



# Regulatory Alert

## Regulatory Insights



March 2020

### Federal Reserve finalizes rule on control determinations

The Federal Reserve Board adopted its final rule on control determinations; the final rule is substantially similar to the rule proposal released in April 2019. The tiered framework clarifies and codifies the factors and thresholds that trigger control. In this regard, the framework helps companies to assess control at the point of diligence (i.e., M&A, third party, joint venture, etc.) as well as ongoing with control changes. In application, the framework serves both bank and nonbank transactions.

#### Key points

- The Federal Reserve finalized, substantially as proposed, 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 a company increases, other relationships and factors, such as directorships, must decrease in order to not trigger control.
- The Federal Reserve considers the framework to be generally consistent with its current practice, including the criteria considered most relevant in control determinations and the combinations of factors that trigger control. As such, the final rule does not grandfather existing investments or provide a transition period for companies to conform existing investments.
- 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, will not change.

The Federal Reserve Board (Federal Reserve or Board) finalized a [rule](#) (effective April 1, 2020) that revises 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 (BHCA) and the Home Owners Loan Act (HOLA). The final rule is largely consistent with the proposed rule (see KPMG's previous Regulatory Alert [here](#)) except for certain modifications, including:

— **Changes to the presumptions of control:**

- When considering business relationships, the Board will only take into account the significance of business relationships from the investee

company's perspective rather than the perspectives of both investor and investee.

- A single total equity threshold will be established for investors independent of their voting interests. Under the BHCA, BHCs will be subject to a total equity threshold of 33 percent (one-third) while, pursuant to the HOLA, SLHCs will be subject to a total equity threshold of 25 percent. (The difference is attributed to the definition of "control" under the HOLA.)
- The proposed exclusion (i.e., presumption of noncontrol) for SEC-registered investment companies has been eliminated.



— **Changes to control related terms and other items including:**

- A narrower definition of “Director Representative” to include an individual that represents the interests of a first company [investor] through service on the board of a second company [investee].
- A requirement that total equity must be measured only when the first company makes an investment in a second company rather than also when the investment is reduced.

Historically, the Federal Reserve has made determinations of control on a case-by-case basis. 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 final rule codifies the factors and thresholds that the agency considers most relevant when assessing control. It introduces a tiered framework that is based on a company’s ownership of any class of voting securities of another company. 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).

<b>Summary of Tiered Presumptions</b>				
<b>(Presumption of control is triggered if any relationship exceeds the amount in the table)</b>				
	<b>Less than 5% voting</b>	<b>5.00-9.99% voting</b>	<b>10.00-14.99% voting</b>	<b>15.00-24.99% voting</b>
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company (audit, compensation, executive)	A quarter or less of a committee with power to bind the company (audit, compensation, executive)
Business relationships	N/A	Generate less than 10% of revenues or expenses <b>of the second company</b>	Generate less than 5% of revenues or expenses <b>of the second company</b>	Generate less than 2% of revenues or expenses <b>of the second company</b>
Business terms	N/A	N/A	Market terms	Market terms
Officer/Employee interlocks	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total equity	<b>BHCs – Less than one-third</b> <b>SLHCs – 25% or less</b>	<b>BHCs – Less than one-third</b> <b>SLHCs – 25% or less</b>	<b>BHCs – Less than one-third</b> <b>SLHCs – 25% or less</b>	<b>BHCs – Less than one-third</b> <b>SLHCs – 25% or less</b>

Source: Federal Reserve Board

Note: bolded text highlights modifications from the proposed rule

The provisions of the final rule include additional presumptions of control and related definitions, most of which were adopted as proposed.

Also consistent with the proposal, the final rule does 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. Similarly, the final rule does 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 presumptions.

Notwithstanding the presumptions of control or noncontrol, the Board allows that it may or may not find

a first company to have a controlling influence based on the facts and circumstances presented by a particular case.

Lastly, the final rule applies only to questions of control under the BHCA and the HOLA; it does not extend to the Change in Bank Control Act, Regulation O (Transactions with insiders), or Regulation W (Transactions with affiliates).

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KPMG's Regulatory Alert on the proposed rule for control determinations is available [here](#).

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