May 2019

Federal Reserve proposal on control determinations

KPMG is issuing this Regulatory Alert to highlight the Federal Reserve’s proposed tiered framework for determining controlling influence.

Key points

— The Federal Reserve proposes to introduce a tiered framework for determining whether a company exercises a controlling influence over another company; under this framework, as an investor’s ownership of the voting securities of one company increases other relationships and factors, such as directorships, must decrease in order to not trigger control.

— This framework would clarify the criteria the Federal Reserve has considered most relevant in control determinations as well as the combinations that would trigger control and subject investors to regulation and oversight by the Federal Reserve.

— The statutory threshold of control, whereby a company that controls 25 percent or more of any class of voting securities of a second company is deemed to control the second company, would not change.

The Federal Reserve Board (Federal Reserve or Board) approved a proposal that would revise its regulations governing determinations of whether a company has the ability to exercise a controlling influence over another company for purposes of the Bank Holding Company Act and the Home Owners Loan Act. Historically, the Federal Reserve has made such determinations on a case-by-case basis. The agency now seeks to provide greater clarity regarding the facts and circumstances it considers most relevant when assessing control and, in so doing, support more consistent decision-making by codifying the factors and thresholds into a formal regulation. A company that controls a bank or bank holding company, or a savings association or savings association holding company, is subject to the Federal Reserve’s regulations and oversight.

The proposal would substantially revise and augment the Federal Reserve’s regulations regarding control by introducing a tiered framework based on a company’s ownership of any class of voting securities of another company (less than 5 percent, 5 percent to 9.99 percent, 10 percent to 14.99 percent, and 15 percent to 24.99 percent). As the first company’s ownership percentage in the second company increases, additional relationships and other factors through which the investor could exercise control (i.e., the presumptions) generally must decrease in order to avoid triggering the application of a presumption of control (please refer to the following table).
### Summary of Tiered Presumptions

(Presumption of control is triggered if any relationship exceeds the amount on the table)

<table>
<thead>
<tr>
<th></th>
<th>Less than 5% voting</th>
<th>5.00-9.99% voting</th>
<th>10.00-14.99% voting</th>
<th>15.00-24.99% voting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Directors</td>
<td>Less than 50%</td>
<td>Less than 25%</td>
<td>Less than 25%</td>
<td>Less than 25%</td>
</tr>
<tr>
<td>Director Service as Board Chair</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>No director representative is chair of the board</td>
</tr>
<tr>
<td>Director service on Board Committees</td>
<td>N/A</td>
<td>N/A</td>
<td>A quarter or less of a committee with power to bind the company (audit, compensation, executive)</td>
<td>A quarter or less of a committee with power to bind the company (audit, compensation, executive)</td>
</tr>
<tr>
<td>Business relationships</td>
<td>N/A</td>
<td>Generate less than 10% of revenues or expenses for either company</td>
<td>Generate less than 5% of revenues or expenses for either company</td>
<td>Generate less than 2% of revenues or expenses for either company</td>
</tr>
<tr>
<td>Business terms</td>
<td>N/A</td>
<td>N/A</td>
<td>Market terms</td>
<td>Market terms</td>
</tr>
<tr>
<td>Officer/Employee interlocks</td>
<td>N/A</td>
<td>No more than 1 interlock, never CEO</td>
<td>No more than 1 interlock, never CEO</td>
<td>No interlocks</td>
</tr>
<tr>
<td>Contractual powers</td>
<td>No management agreements</td>
<td>No rights that significantly restrict discretion</td>
<td>No rights that significantly restrict discretion</td>
<td>No rights that significantly restrict discretion</td>
</tr>
<tr>
<td>Proxy Contests (directors)</td>
<td>N/A</td>
<td>N/A</td>
<td>No soliciting proxies to replace more than permitted number of directors</td>
<td>No soliciting proxies to replace more than permitted number of directors</td>
</tr>
<tr>
<td>Total equity</td>
<td>Less than one-third</td>
<td>Less than one-third</td>
<td>Less than one-third</td>
<td>Less than one-quarter</td>
</tr>
</tbody>
</table>

Source: Federal Reserve Board

Note: Additional situations outlined in the proposal where a company would be presumed to control a second company include the following:

— The first company enters into an agreement or understanding or management contract to direct or exercise significant influence or discretion regarding the general management or core operation of the second.

— The first company serves as an investment adviser (an investment adviser registered under the Investment Advisers Act or a commodity trading advisor under the Commodity Exchange Act) to a second company that is an investment fund and the first company controls 5 percent or more of any class of voting securities of the second company or 25 percent or more of the total equity capital of the second company. This would be subject to an exception for certain new companies.

— The senior management and directors of the first company, together with their immediate family members and the first company, own at least 25 percent of any class of voting securities of a second company, subject to an exception.

— The first company seeks to divest control of the second company but retains 15 percent or more of any class of voting securities of the second company. However:
  - If the first company retains 15 percent or more but less than 25 percent of any class of voting securities of the second company and no other presumptions apply for a period of two years, the first company would not be deemed to control the second company.
  - If the first company retains less than 15 percent of any class of voting securities of the second company and no other presumptions apply, the first company would not be deemed to control the second company.

— The first company consolidates the second company under U.S. GAAP.
The proposed rule would not change the statutory threshold of control, whereby a company that controls 25 percent or more of any class of voting securities of a second company is deemed to control the second company. The proposed rule would, however, establish a formal presumption of noncontrol for a company that controls less than 10 percent of each class of voting securities of a second company and is not presumed to control the second company under any of the other proposed presumptions.

Notwithstanding the presumptions of control or noncontrol, the Board allows that it may or may not find there to be a controlling influence based on the facts and circumstances presented by a particular case. The Board adds, however, that a company not presumed to control a second company based on the triggers of presumption in the proposed rule could be found to be in control only in “unusual circumstances.”

**KPMG Perspectives**

Federal Reserve Chair Powell noted that the Board’s proposed framework for determining what constitutes control would provide “all stakeholders with clearer rules of the road for control determinations.” He suggested the predictability and simplicity of this approach, could make it “easier for banks, particularly community banks, to raise capital to support lending and investment.” The proposal would not significantly change the Board’s current policies and practices with regard to control. However, it would consolidate previous guidance into a single codified framework that would make it easier for banking organizations, investors, or private equity companies not interested in direct ownership to be able to more readily discern the potential triggers of control. In this regard, the framework may facilitate additional investment in fintech companies by banking organizations.

The proposed framework would introduce modest easing to some restrictions on investors related to the number of permissible directors, management interlocks, and proxy contests. For example, the proposal would generally allow noncontrolling investors to appoint any number of directors up to a “less than 25 percent” threshold (and in some cases “less than 50 percent”) where past practice has generally limited the number of directors to one. The proposed rule would also allow investors seeking to terminate an existing control relationship to do so while retaining greater levels of ownership than available through past practice.

**For additional information** please contact Deborah Bailey or Tim Johnson.