

Under the BHC Act, control is defined by a three pronged test. A company has control over another company if: (i) it directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company; (ii) controls in any manner the election of a majority of the directors of the other company; or (iii) directly or indirectly exercises a controlling influence over the management or policies of the other company.

The proposed revisions to the Board's control regulations are intended to clarify those circumstances where the Board will determine a company exercises a controlling influence over the management or policies of the other company. Significantly, the Board has proposed a tiered structure such that as an investor's voting ownership 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." For example, as the Summary of Tiered Presumptions that accompanies the proposal as Appendix A demonstrates, an entity that controlled less than 5% of the voting stock of an entity could have 3 of 7 directors in a bank or bank holding company, could have a director it appointed serve as a board chair, could have business relationships with the bank or bank holding company and could control up to one third of the bank or bank holding company's total equity without being presumed to control the bank or bank holding company. By contrast, an entity that controlled between 15% and 24.99% of a bank or bank holding company could appoint less than 25% of the directors, would not be able to have a director representative serve as a board chair, would be limited in the amount of revenues or expenses derived from the relationship, could only transact business on market terms and could not control 25% or more of the bank or bank holding company's total equity to avoid being determined to control the bank or bank holding company. Between those two extremes, the Board would create a tier for entities that control between 5 and 9.99% of a bank or bank holding company's total stock and a tier for an entity that controls between 10 and 14.99% of a bank or bank holding company.

In the notice of proposed rulemaking, the Board reviewed its history in determining a controlling influence (including its 2008 Policy Statement on equity investments in banks and bank holding companies) and stated that, following the Board's historical considerations, it would focus its analysis of control on the following factors: "(i) the size of the entity's voting equity investment in the bank or bank holding company; (ii) the size of the entity's total equity investment in the bank or bank holding company; (iii) the entity's rights to director representation and committee representation on the board of directors of the bank or bank holding company; (iv) the entity's use of proxy solicitations with respect to the bank or bank holding company; (v) management, employee, or director interlocks between the companies; (vi) covenants or other agreements that allow the entity to influence or restrict management or operational decisions of the bank or bank holding company; and (vii) the scope of the business relationships between the companies."

In the notice of proposed rulemaking, the Board asks for comment on over fifty questions, including:

A. Should the proposed presumption instead allow an investor to have director representation that is proportional to its voting percentage without triggering a presumption of control or, should the proposed presumption require an inverse relationship

between voting percentage and director representation to avoid triggering a presumption of control?

B. What amount of business relationships must be found before a controlling influence is determined, what types of specific business relationships raise control concerns and is it required as proposed on Appendix A that business relationships be on market terms for an entity that controls 10% or more of a bank or bank holding company?

C. Should the Board permit an investor to have a greater ownership of total equity (voting and non-voting) than currently proposed on Appendix A without triggering a presumption of control?

D. Should the Board presume that an entity controls a bank or bank holding company for purposes of the BHC Act when the entity accounts for the second company using the GAAP equity method of accounting?

E. How should the Board of Governors more clearly describe the principle that options, warrants, and convertible instruments be looked through (and assumed exercised) in calculating the percentage of voting securities that an entity controls in determining whether a control relationship exists and should the Board limit this principle in any way?

Although a complete summary of the notice of proposed rulemaking is beyond the scope of this post, we believe some of the Board's long standing principles remain problematic and are worthy of comment and reexamination. For example, we believe it inappropriate for the Board to include options and warrants that are not exercisable due to an unsatisfied condition precedent in an examination of control. The proposed rule also continues to provide that a person controls securities if the person is a party to an agreement or understanding under which the rights of the owner or holder of securities are restricted in any manner. Although the notice of proposed rulemaking provides certain exceptions (including for some rights of first refusal, tag-along rights, drag-along rights, pending consummation of a transaction, to preserve tax status), even if the rule is adopted there will be ambiguity for shareholders of a closely-held corporation seeking to negotiate a shareholder agreement.

That said, it is useful to the industry for the Board to articulate principles and rules which have developed on a case by case basis that are now being applied universally.