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US Federal Reserve Adopts Final Rule on "Control" Determinations Under Certain Banking Laws; Implications for Regulated US and Non-US Funds

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February 7, 2020 TO: ICI Members
ICI Global Members SUBJECTS: Compliance
International/Global
Investment Advisers RE: US Federal Reserve Adopts Final Rule on "Control" Determinations Under Certain Banking Laws; Implications for Regulated US and Non-US Funds

The US Federal Reserve Board (FRB) has adopted a final rule to revise its regulations related to determinations of whether a company has an ability to exercise a controlling influence over another company for purposes of the Bank Holding Company Act (BHC Act) or the Home Owners' Loan Act (HOLA).[1] The final rule becomes effective on April 1. This memorandum highlights aspects of the final rule that are particularly relevant to US registered investment companies (RICs) and similar funds organized outside the United States (collectively, regulated funds).

Background

A company will be deemed to be a "bank holding company" subject to FRB regulation under the BHC Act or a "savings and loan holding company" subject to FRB regulation under HOLA if it directly or indirectly controls a bank or thrift, respectively. Control for purposes of these two laws is defined by a multi-pronged test, most of which involve relatively straightforward standards (*e.g.*, prongs relating to ownership of voting shares and to control over the election of directors). One prong of the control definition—whether a company directly or indirectly exercises a "controlling influence" over the management or policies of another company—requires a factual determination based on the circumstances presented in each case.

In May 2019, the FRB issued a proposed framework to guide "controlling influence" determinations, consisting of tiers of rebuttable presumptions of control.[2] It included a presumption of control specific to investment funds and a conditional exception from that presumption for RICs. Generally speaking, the proposed framework contemplated that as a company's ownership of another company increases, other indicia of control (such as the

business relationships between the two) must decrease in order to avoid triggering a presumption that the first company exercises a controlling influence over the second company. The FRB explained that its proposal "generally would codify a significant portion of the [FRB's] historical practice with respect to controlling influence" but also would make "certain targeted adjustments" based on the FRB's experience.

In July 2019, ICI commented on several aspects of the proposal as they would relate to (1) regulated funds sponsored or advised by banking organizations and (2) other regulated funds that make investments in banking organizations.[3] ICI's letter recommended changes intended to ensure that any final rule would not unnecessarily impede routine and ordinary-course business relationships between regulated funds, their investment advisers and other affiliated entities; business relationships between regulated fund advisers and the funds' portfolio companies; or passive investments of regulated funds in banking organizations.

Final rule

The preamble explains that the final rule is "largely consistent" with the proposal. The rule retains the tiers of rebuttable presumptions, which are intended to guide the FRB in any control determination and to provide information to the public about the circumstances in which the FRB believes a controlling influence may exist. We understand that, as a practical matter, industry participants are likely to treat these rebuttable presumptions as bright-line tests.

The following aspects of the final rule are particularly relevant for regulated funds and their advisers.

- RIC Exclusion. Unlike the proposal, the final rule does *not* include an exception to the presumptions of control for RICs. In its comment letter, ICI had strongly supported the exception and recommended targeted changes to make the proposed exception align better with FRB precedent and to account for the existing regulatory structure for RICs. The preamble suggests that the proposed exception had "minimal incremental information value" beyond the general presumption covering investment funds and notes that "the details of the exception raised many questions regarding how it would function." According to the preamble, the exception was removed to "simplify" the final rule.

- Investment Fund Presumption. The final rule retains the investment fund presumption as proposed. The presumption of control would apply to an investment fund where the adviser directly or indirectly controls five percent or more of any class of voting securities of the fund or 25 percent or more of its total equity, except during a one-year seeding period.[4]

  The final rule does not exclude regulated funds from the investment fund presumption, as ICI had recommended. Nor does it provide a multi-year seeding period and 24.9 percent voting security ownership threshold for regulated funds, as ICI had recommended.

- Scope of the Rule. The final rule applies only to control determinations under the BHC Act and HOLA. It does not extend, as ICI had recommended, to determinations under FRB Regulations O and W. The final rule likewise does not extend to determinations under the Change in Bank Control Act (CIBC Act). The preamble observes that "[w]hile

common control standards across the Board's regulatory framework may provide efficiency benefits, each of the regulations identified by commenters arises out of different provisions of law and is intended to address different concerns in specific contexts." It notes, however, that the FRB "may in the future consider conforming revisions" to those elements of its regulatory framework.

- Status of FRB General Counsel Letters Related to Control of Banking Organizations. As ICI's comment letter explained, in a long line of letters to RIC complexes (RIC Letters) dating back more than 15 years, the FRB General Counsel has determined that RICs (and other vehicles and accounts sponsored and/or managed by the same or affiliated advisers) may collectively acquire up to 15% of the voting stock of a banking organization without the funds or their adviser being deemed to control the banking organization under the BHC Act, HOLA or the CIBC Act. The RIC letters rely on the fact that RIC complexes do not present the same control risks as investors in banking organizations do generally, and the relief they allow is conditioned on commitments designed to mitigate the ability of a RIC complex (together with related vehicles and accounts) to control a banking organization. ICI's letter asked the FRB to confirm that any final rule adopted as a result of the proposal does not affect the RIC Letters or any investments made in accordance with the RIC Letters. The preamble to the final rule indicates that the FRB "does not intend to revisit existing structures that were previously reviewed by the Federal Reserve System and have not changed materially."

- Passivity Commitments. The preamble indicates that the FRB does not intend to require standard passivity commitments going forward. Notwithstanding the final rule, however, the FRB will "continue to obtain control-related commitments in specific contexts, such as commitments from . . . mutual fund complexes." (This appears to be a reference to the types of commitments contained in the RIC Letters, discussed above, and may suggest a willingness by the FRB General Counsel to grant similar letters to other RIC complexes under similar factual circumstances, as ICI's comment letter recommended.)

ICI's comment letter touched on certain additional elements of the FRB's proposed control framework, recommending revisions to the generally applicable presumptions of control to mitigate any negative effects the presumptions could have on regulated funds.

- Treatment of Business Relationships. The proposed control framework would have presumed that a company controlled a second company if the first company owned five percent or more of the voting securities of the second company and the business relationships between the companies exceeded specified thresholds (ranging from two to ten percent) of either company's revenues or expenses. ICI's letter observed that the types of business relationships that arise in the asset management context (*e.g.*, custody, brokerage, securities lending, fund accounting) are critical to supporting fund formation and the ongoing, day-to-day operations of funds, and further, that such relationships do not allow an investment adviser whose funds are investing in a banking organization providing such services to exert a controlling influence over that banking organization. The letter recommended against applying the proposed quantitative restrictions on business relationships to these arm's-length, nonexclusive business relationships between a banking organization, on the one hand, and an investment adviser, its affiliates, and advised funds on the other. At a minimum, the letter urged, the quantitative thresholds for business relationships

should be increased and should be based on measures that are generally available (*e.g.*, assets of the banking organization) so that monitoring is less burdensome and does not necessitate increased involvement in the banking organization.

In the final rule, the FRB did not amend the treatment of business relationships other than to eliminate the requirement to measure the relationships as a percentage of the first company's revenue and expenses.

- Total Equity Calculation. ICI and other commenters recommended a range of changes to the proposal's methodology for calculating a company's total equity ownership in a second company that prepares GAAP financial statements. The methodology in the final rule is largely consistent with that of the proposal, and the rule retains the "functionally equivalent to equity" test that ICI's letter described as unclear and unnecessary. Unlike the proposal, the final rulepermitsinstruments that are identified as equity to be excluded from the total equity calculation if they are "functionally equivalent to debt," although the preamble states that companies should consult with FRB to determine whether equity instruments may be excluded from the calculation.

- Fiduciary Exception. Under the proposal, the presumptions of control would not have applied to the extent that a company holds shares in a second company in a fiduciary capacity, provided that the fiduciary lacks sole discretionary authority to exercise the voting rights associated with the shares. In response to comments by ICI and others, the final rule clarifies that this limitation on voting authority applies only to control of voting shares of a banking organization, which more closely aligns with the BHC Act. In other words, the fiduciary exemption applies to acquisitions of non-banks regardless of whether the investor has sole discretionary authority to vote the shares.

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endnotes

[1] Board of Governors of the Federal Reserve System, *Control and Divestiture Proceedings*, RIN 7100-AF 49, *available at* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-rule-fr-notice-20200130.pdf.

[2] Board of Governors of the Federal Reserve System, *Control and Divestiture Proceedings*, 84 Fed. Reg. 21634 (May 14, 2019).

[3] The ICI letter is *available at* https://www.ici.org/pdf/31861a.pdf.

[4] The final rule is not clear as to whether other presumptions of control (based on, *e.g.,* total equity, accounting consolidation or business relationships) may apply during the one-year seeding period.