent of the issuer's securities are transferred to a new owner (*not counting the investor's nonvoting securities for purposes of the 50 percent test*)

In practice, the Federal Reserve has also limited the transfers of nonvoting securities themselves to these four circumstances.[10] This is because the Federal Reserve generally views control over the disposition of a security as control of the security.

There is long-standing precedent for this position in the context of *voting* securities, although one may question its application to *nonvoting* securities. In a 1982 letter, the Federal Reserve disapproved of a proposal whereby an investor that had an option for 32.4 percent of the voting shares of a bank holding company stated that it intended only to acquire 24.9 percent and sell the other 7.5 percent, stating:

> The [Federal Reserve] is concerned that approval of your proposal, which would effectively allow control of up to 32.4 per cent of the voting shares of Florida National, could seriously impair the objectives and purposes of the Change in Bank Control Act and Bank Holding Company Act. General approval of such arrangements would establish a precedent permitting acquirors of bank holding company stock to accumulate up to 24.9 per cent of voting shares, proceed to dispose of these shares in a form subject to their control, acquire additional shares up to the 24.9 per cent level, and then possibly repeat this process.[11]

<u>Options and Warrants as Voting Securities/Fed Math.</u> The Federal Reserve has taken the position that an option or warrant for a voting security that is freely exercisable must be counted as a voting security, no matter how out-of-the-money the warrant or option is. Compounding the effects of this position, the Federal Reserve has also taken the position that when calculating the percentage of voting securities owned by an investor, one must treat the investor's options or warrants as exercised (as long as they are freely exercisable, no matter how out of the money), but no one else's. This is the position that elicited the "That can't be right!" statement cited above.

<u>Tear Down Rule.</u> The Federal Reserve has taken the position that if a party has control of a company – for example, controlling 25 percent of more of a class of voting securities – it is more difficult to shed control. It has therefore insisted on sell downs to a lower level of control than would otherwise be the case – selling down to 24.9 percent has generally been insufficient, with 10 percent, and sometimes less, frequently desired. This is a position more suited to metaphysics than law, and can have perverse results particularly when a BHC is seeking to divest a business but retain some form of economic interest in it.

Directors/Observers. The statute defines "control" as the ability to control the election or appointment of a majority of directors. The Federal Reserve's articulated position on "controlling influence," however, is that a 24.9 percent voting share investor or a 14.9 percent voting/one-third total equity investor may generally only appoint one director to the company's board. Moreover, as a general matter, an investor's director representation should be proportional to the percentage of voting shares it owns. The Federal Reserve now generally permits an additional observer as long as the observer is truly an observer.[12]

In addition, the director representative cannot be the chairman of the board and generally cannot chair a board committee. Such a director may participate on a committee as long as he or she does not make up more than 25 percent of the seats on the committee or have the authority or practical ability to make or block the making of policy decisions.[13]

Veto Rights. Although an investor may wish to have the ability to veto material business decisions, the Federal Reserve has limited such veto rights generally to Fundamental Matters, not without some potential inconsistency in its written statements. The 2008 Policy Statement declares that the Federal Reserve has traditionally been concerned about restrictions on the ability to raise "additional debt or equity capital," but in the next paragraph states that it is permissible to have a veto over "issuing senior securities or borrowing on senior basis,"[14] in addition to modifications to the terms of the investor's security or dissolution of the company.

Business Relationships. The extent of business connections between an investor and the company invested in is an area to which the Federal Reserve staff applies considerable attention. The general principle is that such business relationships must be "quantitatively limited and qualitatively immaterial,"[15] but the Federal Reserve looks at the facts of each transaction and make its determination on a case-by-case basis. Critical factors are that the connections be on market terms, be non-exclusive, and be terminable without penalty by the company invested in. The 2008 Policy Statement stated a preference for allowing more extensive business relationships when the investor's voting securities percentage was closer to 10 than 25 percent.[16]

Why the Control Definition Is Important

The Federal Reserve definition of control affects bank holding companies and nonbanks alike. In the first instance, it limits the ability of private investors – principally private equity funds and hedge funds – from making equity investments in banks and their holding companies, because it is an extremely rare private fund that will take on the burdens of Federal Reserve supervision and regulation, including activity restrictions and capital requirements. The disincentives have increased immeasurably with the Volcker Rule, which generally limits BHCs to owning no more than 3% of the ownership interests of any private fund they sponsor. In the Financial Crisis, the current control rules – and other restrictions imposed by the Federal Deposit Insurance Corporation – clearly limited the ability of private capital to support the banking sector.

In addition to private investors, the control definitions are relevant to nonbanking companies that wish to partner with banking organizations and may wish to obtain equity in their partner as well – since a controlling investment would subject them to the restrictions on commercial activities contained in the BHC Act.

Finally, revised control interpretations would also be relevant to BHCs themselves. One legal authority available to BHCs to make equity investments is the so-called "Section 4(c)(6)" authority permitting an investment in up to 5 percent of the voting shares of any company. Such investments – which may also include nonvoting securities – must also be noncontrolling. And because the Volcker Rule applies to every company that a BHC or other insured depository institution holding company controls, reform of the control rules would have beneficial effects in this area as well.

Areas of Potential Rationalization and Recalibration

The areas below are only certain examples where current Federal Reserve precedent may be an unduly restrictive interpretation of the statutory language. Any suggested recalibrations, too, are only possible ones.

Combination of Voting and Nonvoting Securities. The current limitations to 14.9% voting and one-third total equity do not derive from any particular aspect of the statute – which is focused only on control of *voting securities*. In another context, so-called "portfolio investments" under the Federal Reserve's Regulation K, an investor may own 19.9% voting securities and up to 40 percent total equity of a company without being deemed in control.[17] But this is but one alternative to the current limitation.

Fed Math/Tear Down Rule. It is very difficult to justifying treating freely exercisable but out-of-the-money warrants and options as voting securities, particularly when that rule applies only to the investor in question, but no other holder of the same securities – and so this "new math" should be one of the first candidates for "rationalization." Similarly, the so-called "tear down" rule is unanchored to the statutory language and thus is a prime candidate for reconsideration.

Directors. The Federal Reserve has stated that generally the number of directors must be proportionate to *voting shareholdings*. Again, although a greater number of directors suggests "influence," it does not necessarily lead to a "controlling influence." If an investor has contributed 40 percent of a company's total equity, it does not seem unreasonable to permit a right to appoint 40 percent of a company's board. Moreover, the restriction on committee chairing is arguably inconsistent with the statutory language, and keeps qualified candidates – for example, retired Federal Reserve Governors or Reserve Bank Presidents affiliated with private investors – on the sidelines.

Limitations on Transfer of Nonvoting Securities.

Although one can understand the Federal Reserve's concern about the circumstances in which nonvoting securities can become voting, this is a separate issue from the issue of *transfers of nonvoting* *securities*. If one focuses on the statutory term "controlling influence," it would seem reasonable to permit transfers of nonvoting securities to a wider group of transferees than the four limited circumstances in which nonvoting securities can currently become voting. This is a prime example of the side effects of the piecemeal construction of the current control framework – one might have concerns about "seriously impair[ing] the objectives and purposes" of the BHC Act when control over transfer of 25 percent or more *voting securities* is at issue. It is not clear that these concerns apply in the *nonvoting securities* context where there are substantial limitations on the securities ever becoming voting at all.

In addition, recalibrating the circumstances when nonvoting securities may become voting should also be given consideration, because certain aspects of the current rules – such as not counting the transfer of an investor's nonvoting securities for purposes of the 50 percent transfer test – seem to be conservative simply for conservatism's sake.

Veto Rights/Class Votes.

Current Federal Reserve regulation and policy limit an investor's veto rights to matters that "significantly and adversely affect the rights and privileges" of the investor's security. Even if this formulation is correct as an original matter (and a recalibration subject to notice and comment would allow for discussion of this point), there may well be more corporate matters than those the Federal Reserve currently permits that may be viewed as having such an effect. Holding an equity interest of course gives economic rights, but it can also be considered as taking a fundamental stake in a particular business – and therefore, to use but one example, it is not clear why a material change to the nature of that business should not be a Fundamental Matter subject to an investor veto. To the extent the scope of permissible investor vetoes is broadened, similar broadening of matters that may be subject to a class vote without creating a separate class of voting securities should also be considered.

Business Relationships.

The area of permitted business relationships between an investor and a bank or other company is one in particular where "supplication to someone who has spent a long apprenticeship in the art of Fed[eral Reserve] interpretation" is frequently necessary. Granting that it is impossible to predict in advance every possible contemplated business relationship, it does seem that a retreat from the current all-facts-and-circumstances test is both possible and desirable, such as through the use of regulatory presumptions of permissible arrangements, in a manner similar to the approach taken in aspects of the proposed recalibration of the Volcker Rule.

Conclusion

If the hinted-at rationalization and recalibration of the control rules occurs, it is hoped that the Federal Reserve will do so – as it has done this year in other areas of federal banking law – in the transparent manner of a proposal subject to notice and comment. The peculiarities of the common law of control that have developed over more than four decades provide considerable material for interested parties to share their perspectives on improvements for the future.

[1] Vice Chairman Randal K. Quarles, "Early Observations on Improving the Effectiveness of Post-Crisis Regulation," January 19, 2018.

[2] Although this Client Alert focuses on control under the BHC Act, with the abolition of the Office of Thrift Supervision, the Federal Reserve also interprets control under the Savings and Loan Holding Company Act, which has a similar, if not identical, definition, including a "controlling influence" prong.

[3] 12 U.S.C. § 1841(a)(2).

[4] *See, e.g.*, 12 C.F.R. §§ 225.31, 225.143; Policy Statement on Investments in Banks and Bank Holding Companies (2008).

[5] 12 C.F.R. § 225.2(q)(1).

[6] *Id.* § 225.2(q)(3).

[7] *Id.* § 225.2(q)(2). The Federal Reserve has considered certain subordinated debt to be a nonvoting security.

[8] *Id.*

[9] *See* Policy Statement on Investments in Banks and Bank Holding Companies (2008).

[10] *See, e.g.*, Letter from Scott G. Alvarez, Esq. to Peter Heyward, Esq., June 29, 2011. An investor may also generally transfer nonvoting securities to one of its affiliates.

[11] *See* Letter of William W. Wiles (March 18, 1982).

[12] *See* Policy Statement on Investments in Banks and Bank Holding Companies (2008).

[13] *See id.*

[14] *Id.* The two statements are reconcilable if a veto over additional *pari passu* and subordinated instruments is impermissible, but one over senior debt and equity issuances is permissible.

[15] *Id.*

[16] *Id.*

[17] *See* 12 C.F.R. § 211.8(c)(3).

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or the authors:

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