Federal Reserve's Proposed Rule on Controlling Influence: A Step in the Right Direction

May 2, 2019

Contents

The Board of Governors of the Federal Reserve System ("**Federal Reserve**") has invited comments on a highly anticipated **notice of proposed rulemaking** to amend its regulatory framework for deciding when a company exercises a controlling influence over another company under the Bank Holding Company Act ("**BHC Act**") and the Home Owners' Loan Act ("**HOLA**").[1]

The proposal is a welcome step in the right direction. It would provide greater transparency, certainty and predictability, and relax some of the limits and restrictions in the Federal Reserve's existing practices and precedents. This would make the Federal Reserve's framework more consistent with the ordinary meaning of the words "controlling influence" as distinguished from a mere important, significant or potentially controlling influence. At least in the case of the BHC Act, the proposal would also adjust the Federal Reserve's framework so that it is more consistent with the text and legislative history of the controlling influence test, as well as the Federal Reserve's original framework for applying that statutory test.

The proposal would formalize in Regulation Y (for bank holding companies) and Regulation LL (for savings and loan holding companies) the framework for making controlling influence determinations that is currently reflected in a patchwork of Federal Reserve policy statements, ad hoc written non-control determinations, and a combination of written and unwritten precedents and practices. The controlling influence test applies when a company does not trigger either of the two bright-line alternative definitions of control under the statutes. That is, it applies when a company does not control 25% or more of any class of voting securities of another company or the election of a majority of the other company's board of directors, but nevertheless still has control over the other company.

If finalized as proposed, the proposal would make it easier for banking organizations to make non-controlling investments in other companies and to divest control of previously controlled companies. It would also make it easier for non-banking investors such as private equity funds and other investment funds to make non-controlling investments in banking organizations. In particular, the proposal would, compared to the Federal Reserve's existing general practice and precedents:

[1] This memorandum focuses on the Federal Reserve's proposed revisions to Regulation Y, which implements the BHC Act, rather than the proposed revisions to Regulation LL, which implements HOLA. The statutory definitions of control under the BHC Act and HOLA are "substantially similar," and the Federal Reserve proposed to amend Regulation LL "in essentially the same manner" as Regulation Y.

- Increase the level of voting equity ownership that benefits from a presumption of non-control from less than 5% (i.e., up to 4.99%) to less than 10% (i.e., up to 9.99%) (assuming no other applicable presumptions of control are triggered);
- Leave the levels of permitted total equity (voting equity plus non-voting equity) unchanged at less than one third (i.e., up to 33.3%) when an investor controls less than 15% of voting equity;
- Permit an increased level of an investor's representation on a company's board of directors, from the general precedent of one director to either less than 50% or less than 25% of the board, depending on the level of voting equity ownership;
- Relax the limits on board committee representation for an investor's board representative(s);
- Permit increased levels of business relationships between an investor and a company at voting equity levels of 14.99% or less;
- Leave the restrictions on contractual covenants and consent rights over a company's operational and policy decisions effectively unchanged; and
- Largely eliminate the quantitative differences between the presumptions of control and non-control that apply when a banking organization is acquiring an interest in another company compared to when it is divesting control of the company.

Yet the proposal falls short of making the Federal Reserve's framework fully consistent with the ordinary meaning of the words "controlling influence," as distinguished from a mere important, significant or potentially controlling influence. It also falls short of making the Federal Reserve's framework fully consistent with the text and legislative history of the controlling influence test, as well as the Federal Reserve's original framework for applying that statutory test. The text and legislative history of the statute, and the Federal Reserve's original framework, all focused on whether the level of a company's influence over another company amounted to actual control.

Instead, the Federal Reserve continues to approach controlling influence as a function of how closely various factors approach the two other statutory tests of control—25% or more of any class of voting securities or a majority of the board of directors—instead of whether the level of influence amounts to actual control. We believe that a standard of actual control would be more consistent with the text and legislative history of the controlling influence provision in the 1970 amendments to the BHC Act. The text of the statutory definition of control defines a controlling influence as turning on whether a company *exercises* a controlling influence over the management or policies of another company. In contrast, the Federal Reserve's proposed framework would continue to focus on whether a company has the *potential ability* to exercise a controlling influence over the management or policies of another company. The legislative history shows that the Vice Chairman of the Federal Reserve at the time, the sponsor of the controlling influence amendment and the Chairman of the House

Financial Services Committee all stated that the standard for controlling influence was one of "actual control"—in other words, facts falling short of the other two statutory tests of control, but nevertheless constituting actual control.[2] That is also how the Federal Reserve originally interpreted and applied it.[3]

It will be interesting to see whether, as a result of the public comment process, the Federal Reserve would be willing to move closer to or adopt a controlling influence test based on actual control. Such a standard would, as explained more fully below, strengthen the justifications for some of the proposed thresholds and other adjustments to the Federal Reserve's existing framework. It would also suggest that still higher thresholds would be justified to make the proposal fully consistent with the text and legislative history of the controlling influence provision in the 1970 amendments to the BHC Act.

Comments on the proposal are due 60 days after publication in the Federal Register.

---

[2] *Bank Holding Company Act Amendments: Hearing Before the H. Comm. on Banking and Currency*, 91st Cong. 235 (1969) (statement of James L. Robertson, Vice Chairman of the Federal Reserve, in response to a question from Rep. Rees about what criteria the Federal Reserve would use to determine whether a company had control over another company if it had less than 25% of the voting equity of the other company: "We would have to go in and establish in the course of the hearings, with a record that would be adequate to sustain whatever conclusion we arrived at, that there was in reality control");115 Cong. Rec. 33141 (1969) (statement of Rep. Thomas W. L. Ashley) (stating that the proposed controlling influence test would modify the definition of "control" in the BHC Act "by providing that actual control of any bank, even at less than 25 percent, is sufficient to require the controlling company to register as a bank holding company"); 115 Cong. Rec. 3368 (1969) (statement of Rep. Wright Patman) (stating in a press release that under the bill he introduced, which included a proposed controlling influence test, "the Federal Reserve would be allowed to make a finding of 'actual control' even though the holding company held less than 25% of the stock" of a bank).

[3] *See, e.g.*, Patagonia Corporation, 63 Fed. Res. Bull. 288 (1977) (holding that Patagonia did not have the degree of influence over the management or policies of a savings association that amounted to actual control, even though it owned more than 20% but less than 25% of the association's voting securities, had three director representatives on the association's 15-member board of directors and was actively seeking to acquire a majority of the association's voting securities, which it did approximately one year later); Opinion Letter, Board of Governors of the Federal Reserve System to John L. Douglas, 1982 Fed. Res. Interp. Ltr. LEXIS 8 (Apr. 5, 1982) (rejecting Florida National's argument that because Cavendes had actively attempted to exercise a controlling influence over Florida National through proxy solicitations and other hostile actions, it should be deemed to have a controlling influence over Florida National upon acquiring 24.99% of Florida National's voting securities, reasoning that while Cavendes had attempted to exercise a controlling influence over Florida National, it had not been successful in actually doing so).

Background

The proposal comes more than a year after Vice Chairman for Supervision Randal Quarles first announced that the Federal Reserve was re-examining its control framework.[4] As Vice Chairman Quarles described in his statement on the proposal, the Federal Reserve's existing control framework "has developed over many decades through a common law process and has become one of the more ad hoc and complicated areas of the [Federal Reserve's] regulatory administration."[5] Indeed, while the Federal Reserve's 2008 and 1982 policy statements on equity investments in banks and bank holding companies ("**BHCs**")[6] provided public statements of the Federal Reserve's views on many potential indicia of a company's "controlling influence" over another company, many other elements of the Federal Reserve's approach to interpreting that facts-and-circumstances-based prong of the statutory definitions of control under the BHC Act and HOLA were developed in non-public practices and precedents.

As a result of this non-public approach, divining whether the Federal Reserve would find a controlling influence under its existing framework has required, according to Vice Chairman for Supervision Quarles, "supplication to a small handful of people who have spent a long apprenticeship in the subtle hermeneutics of Federal Reserve lore, receiving the wisdom of their elders through oral tradition in the way that gnostic secrets are transmitted from shaman to novice in the culture of some tribes of the Orinoco."[7]

In an effort to improve the predictability, simplicity and transparency of the control framework, the Federal Reserve has proposed to codify in its regulations a framework based on (1) different levels of voting equity ownership, ranging from less than 5% to between 15% and 24.99%, and (2) a series of quantitative or qualitative factors or criteria that, if satisfied, create presumptions of control. Pursuant to any of these presumptions of control, the Federal Reserve would presume an investor[8] to exercise or

---

[4] For our analysis at the time of Vice Chairman Quarles' announcement, please see our *FinReg* blog post, *Federal Reserve Signals Long-Overdue Re-examination of BHC Act Control Framework* (Jan. 24, 2018), **https://www.finregreform.com/single-post/2018/01/24/federal-reserve-signals-long-overdue-re-examination-of-bhc-act-control-framework/**.

[5] Opening Statement on Proposal to Revise the Board's Control Rules by Vice Chairman for Supervision Randal K. Quarles (Apr. 23, 2019), **https://www.federalreserve.gov/newsevents/pressreleases/quarles-opening-statement-20190423.htm**.

[6] Policy statement on equity investments in banks and bank holding companies (2008), **https://www.federalreserve.gov/bcreg20080922b1.pdf**; 12 C.F.R § 225.143 (1982 policy statement).

[7] Board of Governors of the Federal Reserve System, Transcript of Open Board Meeting (Apr. 23, 2019), at 2–3, **https://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20190423.pdf**.

[8] For the sake of simplicity, in this memorandum we use the term "investor" to refer to a banking organization or company that makes an investment in or becomes a holder of voting or non-voting securities of another banking organization or company.

have the ability to exercise a controlling influence over, and thus to control, a company unless the investor is able to rebut the presumption in a hearing before the Federal Reserve or a judicial proceeding. The proposal would also introduce a number of definitions and technical provisions that would affect the application of the presumptions of control.

The Federal Reserve explained that it intends for the proposed framework of 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 [Federal Reserve's] control framework." While the Federal Reserve described the presumptions of control as codifying "a significant portion of [its] historical practice with respect to controlling influence," it also stated that the presumptions of control reflect "certain targeted adjustments that [it] believes are appropriate based on its experience."

As described in more detail below, the presumptions and related definitions and technical provisions would codify a framework for controlling influence determinations that varies from the Federal Reserve's existing approach in important and sometimes subtle ways. Some aspects of the proposal would make the Federal Reserve's framework more consistent with the ordinary meaning of "controlling influence," while other aspects are broadly unchanged and some could even broaden the scope of investors deemed to have a controlling influence. Consequently, while the proposal is certainly an important step toward greater predictability, simplicity and transparency, its substantive impact on investments by and in banking organizations may not be fully consistent with the ordinary meaning of "controlling influence," as distinguished from a mere important, significant or potentially controlling influence. This conclusion is especially the case if the substance of the proposal is measured not against the Federal Reserve's existing practice and precedents, but against a controlling influence standard based on actual control.

Application in Control Proceedings

The proposed framework of rebuttable presumptions of control and non-control would formally apply where an investor contests a preliminary determination by the Federal Reserve that the investor has a controlling influence over the management or policies of a company. Specifically:

- The investor could contest a preliminary determination of controlling influence by submitting a written response and, if desired, requesting a hearing or other proceeding. The response could include a description of all current and proposed relationships between the investor and the company, including relationships of the type that are identified under any of the rebuttable presumptions of control and non-control, copies of any formal agreements related to such relationships, and a discussion regarding why the Federal Reserve should determine that the investor does not control the company.
- If the investor petitioned for a hearing or other proceeding and the Federal Reserve found that material facts were in dispute, the Federal Reserve would be required to order a formal hearing or other appropriate proceeding. Even if the investor did not petition for a hearing or other proceeding, the Federal Reserve could also order one in its discretion. Any applicable presumptions of control or non-control would be considered at the hearing or other proceeding.

Tiers of Voting Equity and Presumptions of Control

Tiers of Voting Securities

Under the proposal, the determining factor for which presumptions of control apply is the level of voting securities that a banking organization or other investor has in a company. The proposal establishes four tiers of voting equity, each measured by ownership or control of any class of voting securities:

- Less than 5%;
- 5% to 9.99%;
- 10% to 14.99%; and
- 15% to 24.99%.

- After considering the submissions of the investor and other evidence, including the record of any hearing or other proceeding, the Federal Reserve would issue a final determination on whether the investor has the power to exercise a controlling influence over the management or policies of the company. If the Federal Reserve finds control, the Federal Reserve could direct the investor to terminate the control relationship or file an application or notice to retain the relationship.

The Federal Reserve noted that 5% is the level at which the statutory presumption of non-control in the BHC Act ceases to apply, 10% is the level used to identify persons required to file Change in Bank Control Act notices, and 15% or higher is a level at which an investor is closer to the 25% level for statutory control than to the presumption of non-control at less than 5%.

The proposal would also codify standards for determining when an investor "controls" a security as distinguished from another company, and a methodology for calculating the investor's voting percentage in a company's voting equity securities. Please see the section "**Control over Voting and Non-Voting Securities and Calculation of Voting Ownership**" below for a discussion of those standards.

Rebuttable Presumption of Non-Control

The proposal would create a new rebuttable presumption of non-control in Regulation Y, for purposes of a Federal Reserve hearing held after the Federal Reserve has made a preliminary determination of control and the investor requests a hearing to contest it. It would apply to any investor that:

- controls less than 10% (i.e., up to 9.99%) of each class of voting securities of a company, and
- does not trigger any of the proposal's presumptions of control that apply to investments between 5% and 9.99% of any class of voting securities of the company (which are described in more detail below).

This presumption would replace the current regulatory presumption of non-control that applies to an investor that controls less than 5% of any class of voting securities in a Federal Reserve proceeding in which the Federal Reserve makes a preliminary determination of a controlling influence that is contested by the investor.[9] A complementary provision of Regulation Y applies to any judicial proceeding under the BHC Act or a Federal Reserve proceeding other than one in which the Federal Reserve makes a preliminary determination of a controlling influence.[10] It prohibits an investor from being held to control another company unless (1) the investor controls 5% or more of any class of voting securities of the company or (2) has already been found to control the company on the basis of a controlling influence relationship.[11] That provision would remain unchanged.[12]

While the proposal introduces a gray area for companies with between 10% and 24.99% voting ownership that do not trigger any of the rebuttable presumptions of control, the Federal Reserve indicated in the preamble to the proposal that the mirror images of these presumptions of control would implicitly be treated as presumptions of non-control by stating that "[a]bsent unusual circumstances, [it] generally would not expect to find that a

---

[9] 12 C.F.R. § 225.31(e)(1).

[10] 12 C.F.R. § 225.31(e)(2).

[11] *Id.*

[12] Compare 12 C.F.R. § 225.31(e)(2) to proposed new § 225.33(b).

company controls another company where the [investor] is not presumed to control the . . . company under the proposal."

Rebuttable Presumptions of Control

The proposal would significantly expand the number of rebuttable presumptions of control that would apply in the context of a contested preliminary determination of control. The rebuttable presumptions of control, which are described in more detail below, are based on:

- the extent of an investor's representation on the board of directors or board committees of a company;
- the extent and terms of business relationships between the investor and the company;
- senior management official interlocks between the investor and the company;
- covenants or other agreements that allow the investor to significantly influence or restrict management or operational decisions of the company;
- the investor's solicitation of proxies to vote on certain matters; and
- the percentage of the company's total equity controlled by the investor.

In addition, there are specific presumptions that relate to control of an investment fund, companies consolidated for accounting purposes, and situations in which an investor seeks to divest control of a company.

Under the proposal, the relationship between an investor's level of voting equity ownership and the presumptions of control would continue to reflect, consistent with existing Federal Reserve practice and precedents, a "see-saw" or inverse relationship: the lower the level of voting equity, the less restrictive the presumptions of control are; the higher the level of voting equity, the more restrictive the presumptions of control are. According to the Federal Reserve, the tiered framework was designed "so that, as an investor's [voting] 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."

In and of itself, the see-saw approach is perfectly sensible. The problem, as discussed in more detail below, lies with the Federal Reserve continuing to tie the calibration of some of the limits—especially for business relationships and non-voting equity—to its existing practice and precedents, rather than to a standard such as actual control, which is clearer and simpler to apply and which is also better grounded in the text and legislative history of the 1970 amendments to the BHC Act. For example, the upper limit on total equity of 33.3% when an investor's voting equity is less than 15% is consistent with the Federal Reserve's practice and its 2008 policy statement. But because there is no statutory guidance one way or the other on any limit for non-voting equity, the 33.3% limit has no grounding in the statute, but is purely a creation of the Federal Reserve based on years of ad-hoc decisionmaking. It is unclear why fixing the limit at 33.3% is more appropriate than fixing it at a higher limit that would still fall short of actual control, such as 40%, 49.9% or even higher,[13] at least at the lower levels of voting equity or if the investor controls no voting securities at all.

Summary Chart of Presumptions of Control

The following chart provides a simplified visual summary of the tiered presumptions of control under the BHC Act set out in the Federal Reserve's proposal (other than those specifically relating to investment funds, which are summarized in separate charts on pages 20 and 22 below). The chart uses color coding to indicate whether a particular presumption is: generally a liberalization compared to the Federal Reserve's existing practice and precedents (green); generally consistent with the Federal Reserve's existing practice and precedents (white); or generally a stricter approach compared to the Federal Reserve's existing practice and precedents (red). The color coding assumes, for any investor at 5% or above, that the investor was subject to passivity commitments.

	Investor Controls Less than 5% (i.e., up to 4.99%) of each Class of Voting Securities	**Investor Controls Between 5-9.99% of any Class of Voting Securities**	**Investor Controls Between 10-14.99% of any Class of Voting Securities**	**Investor Controls Between 15-24.99% of any Class of Voting Securities**
Investor Benefits from Presumption of Non-Control	Yes	Yes, so long as no other factor would create a presumption of control	No	No
Number of Director Representatives of Investor	No presumption of control at less than 50% of board of directors	No presumption of control at less than 25% of board of directors	No presumption of control at less than 25% of board of directors	No presumption of control at less than 25% of board of directors
Director Representative of Investor as Board Chair	No presumption of control	No presumption of control	No presumption of control	Presumption of control
Director Representatives of Investor on Board Committees	No presumption of control	No presumption of control	No presumption of control at up to 25% or less of a committee that has the power to bind the company (including compensation, audit or executive committee)	No presumption of control at up to 25% or less of a committee that has the power to bind the company (including compensation, audit or executive committee)

[13] We note that any higher level of total equity could potentially trigger the presumption of control for accounting consolidation, discussed below.

	Investor Controls Less than 5% (i.e., up to 4.99%) of each Class of Voting Securities	Investor Controls Between 5-9.99% of any Class of Voting Securities	Investor Controls Between 10-14.99% of any Class of Voting Securities	Investor Controls Between 15-24.99% of any Class of Voting Securities
Business Relationships Between Investor and Company – Quantitative Limits	No presumption of control	No presumption of control at less than 10% of annual revenues or expenses of investor and of company	No presumption of control at less than 5% of annual revenues or expenses of investor and of company	No presumption of control at less than 2% of annual revenues or expenses of investor and of company
Business Relationships Between Investor and Company – Qualitative Terms	No presumption of control	No presumption of control	No presumption of control if business relationships on market terms	No presumption of control if business relationships on market terms
Senior Management Official Interlocks	No presumption of control	No presumption of control unless more than 1 interlock or any CEO interlock	No presumption of control unless more than 1 interlock or any CEO interlock	Presumption of control
Management Agreement	Presumption of control	Presumption of control	Presumption of control	Presumption of control
Limiting Contractual Rights of Investor	No presumption of control	Presumption of control if investor has rights that significantly restrict discretion over major operational or policy decisions of company	Presumption of control if investor has rights that significantly restrict discretion over major operational or policy decisions of company	Presumption of control if investor has rights that significantly restrict discretion over major operational or policy decisions of company
Proxy Solicitations by Investor	No presumption of control	No presumption of control	Presumption of control if investor solicits proxies for director representatives comprising 25% or more of board of directors (when aggregated with investor's existing director representatives, if any) No presumption of control for proxy solicitation on other issues	Presumption of control if investor solicits proxies for director representatives comprising 25% or more of board of directors (when aggregated with investor's existing director representatives, if any) No presumption of control for proxy solicitation on other issues
Total Equity Controlled by Investor	No presumption of control at less than one third (up to 33.3%)	No presumption of control at less than one third (up to 33.3%)	No presumption of control at less than one third (up to 33.3%)	No presumption of control at less than 25%

	Investor Controls Less than 5% (i.e., up to 4.99%) of each Class of Voting Securities	Investor Controls Between 5-9.99% of any Class of Voting Securities	Investor Controls Between 10-14.99% of any Class of Voting Securities	Investor Controls Between 15-24.99% of any Class of Voting Securities
Accounting Consolidation	Presumption of control if company is consolidated with investor under U.S. GAAP	Presumption of control if company is consolidated with investor under U.S. GAAP	Presumption of control if company is consolidated with investor under U.S. GAAP	Presumption of control if company is consolidated with investor under U.S. GAAP
Divestiture of Control	No presumption of control based solely on continued ownership of this reduced level of voting securities	No presumption of control based solely on continued ownership of this reduced level of voting securities	No presumption of control based solely on continued ownership of this reduced level of voting securities	Presumption of control for two years after reduction to less than 25% of each class of voting securities, unless 50% or more of each class of voting securities is owned by unaffiliated person or company, in which case there is no presumption of control upon reduction to less than 25%

Representation on Board of Directors

Voting Equity	Limit on Board Seats
≥ 5% ≤ 24.99%	**< 25%**
< 5%	**< 50%**

Representation on Board of Directors and Board Committees

The proposal would introduce several tiered rebuttable presumptions of control based on an investor's rights to director representation on the board of directors of a company.

Number of Board Seats

- An investor would be presumed to control a company if (1) it controls 5% or more of any class of voting securities of the company and (2) director representatives of the investor or any of its subsidiaries comprise 25% or more of the board of directors of the company or any of its subsidiaries.
- If an investor owns less than 5% of each class of voting securities of a company, its director representatives could comprise up to less than 50% of the company's board without triggering the presumption of control. (If it held a majority of the seats on the board, it would control the company based on the second prong of the statutory definition of "control.")
- The proposed presumptions would significantly liberalize the Federal Reserve's current approach to board representation for non-controlling investments.
  - The 2008 policy statement generally limited an investor with a voting equity interest in a company between 10% and 24.99% to a single seat on the board of the company. In

practice, the Federal Reserve has generally applied this limit to any investor with a voting equity interest of less than 25%.

- The 2008 policy statement only allowed an investor to have two seats on the board of a company if that representation was proportionate to its total interest in the company but did not exceed 25% of the seats on the board and an unaffiliated BHC shareholder otherwise controlled the company. In practice, the Federal Reserve has only exceptionally allowed a non-controlling investor to have more than one seat on a company's board.

- As a practical matter, the new presumption of control will only be less restrictive compared to existing Federal Reserve practice for investors with 5% or more but less than 25% of a company's voting equity when a company's board consists of at least 9 directors, because until that size of board the investor would in any event be limited to one director.

Special Director Representative Powers

- An investor would be presumed to control a company if (1) it controls 5% or more of any class of voting securities of the company and (2) director representatives of the investor or any of its subsidiaries are able to make or block the making of major operational or policy decisions of the company or any of its subsidiaries.
- According to the Federal Reserve, this presumption 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 . . . company to control effectively major operational or policy decisions of the . . . company," and is consistent with the Federal Reserve's existing practice.

Board Chair

- An investor would be presumed to control a company if (1) the investor controls 15% or more of any class of voting securities of the company and (2) a director representative of the investor or of any of its subsidiaries serves as the chair of the board of directors of the company or any of its subsidiaries.
- An investor with less than 15% of each class of voting securities of a company would be permitted to have a director representative serving as chair of the board of the company without triggering a presumption of control. The proposal would liberalize the Federal Reserve's practice with respect to service as board chair for such investors.
  - The 2008 policy statement flatly prohibited a director representative of an investor with a non-controlling voting equity interest in a company between 10% and 24.99% from serving as chair of the board of the company. The Federal Reserve's standard passivity commitments, which often

Application of Limits to Sizes of Boards

Size of Board	Limit on Board Seats
8 directors	**3** (if voting equity < 5%) **1** (if voting equity ≥ 5% ≤ 24.99%)
9 directors	**4** (if voting equity < 5%) **2** (if voting equity ≥ 5% ≤ 24.99%)
10 directors	**4** (if voting equity < 5%) **2** (if voting equity ≥ 5% ≤ 24.99%)

Definition of Director Representative

The proposal would define "director representative" as, with respect to an investor, any individual that serves on the board of directors of a company and:

- was nominated or proposed to serve by the investor;
- is a current employee, director, or agent of the investor;
- served as an employee, director, or agent of the investor during the immediately preceding two years; or
- is a member of the immediate family of any employee, director, or agent of the investor.

applied to any investor with 5% or more of any class of voting securities of a company, contained the same prohibition.

Representation on Board Committees

Voting Equity	Limit on Board Committee Seats
≥ 10% ≤ 24.99%	≤ 25%
< 10%	No limit

Number of Board Committee Seats

- An investor would be presumed to control a company if (1) it controls 10% or more of any class of voting securities of the company and (2) director representatives of the investor and its subsidiaries comprise more than 25% of any committee of the board of directors of the company or any of its subsidiaries that can take actions that bind the company or any of its subsidiaries without the consent of the full board.
- In the preamble to the Proposal, the Federal Reserve identified audit, compensation and executive committees as examples of committees that, in its experience, "can take actions that bind the . . . company" and would therefore be the subject of the presumption.
- This presumption is generally consistent with the 2008 policy statement, which provided that representatives of a non-controlling investor with a voting equity interest between 10% and 24.99% may serve as members of committees of the board of a company when those representatives do not occupy more than 25% of the seats on any committee and do not have the authority or practical ability unilaterally to make (or block the making of) policy or other decisions that bind the board or management of the company. The Federal Reserve's standard passivity commitments, which often applied to any investor with 5% or more of any class of voting securities of a company, contained the same limitation.
- An investor with less than 10% of each class of voting securities of a company would be permitted to have its director representatives hold any number of the seats on any committee of the company, including any committee with the power to bind the company without further action by the full board, without triggering the presumption of control. This represents a liberalization compared to the same limitation in the Federal Reserve's standard passivity commitments, which often applied to any investor with 5% or more of any class of voting securities of a company.

No Presumption for Board Committee Chair

The Proposal does not include a presumption of control relating to service by any director representative of an investor as chair of any committee of the board of a company. This represents a departure from the 2008 policy statement, which flatly prohibited a director representative of a non-controlling investor with a voting equity interest between 10% and 24.99% from serving as chair of a board committee of the company (as opposed to chair of the full board). It also represents a liberalization compared to the same prohibition in the Federal Reserve's standard passivity commitments, which often applied to any investor with 5% or more of any class of voting securities of a company.

No Presumption for Board Observers

Non-voting observers are expressly excluded from the proposed definition of "director representative." This approach is consistent with the 2008 policy statement and with the Federal Reserve's existing practice, which generally permitted non-controlling investors to have board observers.

Extent and Terms of Business Relationships

Percentage of Annual Revenues or Expenses

- An investor would be presumed to control a company if the investor or any of its subsidiaries enters into transactions or has business relationships with the company or any of its subsidiaries that generate in the aggregate total annual revenues or expenses of either (1) the investor or (2) the company, each on a consolidated basis, in excess of the following tiered percentage thresholds:
  - If the investor controls 5% or more of any class of voting securities of the company, 10% or more of total annual revenues or expenses;
  - If the investor controls 10% or more of any class of voting securities of the company, 5% or more of total annual revenues or expenses; or
  - If the investor controls 15% or more of any class of voting securities of the company, 2% or more of total annual revenues or expenses.
- In the preamble to the proposal, the Federal Reserve requested comment on whether this presumption of control should be based solely on the revenues and expenses of the company or also on those of the investor as proposed, reflecting the fact that if the company accounts for a large portion of the investor's revenues or expenses, that may offset any influence the investor has over the company.
- An investor with less than 5% of each class of voting securities of a company would not be subject to any presumption of control based on the extent of its business relationships with the company.
- Limitations on the extent of business relationships are consistent with both the Federal Reserve's 2008 policy statement, which stated that the Federal Reserve had frequently permitted business relationships that were "quantitatively limited and qualitatively nonmaterial," and its general practice of imposing quantitative limits in passivity commitments, which often applied to investors with 5% or more of any class of voting securities of a company. Although the Federal Reserve's precedents on limits on business relationships tend to vary—ranging from lows of a single $500,000 deposit to 2% or 2.5% of gross revenues and occasionally up to higher percentages of gross revenues—more recently its practice focused on the lower end of the percentage range.

Limits on Business Relationships

Voting Equity	Limits
≥ 5% ≤ 9.99%	Total annual revenues and expenses < 10%
≥ 10% ≤ 14.99%	Total annual revenues and expenses < 5% <u>and</u> market terms
≥ 15% ≤ 24.99%	Total annual revenues and expenses < 2% <u>and</u> market terms

- The proposal would generally represent a liberalization of the quantitative limits applied to investors with between 5% and 14.99% of any class of voting securities, while remaining generally consistent with or slightly lower than the quantitative limits applied to investors with between 15% and 24.99% of any class of a company's voting securities.
- The proposal would, however, measure the limits not just by the percentage of revenues, but also by the percentage of expenses of the investor and the company. The Federal Reserve's practice, especially in more recent years, generally has been to apply quantitative limits based on the gross revenues of each of the investor and the company, although more recently its practice also focused on the extent to which a company was dependent on an investor for services. The proposal would therefore apply not just to business relationships that generate revenues for either the investor or the company, but also that result in expenses for either party.
  - Although the proposal is not clear on this point, presumably the limits on revenues and expenses would be calculated separately, i.e., the investor and company would each measure (1) the percentage of its revenues derived from the business relationships and (2) the percentage of its expenses attributable to the business relationships.
- The Federal Reserve's see-saw approach poses a problem for the extent of business relationships consistent with non-control. It illustrates the potential pitfall of calibrating the limits for the various presumptions of control based on the Federal Reserve's past practice and precedents instead of by analogy to the limits on non-voting equity or total equity or based on a standard of actual control. There is no statutory guidance applicable to any quantitative limitations on business relationships. The thresholds of 2%, 5% and 10% are a product of the Federal Reserve's existing precedents or a proposed relaxation, as applicable.
  - By applying the see-saw approach, whereby the limits on business relationships tighten as an investor's level of voting equity ownership increases, the Federal Reserve makes it more difficult for a strategic equity investor to support a company with a proportionate commitment to doing business with the company. These limits also make it difficult for a relatively limited number of banking organizations or other investors to establish user-owned utilities that would provide services or otherwise do business with those organizations or investors because the investors' pro rata share of a utility's business would likely exceed the applicable threshold for a presumption of control.
  - Because the 2%, 5% and 10% thresholds are not anchored in any statutory thresholds, the Federal Reserve would be justified in taking a different approach and adopting higher limits based on either (1) an analogy between business

relationships and non-voting equity (in the same way that the proposal equates certain debt instruments or profit-sharing arrangements with total equity)—for example, business relationships up to 33.3% of revenues or expenses for investors with less than 15% of each class of voting securities of a company—or (2) a standard of actual control.

- Lastly, the proposal would perpetuate another recurring problem with limits on business relationships, namely, their extension to "subsidiaries" of both the investor and the company. Because the definition of "subsidiary" in the BHC Act and Regulation Y is still tied to the three-prong definition of control, as a practical matter it is difficult and burdensome to identify another company's subsidiaries for this purpose, particularly if the company is not itself subject to the BHC Act and therefore has never used this standard to define its subsidiaries. As the proposal itself would measure the limit's annual revenues and expenses for each of the investor and the company on a consolidated basis, it would be far more practical if a "subsidiary" for purposes of business relationships were limited to a consolidated subsidiary under applicable accounting principles.

Market Terms

An investor would also be presumed to control a company if (1) the investor controls 10% or more of any class of voting securities of the company and (2) the investor or any of its subsidiaries enters into transactions or has business relationships with the company or any of its subsidiaries that are not on market terms.

- An investor with less than 10% of each class of voting securities of a company would not be subject to any presumption of control based on the terms of business relationships with the company.
- The proposal does not define "market terms" for purposes of this presumption. The Federal Reserve requests comments on which standards it should apply to determine whether a business relationship is on market terms.
  - In its standard passivity commitments, which often apply to investors with 5% or more of any class of voting securities of a company, the Federal Reserve has generally adopted a standard equivalent to that in Section 23B of the Federal Reserve Act, i.e., terms comparable to or no less favorable than those offered in good faith to unaffiliated persons.
- In the 2008 policy statement, the Federal Reserve stated that in its review of business relationships, it would "pay particular attention . . . to whether the proposed business relationships would be on market terms, non-exclusive, and terminable without penalty by the banking organization." The proposal does not include a rebuttable presumption based on whether business relationships are non-exclusive and terminable without penalty.

> **Definition of Senior Management Official**
>
> For purposes of the rebuttable presumptions of control described in this section, the proposal would define "senior management official" as 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. This definition is substantially similar to the definition of "executive officer" in the Federal Reserve's Regulation O.

Senior Management Official Interlocks Between the Companies

Number of Interlocks

- An investor would be presumed to control a company if:
  - (1) (A) the investor controls 5% or more of any class of voting securities of the company and (B) two or more employees or directors of the investor or any of its subsidiaries serve as senior management officials of the company or any of its subsidiaries; or
  - (2) (A) the investor controls 15% or more of any class of voting securities of the company and (B) one or more employees or directors of the investor or any of its subsidiaries serves as a senior management official of the company or any of its subsidiaries.
- An investor with less than 5% of each class of voting securities of a company is not subject to any presumption of control based on any of its employees or directors serving as a senior management official of the company.[14]
- This tiered approach is slightly less restrictive than the Federal Reserve's existing practice and precedents, including its standard passivity commitments, under which an investor with 5% (if subject to passivity commitments) or 10% or more of any class of voting securities of a company was generally not permitted to have any representative serve as a senior executive officer of the company.

CEO Interlocks

- An investor would also be presumed to control a company if (1) the investor controls between 5% and 14.99%[15] of any class of voting securities of the company and (2) an employee or director of the investor or any of its subsidiaries serves as the chief executive officer, or serves in a similar capacity, of the company or any of its subsidiaries.
- An investor with less than 5% of each class of voting securities of a company would not be subject to this additional presumption of control.
- Because the Federal Reserve's existing practice and precedents, including its standard passivity commitments, generally did not

---

[14] The proposal would also remove the current presumption of control in Section 225.31(d)(2)(iii) of Regulation Y that applies to any company with (1) 5% or more of any class of voting securities of another company, and (2) one or more management interlocks with the other company, if (3) no other person controls 5% or more of any class of voting securities of the other company.

[15] As noted above, an investor with 15% or more of any class of voting securities would not be permitted to have any senior management official interlocks in order to avoid a presumption of control.

permit an investor with 5% (if subject to passivity commitments) or 10% or more of any class of voting securities of a company to have any representative serve as a senior executive officer of that company, the proposal effectively leaves unchanged this restriction for any such investor.

Covenants or Other Agreements that Allow the Investor to Significantly Influence or Restrict Management or Operational Decisions of the Company

Management Agreements

- An investor would be presumed to control a company, regardless of its level of voting equity ownership of the company, if it enters into any agreement, understanding, or management contract (other than to serve as investment adviser) with the company, under which the investor directs or exercises significant influence or discretion over the general management, overall operations, or core business or policy decisions of the company.
- Examples of agreements that would trigger the presumption of control include those in which the investor is a managing member, trustee, or general partner of the company, or exercises similar powers and functions.
- The Federal Reserve states in the preamble to the proposal that it "does not intend for routine outsourcing agreements, such as IT services agreements, to qualify as management agreements" that would trigger the presumption.
- This presumption is generally consistent with the existing presumption of control in Section 225.31(d)(2)(i) of Regulation Y.

Examples of Limiting Contractual Rights

The proposal lists several examples of contractual rights that the Federal Reserve considers to be limiting contractual rights and thus may not be included in investment agreements without triggering a presumption of control.

Please see **Appendix A** for the list of these examples.

Limiting Contractual Rights

- An investor would be presumed to control a company if (1) the investor controls 5% or more of any class of voting securities of the company and (2) the investor or any of its subsidiaries has any "limiting contractual right" with respect to the company or any of its subsidiaries, subject to certain exceptions.
- The presumption of control would not apply if the limiting contractual right:
  - is (i) part of an agreement to merge with or make a controlling investment in the company that is reasonably expected to close within one year and (ii) designed to ensure that the company continues to operate in the ordinary course until the merger or investment is consummated, or
  - requires the company to take an action necessary for the merger or investment to be consummated.
- The proposal defines "limiting contractual right" as a contractual right of the investor that would allow it to restrict significantly, directly or indirectly, the discretion of the company, including its

Examples of Permissible Contractual Rights

The proposal lists examples of contractual rights that the Federal Reserve does not consider to be limiting contractual rights and thus may be included in investment agreements without triggering a presumption of control related to limiting contractual rights. The examples are generally consistent with the Federal Reserve's existing practice in permitting investment agreements that contain similar provisions as post-closing contractual covenants or shareholder consent rights without raising controlling influence concerns.

Please see **Appendix A** for the list of these examples.

Limits on Investor's Solicitation of Proxies

Subject Matter	Limit on Proxy Solicitation
Director Elections	If voting equity ≥ 10% but < 25%, number of proposed directors and existing director representatives together must be < 25% of board seats
Other Issues	No limit, regardless of voting equity

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

- The proposal contains a list of examples of limiting contractual rights that is more expansive and specific than the types of covenants that the Federal Reserve described as raising controlling influence concerns in its 1982 or 2008 policy statements, but is generally consistent with its existing practice in raising controlling influence concerns with investment agreements that contain similar provisions as post-closing contractual covenants or shareholder consent or veto rights.
    - The proposal's exceptions for limiting contractual rights in merger agreements or agreements to acquire control of a company are a welcome clarification. Although the exceptions are consistent with past Federal Reserve practice, more recently similar provisions had attracted a higher level of scrutiny.
- A number of the rights that are identified as examples of limiting contractual rights are also rights that, according to Federal Reserve staff in a 2001 letter, would generally be permissible for a financial holding company ("**FHC**") with respect to a portfolio company it holds under the BHC Act merchant banking authority without impermissibly involving the FHC in routinely managing or operating the portfolio company.[16]

Investor's Solicitation of Proxies

Proxies for Director Elections

- An investor would be presumed to control a company if (1) the investor controls 10% or more of any class of voting securities of the company and (2) the investor or any of its subsidiaries proposes a number of director representatives to the board of directors of the company or any of its subsidiaries in opposition to the nominees proposed by the management or board of directors of the company or any of its subsidiaries that, together with any director representatives of the investor or any of its subsidiaries on the board of directors of the company or any of its subsidiaries, exceed the number of director representatives that the investor could have without being presumed to control the company under the board seats rebuttable presumption described above (i.e., less than 25% of the seats).
- An investor with less than 10% of each class of voting securities of a company is not subject to any presumption of control for soliciting proxies with respect to the election of directors.

[16] See Letter to Peter T. Grauer (Dec. 21, 2001), https://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/2001/20011221/.

- The effect of the proposal is to significantly liberalize the Federal Reserve's existing practice and precedents, including its standard passivity commitments, for soliciting proxies for director elections. The Federal Reserve's current practice would not generally permit any investor with 5% (if subject to passivity commitments) or 10% or more of any class of voting securities of a company to solicit any proxies on any issue, including director elections. Under the proposal, an investor with less than 10% of each class of voting securities of a company would not be subject to any limitation of soliciting such proxies, while an investor with 10% or more of any class of voting securities would only be limited to soliciting proxies for its permissible number of director representatives without triggering the separate presumption of control relating to the number of director representatives.

Activist Investors

The Federal Reserve's proposal, if finalized as proposed, would make it easier for activist investors to solicit proxies for board representation without triggering a presumption of control compared to the Federal Reserve's current practices.

Proxies for Other Issues

- The proposal does not include a rebuttable presumption relating to proxy solicitations for any issue other than director elections.
- As noted above, this represents a significant liberalization compared to the Federal Reserve's existing practice and precedents, including its standard passivity commitments. In the preamble to the proposal, the Federal Reserve noted that "the proposal would provide a non-controlling investor greater latitude to exercise its shareholder rights and engage with the target company and other shareholders on certain issues."

Investor's Total Equity Interest in the Company

Calculation of Total Equity

The proposal would codify new sections of Regulations Y and LL regarding methods for calculating an investor's total equity stake in a company.

Please see **Appendix B** for a discussion of those methods.

The proposal would create two rebuttable presumptions of control relating to the percentage of a company's total equity owned by an investor:

- First, an investor would be presumed to control a company, <u>regardless of its voting equity level</u>, if the investor controls one third or more of the total equity of the company.
- Second, an investor would be presumed to control a company if (1) the investor controls 15% or more of any class of voting securities of the company and (2) the investor controls 25% or more of the total equity of the company.
- Together, these presumptions are consistent with the 2008 policy statement and the Federal Reserve's existing practice and precedents, under which an investor with less than 15% of each class of voting securities of a company could own a combination of voting and non-voting shares that, when aggregated, represented less than one third of the total equity of a company without having a controlling influence over the company.
- The proposal's limit on the aggregate percentage of a company's total equity owned by a banking organization or other investor without triggering a presumption of control is thus unchanged compared to the Federal Reserve's existing practice and precedents. But, in light of the fact that the same aggregate limit

applies to any investor with less than 15% of each class of a company's voting securities, it falls short of a standard of actual control. The current 33.3% limit on an investor's total equity, like the limits on business relationships discussed above, does not derive from any statute. It is purely a product of the Federal Reserve's own practice and precedents. Consequently, the Federal Reserve would be justified—if it wished to calibrate the aggregate amount of total equity (and especially the amount of non-voting equity) that an investor could own that would be more consistent with the ordinary meaning of "controlling influence" or with a standard of actual control—in raising the limit to 40%, 49.9% or even more, at least at the lower levels of voting equity ownership or with ownership of no voting equity at all.

Presumption of Control Relating to Investment Funds

The proposal includes a presumption of control designed specifically for an investment fund for which the investor serves as investment adviser as well as an exception from the proposal's presumptions of control applicable to all companies for a registered investment company under the Investment Company Act of 1940 ("**RIC**").

Definition of Investment Fund

The proposal does not define "investment fund" in the rule text, but the Federal Reserve explained in the preamble to the proposal that the term "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. Other investment entities, such as commodity funds and real estate investment trusts, generally also would be included as investment funds."

Investment Adviser

The following chart provides a simplified visual summary of the presumption of control for an investment fund for which the investor serves as investment adviser. The chart uses the same color coding as the chart summarizing the general tiered presumptions of control on pages 8 to 10 of this memo.

	Presumption of Control for Investor that Serves as Investment Adviser to an Investment Fund
Voting Securities Controlled by Investor	Presumption of control if ≥ 5% of any class of voting securities after any permissible seeding period
Seeding Period Relief	No presumption of control if investment fund was organized and sponsored by investor within the preceding 12 months
Total Equity Controlled by Investor	No presumption of control if < 25% after any permissible seeding period
Management Agreements	Presumption of control, but not to serve merely as investment adviser
Director Representation	No presumption of control if < 50% of directors and < 5% of each class of voting securities
Other Presumptions of Control	Same presumptions of control as for any other company

Definition of Investment Adviser

The proposal would define "investment adviser" as a company that:

- Is registered as an investment adviser with the SEC under the Investment Advisers Act of 1940;
- Is registered as a commodity trading advisor with the CFTC under the Commodity Exchange Act;
- Is a foreign equivalent of an investment adviser or commodity trading advisor, as described above; or
- Engages in any of the financial and investment advisory activities set forth in Section 225.28(b)(6)(i)-(iv) of Regulation Y.

Seeding Period

While the proposal would provide a one-year seeding period for all investment funds, some investment funds, such as RICs and other open-end funds, may need a seeding period of up to 3 years to establish a track record and be eligible for rating by Morningstar or similar rating services.

Definition of Closed-End and Open-End Fund

Based on Federal Reserve precedent, a "closed-end fund" is an investment fund that issues shares no more than once per quarter, and an "open-end fund" is an investment fund that issues shares continuously or more frequently than quarterly.

- An investor would be presumed to control a company if (1) the investor serves as investment adviser to the company; (2) the company is an investment fund; and (3) the investor (A) controls 5% or more of any class of voting securities of the fund or (B) 25% or more of the total equity of the fund.
- This presumption of control would not apply if the investor organized and sponsored the investment fund within the preceding 12 months.
- While the proposed presumption would be generally consistent with Federal Reserve practice and precedent, it would in some cases liberalize, and in other cases be more limiting compared to, the Federal Reserve's current approach to non-controlling investments in and relationships with an investment fund.
  - *Seeding Period*. The proposed presumption would continue to provide a seeding period of up to 12 months for organizing and sponsoring an open-end fund (such as a RIC) during which an investor could hold 25% or more of the total equity or a class of voting shares of the fund, and would extend this 12-month seeding period exemption to a closed-end fund, which would be generally consistent with the seeding period exemption provided for a "covered fund" for purposes of the Volcker Rule.
  - *Percentage of Voting and Total Shares*. The proposal's 24.99% limitation regarding total equity in a fund (after any permissible seeding period) is unchanged compared to the Federal Reserve's existing practice and precedents. However, while the proposed 4.99% limitation on each class of voting securities (after any permissible seeding period) is generally consistent with Federal Reserve precedents for non-controlling investments in closed-end funds, it is more restrictive than the most recent public Federal Reserve precedent for open-end funds, which states the company must only reduce its interest in the fund to below 25% of the total and voting securities of the fund by the end of the permissible seeding period to avoid control.
  - *Director Representatives.* Because of the general presumption for an investor that controls less than 5% of each class of voting securities of a company, and consistent with the Federal Reserve's statements that "a majority of directors" would be independent of the investor in the First Union precedent for mutual funds,[17] an investor with less than 5% of each class of voting shares of an investment fund and that is the investment adviser to the fund would be able to

[17] Letter to H. Rodgin Cohen, Esq., from Jennifer J. Johnson (June 24, 1999).

have director representation of up to less than 50% of the fund's board of directors. This would represent a liberalization compared to the First Union precedent of up to 25% of the fund's board.

RIC Exception

The following chart provides a simplified visual summary of the exception for RICs from the proposal's presumptions of control applicable to all companies. The chart uses the same color coding as the chart summarizing the general tiered presumptions of control on pages 8 to 10 of this memo.

	Criteria for Exception from All Presumptions of Control for an Investment Fund that is a RIC
Voting Securities Controlled by Investor	< 5% of each class of voting securities after any permissible seeding period
Seeding Period Relief	Investor may hold ≥ 5% of any class of voting securities or ≥ 25% of total equity if RIC was organized and sponsored by investor within the preceding 12 months
Total Equity Controlled by Investor	< 25% after any permissible seeding period
Business Relationships	Limited to investment advisory, custodian, transfer agent, registrar, administrative, distributor, and securities brokerage services provided by the investor to the RIC
Director Representation	≤ 25% of directors
Other Presumptions of Control	No if criteria for exception are satisfied

- None of the presumptions of control in the proposal, not just the presumption of control related to serving as an investment adviser to an investment fund, would apply if:
  - (1) the company is an investment company registered with the SEC under the Investment Company Act of 1940;
  - (2) the business relationships between the investor and the RIC are limited to investment advisory, custodian, transfer agent, registrar, administrative, distributor, and securities brokerage services provided by the investor to the RIC;
  - (3) director representatives of the investor or any of its subsidiaries comprise 25% or less of the board of directors or trustees of the RIC; and
  - (4) (A) the investor controls less than 5% of the outstanding securities of each class of voting securities of the RIC and

less than 25% of the total equity of the RIC, or (B) the investor organized and sponsored the RIC within the preceding 12 months (i.e., the RIC is in its initial seeding period).

- Unlike the definition of "investment fund," the RIC exception to the proposal's various presumptions of control would not apply to any other type of investment fund, including a foreign equivalent of a RIC (i.e., a foreign public fund).
- While the proposed exception for RICs would generally be consistent with existing Federal Reserve practice and precedent, it would in some respects be, like the presumption of control for investment funds in general, more restrictive than the Federal Reserve's current approach.
  - *Scope of exception*. The RIC exception would only apply to RICs and not to other open-end investment funds, such as non-U.S. retail UCITs, which along with RICs have previously been viewed by the Federal Reserve as "mutual funds." The Federal Reserve did not provide any rationale for limiting the exception in this way.
  - *Percentage of Voting and Total Shares*. Much like the presumption of control for investment funds in general, the proposed 4.99% limitation on each class of voting shares after any permissible seeding period is more restrictive than existing Federal Reserve precedent for control of open-end funds, which as described above has allowed a company to hold up to 24.9% of the total and voting shares of a RIC by the end of the permissible seeding period and not have control.
  - *Director Representatives*. The exception would recognize that an investor may have representation of 25% or less of the board of directors or trustees of a RIC without creating a presumption of control, which is consistent with some Federal Reserve precedent. However, the exception would be inconsistent with the Federal Reserve's statement that "a majority of directors" would be independent of the investor in the First Union precedent for mutual funds (implying that the company could have board representatives of up to less than 50% of the board of directors and not control the mutual fund).

Accounting Consolidation

- An investor would be presumed to control a company, <u>regardless of its voting equity level in the company</u>, if the investor consolidates the company on its financial statements prepared under U.S. GAAP.
- The Federal Reserve requested comment on whether the presumption of control should be extended to include any company that the investor accounts for using the equity method of

accounting under U.S. GAAP. It is unclear why equity method accounting should trigger a presumption of control, because there is a distinction between the level of control required for full consolidation (a "controlling interest," which is typically achieved through direct or indirect ownership of a majority of voting securities) and the criteria for equity accounting (a "significant influence," which is presumed when there is direct or indirect ownership of 20% of voting securities). Furthermore, because equity accounting is presumed under U.S. GAAP when one party owns 20% of the voting securities of another party, if control were presumed whenever equity accounting is used, the practical effect would be the creation of a new presumption of control at ownership of 20% of voting securities that could only be rebutted by rebutting the presumption of equity accounting under U.S. GAAP. Causing investors to structure their investments to avoid equity accounting is not only unnecessary, especially in light of the obvious difference in standards (i.e., "controlling influence" and "significant influence"), but could result in unfavorable capital effects, because investments not accounted for under the equity method would be accounted for using the fair value method, which as a general matter may result in greater volatility in the value of the investment.

Combined Ownership Limit

Presumption of Control	**Exception**
Investor voting equity ≥ 5% and Investor and its senior managers / directors own combined voting equity ≥ 25%	Investor voting equity < 15% and Its senior managers / directors (not including investor) own voting equity ≥ 50%

Combined Ownership by an Investor and its Senior Management Officials and Directors

- *5/25 Presumption.* An investor would be presumed to control a company if (1) the investor controls 5% or more of any class of voting securities of the company and (2) (A) senior management officials and directors of the investor and its subsidiaries, together with (B) their immediate family members and (C) the investor and its subsidiaries, own, control, or have power to vote 25% or more of any class of voting securities of the company.
- *15/50 Exception.* There is an exception to this presumption if (1) the investor and its subsidiaries control less than 15% of each class of voting securities of a company and (2) (A) the senior management officials and directors of the investor and its subsidiaries, together with (B) their immediate family members (but <u>not</u> including the investor or its subsidiaries), own, control, or have power to vote 50% or more of each class of voting securities of the company.
- *Consistency with Prior Precedent.* The 5/25 presumption is consistent with the existing presumption in Section 225.31(d)(2)(ii) of Regulation Y, but the 15/50 exception would be a new exception. In the preamble to the proposal, the Federal Reserve explained that this exception reflects its understanding that "when individuals control an outright majority . . . , it is the individuals who are truly exercising control over the . . . company, rather than any [investor] that employs the individuals."

Divestitures

Treatment of Divestitures

Voting Equity	Treatment
≥ 15% but < 25% voting equity after divestiture	Presumption of control until two years after banking organization last had ≥ 25% voting equity, unless an unaffiliated investor has ≥ 50% voting equity, in which case there is no presumption of control
< 15% voting equity after divestiture	No presumption of control

- The proposal would significantly liberalize the Federal Reserve's existing practice and precedents for determining when a banking organization has divested control of a previously controlled company. Under the Federal Reserve's existing practice and precedents, a banking organization has generally been required to reduce its voting and total equity ownership in a company to 9.9% or even less in order to divest control, although a more recent precedent permitted a banking organization to divest control at a voting equity level of 14.9%. The proposal would increase the threshold at which a divestiture of control would be allowed in four ways.
- *Divestitures Where 15% or More is Retained.* First, a banking organization would be presumed to control a company for two years after any divestiture if (1) the banking organization had controlled 25% or more of any class of voting securities or by controlling the election of a majority of the company's board of directors at any time during the prior two years and (2) after the divestiture, the banking organization still controls 15% or more of any class of voting securities of the company, unless the exception for unaffiliated majority shareholders described below applies.
  - This presumption means that if a banking organization reduces its voting equity interest in a company to between 15% and 24.99% of each class of voting securities, it would need to wait two years before it would no longer be presumed to control the company, unless the exception for unaffiliated majority shareholders described below applies. Under the Federal Reserve's existing practice and precedent, such a banking organization would not have succeeded in divesting control of the company.
- *Divestitures to Less Than 15%.* Second, if a banking organization reduces its voting equity level to less than 15% of each class of voting securities of a company, it would not need to wait two years to divest control of the company. Upon reducing its voting equity level to less than 15%, absent any other presumption of control, it would not be presumed to control the company.
- *Divestitures in Return for < 25% of Buyer.* Third, as explained by the Federal Reserve itself in the preamble to the proposal, if a banking organization divests control of a company by selling its entire equity stake in the company to another company (the "**buyer**") in exchange for consideration consisting of less than 25% of each class of voting securities of the buyer and does not trigger any presumption of control with respect to the buyer, the banking organization would no longer be presumed to control the previously controlled company (the "second company" in the proposed rule text) because it would no longer own any voting securities of the company.

- *Exception Where Unaffiliated Majority Shareholder Exists.* Fourth, there is an exception to the presumption of control described above under "Divestitures Where 15% or More is Retained," if 50% or more of each class of voting securities of a company is controlled by (1) a person that is not a senior management official or director of the banking organization, or (2) another company that is not an affiliate of the banking organization.

Definition of Non-Voting Securities

The proposal would amend the definition of non-voting shares in Regulation Y to:

- use the term "non-voting securities" instead of "non-voting shares";
- clarify that common shares and limited liability company interests may qualify as non-voting securities; and
- expressly permit (generally consistent with the Federal Reserve's existing practice and precedents) the following defensive voting rights in limited partnership interests and limited liability company interests:
  - the right to vote for the removal of a general partner or managing member (or persons exercising similar functions at the company) for cause;
  - the right to replace a general partner or managing member (or persons exercising similar functions at the company) because of incapacitation or following the removal of such person; and
  - the right to continue or dissolve the company after removal of the general partner or managing member (or persons exercising similar functions at the company).

Fiduciary Exception to Rebuttable Presumptions of Control

- The proposed presumptions of control would not apply to the extent that an investor or any of its subsidiaries control the securities of a company or any of its subsidiaries in a fiduciary capacity without sole discretionary authority to exercise the voting rights.
- The use of the phrase "to the extent that" implies that the exception would permit an investor to subtract such shares when calculating its voting or total equity stake in a company.
- Currently, Section 225.31(d)(2)(iv) of Regulation Y provides that the existing presumptions of control relating to (1) shares controlled by an investor together with its management officials and (2) management official interlocks do not apply if the investor holds the shares in the company in a fiduciary capacity without sole discretionary authority to exercise the voting rights. The exception in the proposal would be broader than the existing exception because it would be an exception from all the proposed presumptions of control.

Control over Voting and Non-Voting Securities and Calculation of Voting Ownership

Control over Voting and Non-Voting Securities

The proposal would codify the standards for determining when a bank, company or other person "controls" voting and non-voting securities by amending and adding to its existing provisions in Regulation Y. Most of the amendments are included in a proposed new Section 225.9 of Regulation Y and are generally consistent with the Federal Reserve's existing practice and precedents, but there are some noteworthy clarifications or changes, as described below.

Voting Securities Held by Non-Subsidiary

- The proposal clarifies that where an investor[18] makes an investment in a company that in turn owns voting securities of a second

[18] We note that Section 2(a)(2) of the BHC Act refers to control of voting securities by a "company" and Section 225.2(e)(2) of Regulation Y refers to control of voting securities by a "bank or other company," whereas proposed Section 225.9 refers to control of voting or non- (*cont.*)

company, the investor does not control the voting securities of the second company unless the second company is a subsidiary of the investor (i.e., is controlled by the investor for purposes of the BHC Act). This approach should be clear from the existing regulation's use of "directly or indirectly," in that "indirectly" should be limited to any ownership through a controlled subsidiary. This is nevertheless a welcome clarification that addresses the uncertainty created by past practice of the Federal Reserve, at least in considering whether a banking organization owns, directly or indirectly, 5% or more of any class of voting securities of another banking organization.

- Consequently, if a banking organization owns 4.9% of the voting securities of Company A and also owns 10% of the voting securities of Company B (without controlling Company B), and Company B in turn owns 7% of the voting securities of Company A, Company B's 7% ownership of Company A would not be aggregated with the banking organization's 4.9% ownership of Company A.

Options, Warrants and Convertible Instruments

The proposal would continue to treat a holder of securities that are convertible into voting or non-voting securities as controlling the voting or non-voting securities into which they may be converted, as under the existing provision of Regulation Y, but would make the following noteworthy changes:

- Consistent with existing Federal Reserve practice and precedents, it would add a specific reference to a broader range of financial instruments covered by the regulation, including options, warrants or other financial instruments that are "convertible into, exercisable for, or otherwise may become" voting securities or non-voting securities.
- Compared to existing Section 225.31(d)(1)(i) of Regulation Y, which refers to securities that are <u>immediately</u> convertible, <u>at the option of the holder or owner</u>, into voting securities, the proposal would expand the conditions under which an investor would be treated as controlling the underlying voting or non-voting securities.
  - The Federal Reserve's existing practice and precedents disregard the passage of time as a condition to exercise, conversion or exchange, and so in this respect the proposal does not represent a change.
  - But the existing version of the regulation, and past Federal Reserve practice, takes into consideration whether the

---

(*cont.*)

voting securities by a "person," which could include a natural person. The reference to "person" in Section 225.9 may reflect the Federal Reserve's intention to apply the same provisions to a Change in Bank Control Act proceeding, which applies to any "person," but we assume the Federal Reserve will clarify this in any final rule implementing the proposal.

investor has control over the conditions under which an option, warrant or similar instrument may be exercised (i.e., whether it may be exercised at the option of the holder) for purposes of determining whether the investor is treated as owning the underlying voting or non-voting security.

  - Although the Federal Reserve specifically notes in the preamble to the proposal that "[t]he 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," it is unclear whether the apparent elimination of the distinction between conditions to exercise that are under the control of the investor and those that are not under the control of an investor is intentional or unintentional.

"Fed Math" and Anti-Dilution Exception

- The proposal would codify certain assumptions that the Federal Reserve has applied under its existing practices and precedents relating to the calculation of an investor's ownership of the voting or non-voting securities underlying an option, warrant or other convertible instrument:
  - An investor would be treated as controlling the maximum number of voting securities or non-voting securities that the person could obtain under the terms of the option, warrant or convertible based on any applicable formula, rate, or other variable metric.
  - For purposes of calculating an investor's percentage ownership stake in a company, all of the investor's options, warrants and other conversion rights would be treated as if they had been exercised, and none of every other person's options, warrants and other conversion rights would be treated as if they had been exercised (i.e., not on a fully diluted basis assuming the exercise by all other holders), unless by the terms of the financial instruments, the voting securities or non-voting securities controlled by the other person must be issued and outstanding in order for the voting securities or non-voting securities of the investor to be issued and outstanding.
- The proposal would, however, create a new exception to these assumptions and to the attribution of ownership to an investor of the voting or non-voting securities for which an option, warrant or other convertible instrument may be exercised, for antidilution rights:
  - A right that provides an investor the ability to acquire securities in future issuances or to convert non-voting securities into voting securities would not cause the investor to control the voting or non-voting securities that could be acquired under the right, so long as the right does not allow the investor to acquire a higher percentage of the class of

voting securities than the investor controlled immediately prior to the future issuance or conversion.

Securities Not Convertible in the Hands of Investor

- Consistent with the 2008 policy statement and existing Federal Reserve practice and precedents, a person would not be treated as controlling voting securities based on controlling a financial instrument if the financial instrument 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 investor or an affiliate of the investor; and
  - is only transferable (A) in a widespread public distribution; (B) to an affiliate of the investor[19] or to the issuing company; (C) in transfers in which no transferee (or group of associated transferees) would receive 2% 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% of every class of the voting securities of the issuing company without any transfer from the investor.

Pending Acquisitions of Securities

The proposal would include a provision clarifying that an investor that has agreed to acquire voting securities, non-voting securities or other financial instruments pursuant to a securities purchase agreement would not be treated as controlling those instruments until the investor closes the acquisition of those instruments.

Control through Restrictions on Securities

- The proposal would continue to treat an investor that enters into an agreement or understanding with a second person that restricts the rights of the second person in securities that are controlled by the second person, as controlling those securities, subject to certain exceptions. Some of the exceptions are already in existing provisions of Regulation Y, including an exception for rights of first or last refusal, but the proposal would add the following new exceptions:
  - a requirement that, if the second person agrees to sell the securities, the second person provide the investor with the opportunity to participate in the sale of securities by the second person (i.e., a tag-along right);
  - a requirement under which the second person agrees to sell its securities to a third party if a majority of shareholders

---

[19] We expect that, consistent with existing Federal Reserve practice and precedents, an affiliate of the investor would in turn need to be bound by the same transfer restrictions as the investor itself.

agree to sell their shares to the third party (i.e., a drag-along right that is triggered by a majority of shareholders);

- 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; and
- 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, or prevention of events that could impair deferred tax assets, such as net operating loss carryforwards.

- These exceptions are generally consistent with the Federal Reserve's existing practice and precedents. With respect to the exceptions for rights of first refusal or last refusal, tag-along rights and drag-along rights, the Federal Reserve noted in the preamble that any of these rights that "serve to impose significant, non-market-standard constraints on the transfer of securities" would convey control of the underlying securities to the investor. The Federal Reserve cited as problematic examples a right of last refusal that would allow the investor to acquire the securities at a steep discount to market price or that provide the investor with "an unnecessarily long period of time" to decide whether to acquire the shares.

Securities Held by Senior Management Officials or Controlling Equity Holders of a Company

The proposal would provide that an investor that controls (1) 5% or more of the voting securities of a company also controls (2) all securities issued by the company that are controlled by senior management officials, directors, or controlling shareholders of the investor, or by immediate family members of such persons.

Calculation of Voting Ownership

The proposal would include a new definition of voting percentage that would codify the Federal Reserve's existing practice for determining a person's percentage stake in a class of a company's voting securities. A person's voting percentage would be the <u>greater</u> of:

- the number of shares of the class of voting securities controlled by the person, divided by the total number of shares of the class of voting securities that are issued and outstanding; and
- the number of votes that may be cast by the person on the voting securities controlled by the person, divided by the total number of votes that are legally entitled to be cast by the holders of the issued and outstanding shares of the class of voting securities.

Impact on Current Non-Controlling Investments?

Notwithstanding the Federal Reserve's own recognition that it has a long history of making determinations of whether an investor exercises a controlling influence over a company and that there has been an evolution of its framework, practice and precedents over the years, the proposal does not address the question of how, if finalized, the proposal might affect existing investments that have been reviewed by the Federal Reserve and determined to be non-controlling on the basis of, among other things, criteria and passivity commitments that are stricter than the proposal's presumptions of control or that might even be more liberal than the proposal.

If, for example, an investor with 10% of a class of a company's voting securities is subject to passivity commitments that limit its business relationships with the company to 2.5% of the company's gross revenues wishes to benefit from the proposal's higher limit of less than 5% of the company's or investor's revenues or expenses, would the passivity commitments be deemed to be amended by the final rule implementing the proposal or would the investor need to request relief from the passivity commitments? And if the same set of passivity commitments did not, for example, impose any restrictions on the ability of the investor's director representative to serve on the company's audit committee or compensation committee, would the investor be permitted to continue to benefit from that greater latitude under its existing passivity commitments? Presumably any final rule implementing the proposal would contain a grandfathering provision for existing investments that have already been the subject of non-control determinations by the Federal Reserve.

It is also unclear whether, under the proposal, the Federal Reserve contemplates any continuing role for passivity commitments. If an investor at a given ownership level of voting equity of a company does not trigger any of the presumptions of control associated with that level of voting equity, there should be no need for the investor to seek a non-control determination from the Federal Reserve or, if it did, for the Federal Reserve to impose any passivity commitments. While under the proposal as currently drafted only an investor with less than 10% of each class of voting securities of a company benefits from an express presumption of non-control if it does not trigger any of the applicable presumptions of control, we expect that in practice an investor with between 10% and 24.99% of any class of voting securities that does not trigger any of the applicable presumptions of control would be treated in the same way. Indeed, as noted above, the Federal Reserve stated in the preamble to the proposal that "[a]bsent unusual circumstances, [it] would not expect to find that a company controls another company where the [investor] is not presumed to control the . . . company under the proposal."

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Luigi L. De Ghenghi
+1 212 450 4296
luigi.deghenghi@davispolk.com

Randall D. Guynn
+1 212 450 4239
randall.guynn@davispolk.com

Margaret E. Tahyar
+1 212 450 4379
margaret.tahyar@davispolk.com

Christopher M. Paridon
+1 202 962 7135
chris.paridon@davispolk.com

Eric McLaughlin
+1 212 450 4897
eric.mclaughlin@davispolk.com

Dana E. Seesel
+1 212 450 3423
dana.seesel@davispolk.com

Tyler X. Senackerib
+1 212 450 3419
tyler.senackerib@davispolk.com

Appendix A

Examples of Limiting Contractual Rights

Impermissible Rights

The definition of limiting contractual right states that a limiting contractual right includes, but is not limited to, a right that allows an investor to restrict or to exert significant influence over decisions related to:

- (A) Activities in which the 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 company;
- (B) How the company directs the proceeds of the investor's investment;
- (C) Hiring, firing, or compensating one or more senior management officials of the company, or modifying the company's policies or budget concerning the salary, compensation, employment, or benefits plan for its employees;
- (D) The 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 company's ability to make investments or expenditures;
- (F) The 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 company's payment of dividends on any class of securities, redemption of senior instruments, or voluntary prepayment of indebtedness;
- (H) The 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;
- (I) The 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 investor to have the same status as other securities of the same class;
- (J) The company's ability to amend its articles of incorporation or by-laws, other than in a way that is solely defensive for the investor;
- (K) The removal or selection of any independent accountant, auditor, investment adviser, or investment banker employed by the company; or
- (L) The 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).

Permissible Rights

The definition of limiting contractual right states that a limiting contractual right does <u>not</u> include a contractual right that would not allow an investor to significantly restrict, directly or indirectly, the discretion of a company over operational and policy decisions of the company, such as:

- (A) A right that allows the investor to restrict or to exert significant influence over decisions relating to the company's ability to issue securities senior to securities owned by the investor;
- (B) A requirement that the investor receive financial reports of the type ordinarily available to common stockholders;
- (C) A requirement that the company maintain its corporate existence;

- (D) A requirement that the company consult with the investor on a reasonable periodic basis;
- (E) A requirement that the company provide notices of the occurrence of material events affecting the company;
- (F) A requirement that the company comply with applicable statutory and regulatory requirements;
- (G) A market standard requirement that the investor receive similar contractual rights as those held by other investors in the company;
- (H) A requirement that the investor be able to purchase additional shares issued by the company in order to maintain the investor's percentage ownership in the company;
- (I) A requirement that the company ensure that any shareholder who intends to sell its shares of the company provide other shareholders of the company or the company itself the opportunity to purchase the shares before the shares can be sold to a third party; or
- (J) A requirement that the company take reasonable steps to ensure the preservation of tax status or tax benefits, such as its status as a Subchapter S corporation or the protection of the value of net operating loss carry-forwards.

Appendix B

Total Equity Ownership

Calculation Method

The proposal would codify a methodology for calculating an investor's total equity stake in a company.[20]

- The investor's total equity in a company would be equal to (1) the sum of (A) Investor Common Equity and (B) for each class of preferred stock issued by the company, Investor Preferred Equity, divided by (2) Issuer Shareholders' Equity.
- "Investor Common Equity" would equal (1) the quotient of (A) the number of shares of common stock of the company that are controlled by the investor, divided by (B) the total number of shares of common stock of the company that are issued and outstanding, multiplied by (2) the amount of shareholders' equity of the company not allocated to preferred stock under U.S. GAAP, subject to a floor of zero.
  - All classes of common stock would be treated as a single class. If certain classes of common stock have different economic interests per share in the company, the number of shares of common stock would be adjusted to equalize the economic interest per share. For example, if each Class B common share has twice the economic interest as each Class A common share, each Class B common share would be treated as two shares of common stock and each Class A common share would be treated as one share of common stock.
  - Retained earnings would be allocated to common stock.
- "Investor Preferred Equity" would equal, for each class of preferred stock issued by the company, (1) the quotient of (A) the number of shares of the class of preferred stock of the company that are controlled by the investor, divided by (B) the total number of shares of the class of preferred stock that are issued and outstanding, multiplied by (2) the amount of shareholders' equity of the company allocated to the class of preferred stock under U.S. GAAP, subject to a floor of zero.
  - The amount of shareholders' equity allocated to preferred stock on a company's balance sheet would generally reflect the liquidation preference per share.
- "Issuer Shareholders' Equity" is not defined in the proposed rule text or preamble. Based on the proposed definitions of Investor Common Equity and Investor Preferred Equity, we assume that Issuer Shareholders' Equity would equal the total amount of shareholders' equity of the company under U.S. GAAP.

Treatment of Debt Instruments

The proposal would provide that a debt instrument or other interest issued by a company and held by an investor that is "functionally equivalent to equity" may be treated as an equity instrument for purposes of the total equity calculation.

- The principal amount of all such debt instruments and the market value of all such other interests that are owned or controlled by the investor would be added to the numerator of the total equity calculation.
- The principal amount of all such debt instruments and the market value of all such other interests that are outstanding would be added to the denominator of the total equity calculation.

---

[20] The methods outlined in the proposal would apply to investments by an investor in a company that is a stock corporation and prepares financial statements pursuant to U.S. GAAP. For companies that do not meet those criteria, total equity would be calculated using a methodology that is "reasonably consistent" with the proposed methodology, but taking into account the differences in legal form or accounting.

- The proposal provides the following non-exclusive list of equity-like characteristics that could cause a debt instrument to be considered functionally equivalent to equity:
  - Extremely long-dated maturity;[21]
  - Subordination to other debt instruments issued by the company;[22]
  - Qualification as regulatory capital under any regulatory capital rules applicable to the company;
  - Qualification as equity under applicable tax law;
  - Qualification as equity under U.S. GAAP or other applicable accounting standards;
  - Inadequacy of the equity capital underlying the debt at the time of the issuance of the debt; and
  - Issuance not on market terms.
- Provisions entitling the investor to a share of the profits of the company are an example of an equity-like characteristic that could cause other interests that are not debt instruments to be considered functionally equivalent to equity.

Treatment of Investments in Parent Company of a Company

- An investor that controls interests directly in a company and in one or more other companies that control that company would be required to aggregate its direct and indirect interests in the company for purposes of calculating its total equity in the company.
  - Although the Federal Reserve uses the term "parent company" to refer to companies that control a company, this calculation principle is not limited to the typical use of that term, i.e., the parent of a wholly owned subsidiary.
- The proposal provides that an investor's total equity in a company equals (1) its total equity in the company plus (2) its total equity of each other company that controls the company multiplied by that controlling company's total equity in the company (i.e., the investor's indirect pro-rata interest in the company).

Frequency of Calculation of Total Equity

The proposal specifies that the total equity of an investor in a company would be calculated each time the investor acquires or divests control over equity instruments of the company, including any debt instruments or other interests that are functionally equivalent to equity.

---

[21] The proposal does not define what an extremely long-dated maturity would be.

[22] The proposal does not indicate one way or the other whether this factor would apply to long-term debt that is subordinated to short-term debt, such as long-term debt that qualifies as eligible debt securities under the Federal Reserve's total loss-absorbing capacity rule. *Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations*, 82 Fed. Reg. 8266 (Jan. 24, 2017).