BANK POLICY INSTITUTE

July 15, 2019

Via Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551
Attention: Ann E. Misback, Secretary

Re: Control and Divestiture Proceedings (Docket No. R-1662; RIN 7100-AF 49)

Ladies and Gentlemen:

The Bank Policy Institute[1] appreciates the opportunity to comment on the notice of proposed rulemaking ("NPR")[2] by the Board of Governors of the Federal Reserve System (the "Board") that would revise the Board's Regulation Y[3] and Regulation LL,[4] promulgated under the Bank Holding Company Act of 1956 (the "BHC Act") and the Home Owners' Loan Act of 1933 ("HOLA"), respectively, to codify presumptions the Board uses to evaluate whether a company has the ability to exercise a controlling influence over another company for purposes of the BHC Act and HOLA.[5] We appreciate the Board's efforts to be more transparent, to reconsider prior staff positions and to adopt positions that are consistent with the realities of the investment. In a number of cases, the Board's prior guidance regarding the factors it considers, and when such factors result in a presumption that a company exercises a

1 The Bank Policy Institute ("BPI") is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost two million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

2 Control and Divestiture Proceedings, 84 Fed. Reg. 21,634 (May 14, 2019).

3 12 C.F.R. Part 225.

4 12 C.F.R. Part 238.

5 Although the NPR would revise regulations applicable to both the BHC Act and HOLA, the recommendations in this letter focus on recommendations that are particularly relevant for bank and financial holding companies and foreign banking organizations ("FBOs").

controlling influence over another company, had not been codified or otherwise been made public, and banks must rely on institutional knowledge and "word of mouth" regarding the Board's practices to analyze their investments (or investments in them) for potential issues of control. Moreover, there appeared to be a number of cases where the Board's prior positions seemed to result in a "control" determination that was not consistent with the actual facts of the investment.

Nonetheless, we believe that a number of further adjustments are necessary to fulfill the Board's objectives. Our recommendations in this letter are designed to provide greater clarity and to align the "control" framework more closely with the Congressional intent underlying the "controlling influence" standard—that is, to identify actual control that warrants application of the BHC Act and related regulatory framework to the controlled entity.

We appreciate that the Board needs to interpret "control" to assure compliance with the BHC Act and prevent evasions. At the same time, however, an unwarranted finding of control restricts or prevents investments that benefit the banking industry, investors in the banking industry and the economy more generally. Developments since the last major Board pronouncement on control 11 years ago[6]—including technological innovation, the emergence of FinTech companies and their competitive prowess, enhanced prudential standards under Regulation YY (which would apply to any "controlled" company) and the Volcker Rule—have made it even more imperative that the Board's guidance on control comports with business reality.[7]

I. Executive Summary.

The "controlling influence" standard in the BHC Act's definition of "control" has long been a source of uncertainty and confusion. Notwithstanding the clear Congressional intent underlying this standard to capture investments that give rise to *actual control*, but that did not meet the "control" definition's bright-line standards, the Board has significantly expanded the controlling influence standard well beyond the concept of actual control. Although the NPR would, in some cases, bring the Board's position on controlling influence more in line with Congress' intent, many of the Board's historical positions would either be retained or potentially expanded to situations where historical practice has not presumed control, such as consolidation under U.S. GAAP. As a result, there are a number of provisions in the NPR that should be substantially revised. We believe that these revisions would continue to allow the Board to assess investments for control, but would align the Board's positions more closely with Congress' intent.

---

6 *See* the Board's 2008 Policy Statement on Equity Investments in Banks and Bank Holding Companies (the "2008 Policy Statement").

7 We also note that, because nearly all the presumptions and related thresholds presented in the NPR originated with Board interpretations and policy statements, this represents the first time many of these thresholds have gone through a formal notice and comment process. We appreciate the opportunity to revisit the Board's control framework through this important process, particularly in light of the developments that have occurred since the Board adopted the 2008 Policy Statement.

Although we make a number of recommendations in this letter, we draw your particular attention to the following:

- The Board's basic approach should be reconfigured so that conformance with the stated criteria creates a presumption of non-control, rather than non-conformance resulting in a presumption of control.[8]

- The Board's proposed presumptions with respect to business relationships are too restrictive and would result in presumptions of control in cases where actual control is not present. These presumptions should be substantially revised by eliminating metric-based limits in certain cases, by permitting larger relationships than the NPR would allow, and by refining the concept of business relationships to include only those that would have a meaningful relationship to the ability to exercise a controlling influence.

- The proposed methodology for calculating a first company's total equity investment in a second company is fundamentally flawed and leads to untoward results, particularly with respect to investments in startups or in other companies that otherwise have little or negative retained earnings. If the Board proceeds with total equity as a factor it considers for purposes of controlling influence determinations, it should calculate total equity based on a "common stock equivalent" method.

- The scope of contractual limitations that would result in a presumption of control are too broad, and would capture both (1) contractual terms that bank holding companies and FBOs include to preserve the basic conditions under which the investment was made (which contributes to overall safety and soundness), to protect the investor's reputation and to maintain compliance with applicable legal and regulatory requirements, and (2) standard loan covenants that do not provide a first company the ability to exercise actual control.

- The final rule should not adopt the proposed presumption of control over any second company consolidated on the balance sheet of the first company under U.S. GAAP. Doing so would increase the costs and burdens imposed on bank holding companies and FBOs in establishing financing structures for passive investment arrangements without advancing the policies underlying the BHC Act.

- The final rule should substantially revise the presumptions of control relating to investment funds to adhere more closely to the Board's historic precedent and the BHC Act.

- The final rule should confirm that the rule applies prospectively (*i.e.*, only to investments made after the final rule's effective date).

- The Board should not use the final rule's "control" framework to interpret issues of control under the Change in Bank Control Act (the "CIBC Act") because of differences in objectives and consequences.

---

8 In addition, the final rule should not eliminate the presumption of non-control set forth in Section 2(a)(3) of the BHC Act and § 225.31(e) of the Board's Regulation Y regarding investments in less than five percent of any class of a second company's voting securities.

II. Background.

A. Congress' stated purpose in adding the "controlling influence" standard to the BHC Act was to include investments that resulted in *actual control* but that did not meet the bright-line standards of control.

The BHC Act's basic definition of "control" is included in Section 2(a)(2), and provides a three-part test to determine whether a company "controls" a bank or other company for purposes of the BHC Act.[9] Under this test, a company controls a bank or other company if: (i) the company 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 bank or other company; (ii) the company controls in any manner the election of a majority of the directors or trustees of the bank or other company; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or other company.[10] The source of uncertainty and concern regarding the BHC Act's concept of control has predominantly arisen from the third part of the control test.

Congress amended the BHC Act in 1970 to add the last part of the control test, the "controlling influence" standard, to the definition of "control."[11] The legislative history of the 1970 amendment is clear, and without contradiction, that this standard was not designed to expand significantly the basic concept of control, but was instead intended to allow the Board to determine that certain investments resulted in actual control of a banking organization where the investment did not meet one of the other, more straightforward, standards:

> The amended H.R. 6778 . . . authorizes the [Board] to find *actual control* of a bank where a company holds less than 25 percent of its stock . . . .[12]

Similarly, Representative Ashley, the Congressman who sponsored the amendment that added the controlling influence standard, explicitly noted that the standard was to be limited to situations of actual control:

> My amendment simply modifies H.R. 6778 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.[13]

The Board itself has recognized and relied on this same legislative history in interpreting the controlling influence standard:

---

9 12 U.S.C. § 1841(a)(2).

10 *Id*.

11 12 U.S.C. § 1841(a)(2)(C).

12 H.R. Rep. No. 91-1747, at 12 (1970) (emphasis added).

13 115 Cong. Rec. 33141, 91st Cong. (1st Sess.) (statement of Rep. Ashley) (emphasis added).

> The original amendment was offered by Congressman Ashley, and from statements by him and Congressman Patman it was clear that they intended to *reach situations of actual control*.[14]

Further support for this conclusion is provided by the process that Congress adopted and the specific language that Congress used. Before the Board can make a controlling influence determination, it must provide notice and an opportunity for a hearing. This statutory process illustrates Congress' assumption that such determinations would be made only in limited circumstances. Congress' decision to use the current tense "exercises," and not a more subjective standard, such as "potential to exercise" or "ability to exercise," demonstrates that Congress did not intend the "controlling influence" standard to capture just potential for control or incipient control, but only actual control.

This clear and incontrovertible evidence of Congress' intent should be conclusive as to the scope of the controlling influence standard, and the final rule should not create presumptions of control in circumstances where a first company does not exercise actual control over a second company.[15] This requires that controlling influence must occur in fact, and the Board's presumptions relating to control should be consistent with this standard.

B. Over time, the Board expanded the "controlling influence" standard such that, contrary to Congress' intent, application of the standard resulted in determinations of control where there was no actual control.

Since the enactment of the controlling influence standard, the Board has interpreted the standard in a variety of formal determinations, interpretations, regulations, policy statements, guidelines and less formal advice in specific situations. The Board's original interpretations demonstrated, over a 12-year period, its position that the controlling influence standard was intended to address only situations where the controlling influence was so great as to amount to actual control, rather than the possibility of future control or some degree of influence that did not amount to actual control. For example, in 1982, the Board concluded that C.A. Cavendes, Sociedad Financiera, did not exercise a controlling influence over Florida National Banks of Florida, Inc., even though Cavendes (i) owned 24.9 percent of Florida National (a position that was five times greater than any other shareholder's ownership); (ii) sought board representation; (iii) opposed and attempted to block, through litigation and shareholder action, a merger of Florida National; and (iv) undertook efforts to force a sale of Florida National.[16] The Board determined

---

14 63 Fed. Res. Bull. 288, 292 (1977) (emphasis added). In this case, Patagonia Corporation owned almost 20 percent of the stock of Pima Savings & Loan, controlled three of Pima's 15 directors and was attempting to purchase the remainder of Pima's stock. Pima's president even noted that Patagonia's director representatives had an outsized influence in relation to other directors "because of their prestige and status," and that Pima's president had "wooed them to a certain extent because he viewed Patagonia as the likely purchaser of Pima stock." The Board determined that these factors did not amount to a controlling influence in view of the legislative history's emphasis on actual control.

15 Throughout this letter, to remain consistent with the NPR, we refer to the company that would make the investment (and therefore potentially be deemed to be in control) as the "first company," and the company in which the first company has invested as the "second company." We believe, however, that the final rule and related discussion would benefit from additional clarity by instead referring to the first company as the "investor" and the second company as the "investee."

16 Letter to John L. Douglas, Esq., from the Secretary of the Board, dated April 5, 1982.

that Cavendes did not exercise a controlling influence because management was hostile to Cavendes and was supported by other shareholders, *i.e.*, Cavendes was unable to exercise actual control.[17]

Notwithstanding the legislative history underlying the "controlling influence" standard and the Board's contemporaneous interpretations of that standard, which were reinforced for over a decade, the Board subsequently expanded the concept of controlling influence to the point that the Board has found a first company to control a second company in circumstances where the first company could potentially exercise only a relatively small degree of influence over the second company.[18] The Board's expanded view was developed in response to a series of innovative transactions, primarily so-called interstate "stakeout" investments in banks and bank holding companies, and was apparently based largely on policy considerations.[19]

---

17 *Id*. at 3 ("While the record shows that Cavendes has articulately sought to influence Florida National to reverse various management policies, especially a proposed merger, . . . Florida National management has not deviated in any instance from the course it has set. Cavendes' attempts to influence management . . . have not been successful."); *see also The Trust Company of New Jersey*, 60 Fed. Res. Bull. 717, 720 (1972) (distinguishing between the ability to exert "some influence" and the ability to exert a "controlling influence," and determining a shareholder was unable to exercise a controlling influence over the management or policies of a bank, even though the shareholder (i) acquired eight percent of the bank's shares, (ii) participated in management through the "active presence" of the shareholder's president; (iii) had two interlocking directors; and (iv) announced its intention to acquire the bank, which it eventually did); *European-American Bancorp*, 63 Fed. Res. Bull. 595 (1977) (determining that none of several large foreign bank shareholders was able to exercise a controlling influence even though certain of these shareholders had (i) approximately 20 percent voting interests in the subject bank; (ii) multiple director interlocks (consisting of senior executives of the shareholders); (iii) substantial physical operations at the bank's site; and (iv) significant historical ties); *Vickars-Henry Corp.* v. *Board of Governors of the Federal Reserve System*, 629 F. 2d 629 (9th Cir. 1980) (endorsing the Board's determination that a company was not able to exercise a controlling influence even though the company owned more than 16 percent of an investee bank and the company's two shareholders collectively owned more than 50 percent of the same bank in their individual capacities because "the stock owned by [the company's shareholders was] sufficient to give those shareholders outright control" of the investee bank, and thereby preclude controlling influence by the company).

18 In this regard, we note that the courts often provide less deference, or no deference at all, to an agency interpretation that is inconsistent with an earlier interpretation.

> "An agency interpretation of a relevant provision which conflicts with the agency's earlier interpretation is 'entitled to considerably less deference' than a consistently held agency view." *Good Samaritan Hosp.* v. *Shalala*, 508 U.S. 402, 417 (1993) (quoting *INS* v. *Cardoza-Fonseca*, 480 U.S. 421, 446 (1987)).

A court may accord no deference if the agency has failed to explain, or even acknowledge, a change in position.

> "An unexplained inconsistency in agency policy is a reason for holding an interpretation to be an arbitrary and capricious change from agency practice, thereby warranting no Chevron deference." *Encino Motorcars, LLC* v. *Navarro*, 136 S.Ct. 2117, 2125 (2016).

19 These "stakeout" investments involved a bank holding company's investment in nonvoting securities of banking organizations located outside their own states in anticipation of potential state approval of some form of interstate banking. In later cases, bank holding companies made minority investments in financial services companies, such as insurance agencies, in anticipation of legislative or regulatory liberalization of

The Board's initial policy response was its 1982 Policy Statement on Nonvoting Equity Investments by Bank Holding Companies (the "1982 Policy Statement").[20] The 1982 Policy Statement described the Board's expectations regarding the types of arrangements that would avoid a Board determination that the investment resulted in a controlling influence over a company's management or policies. The Board then applied these "expectations" as the functional equivalent of regulatory determinations. They included: a restriction on the amount of any equity investment to 25 percent of the investee's total equity; a limitation on common share equivalents to 25 percent of the pro forma common shares, combined with a requirement of wide disposition; restrictions on contractual covenants designed to protect the investment by limiting the company's ability to take certain actions (*e.g.*, restrictions on entering into new banking activities without the investor's approval); and a prohibition on covenants that would require extensive consultation with the investor on financial matters.

Following the issuance of the 1982 Policy Statement, the Board added a number of significant new restrictions. These included limitations or outright prohibitions on interlocking directors or management officials, business relationships and consultation on major decisions.[21] The 1982 Policy Statement's already expansive restriction to 25 percent of total equity was expanded even further by including subordinated debt in the calculation of total equity. Investors were required to enter into a number of broad "passivity commitments" to obtain the Board's concurrence that the investment would qualify as non-controlling, including commitments not to (i) maintain interlocking directors or management representation, (ii) propose directors in opposition to management's proposed directors, (iii) solicit proxies, (iv) attempt to influence dividend policies, loan and credit decisions, and often a wide range of operational, management or policy decisions, (v) engage in business relationships (apart from very minor exceptions), (vi) threaten to dispose of shares if the board of the investee did not act in a designated way and (vii) enter into joint ventures. The contrast between these commitments and Board decisions such as *Cavendes* is remarkable; *Cavendes* undeniably found that just the attempt to exercise a controlling influence does not constitute a controlling influence, whereas the passivity commitment precedent reached the opposite result. Although the Board sought to clarify, and, to some extent, revisit, these restrictions in the 2008 Policy Statement, the Board appears to have subsequently retreated from the

the Section 4 "closely related to banking" test for permissible activities. These investments generally included convertible preferred securities or merger agreements that would be activated only in the event interstate banking was later permitted or the test for permissible activities was later expanded.

20 47 Fed. Reg. 30,965 (July 16, 1982).

21 *See, e.g.*, Board Interpretive Letter of Dec. 7, 1989, 1989 WL 504548 (F.R.B.) (involving an investment by Mitsui Bank, Limited in a leveraged acquisition fund organized by the Carlyle Group, L.P.); Board Interpretive Letter of Dec. 24, 1987, 1987 WL 428945 (F.R.B.) (involving an investment by the Long Term Credit Bank of Japan in Miller, Anderson & Sherrerd); Board Interpretive Letter of Oct. 31, 1986, 1986 WL 371764 (F.R.B.) (involving an investment by Nortstar Bancorp Inc. in Capital Guaranty Corporation); Board Interpretive Letter of May 21, 1986, 1986 WL 371766 (F.R.B.) (involving an investment by Bank of New York Corporation in the Leonard Newman Insurance Agency, Inc.); Board Interpretive Letter of Dec. 27, 1985, 1985 Fed. Res. Interp. Ltr. LEXIS 92 (involving an investment by Northwestern Mutual Life Insurance Company in Marshall & Ilsley Corporation); Board Interpretive Letter of Nov. 5, 1984, 1984 WL 264813 (F.R.B.) (involving an investment by an undisclosed bank holding company in several newly formed insurance companies).

2008 Policy Statement and established a control "perimeter" far removed from Congress' intent and the Board's more contemporaneous interpretations that focused on *actual control*.

The effect of the Board's practice since 1982 has been to create a fundamental change to the controlling influence standard such that it is no longer a standard of actual control, but a test of whether a first company has the power to exercise any meaningful influence, without regard to whether the first company has even attempted to exercise, much less been successful in exercising, such influence. Notwithstanding the Board's overall approach in the NPR, certain of the broader interpretations discussed above appear to have been carried forward into the NPR, and create presumptions of control in cases where actual control would not exist.

C. An overbroad view of the "controlling influence" standard results in significant adverse consequences for both bank holding companies (including the ability of financially challenged and smaller banking organizations to raise capital) and the companies in which they invest.

An overbroad view of controlling influence, which materially diverges from Congress' standard of actual control, has at least three significant adverse consequences for banking organizations and the companies in which they invest. These considerations weigh heavily in favor of applying the controlling influence standard in a manner that reflects the Board's original interpretations of that standard, which were consistent with Congress' intent.

First, as the federal banking agencies have long recognized, a strong capital position is fundamental to a bank's safety and soundness. An overbroad view of controlling influence, however, could seriously impede banking organizations' capital-raising efforts, particularly those of financially challenged or smaller banking organizations. These organizations may turn to private equity or other large investors as a source of capital if the public markets are closed to, or not readily accessible by, such organizations. These investors are willing to make relatively large investments, but, for the very reason that the bank is financially challenged, they will want some oversight and some level of influence.

In the vast majority of cases, the option for these investors to make investments that constitute control, and thereby become bank holding companies, is not feasible. These investors are likely to be deemed to control other companies that do not comply with the activity restrictions of Section 4 of the BHC Act. Moreover, the very investing activities of these investors may not comply with the Volcker Rule.[22]

Second, banking organizations are unable, without exposing themselves to serious regulatory risk, to make minority investments in companies that do not involve control in fact, but are nonetheless deemed to constitute a "controlling influence" under a broad reading of this term. Such investments subject the banking organization to responsibility for the investee's compliance with the BHC Act and applicable regulations (as well as other legal requirements), yet the banking organization cannot exercise the control in fact to assure compliance or remediate violations. In other words, the banking organization

---

[22] Of course, any investor that acquired 10 percent or more of the bank's stock would presumably be in control of the bank for purposes of the CIBC Act and required to file a "notice" (which enables the Board to conduct a thorough review of the investor).

is treated for regulatory purposes as if it had control over the investee when the banking organization has no ability actually to control the investee's activities and assure compliance with applicable legal and regulatory requirements.

Finally, a company in which a banking organization proposes to invest may be unwilling to accept the investment if the company would become subject to the BHC Act's restrictions on its activities or regulatory requirements that are inapplicable to its peers. This limits the sources of capital for startup and early-phase companies, and deprives banking organizations of the opportunity for profitable investments, experimentation with new technology and rewarding relationships.

These adverse outcomes demonstrate the flaws in applying a standard that departs materially from actual control for purposes of the Board's controlling influence determinations. The sharp dichotomy between the Board's current interpretations of controlling influence and actual control results in a number of outcomes that are contrary to the best interests of the country's banking system and overall economy.

III. Proposed revisions to the NPR.

At the outset, and to be consistent with the statute and its legislative history, the Board's presumptions should be reformatted so that they are all presumptions of non-control and not of control.[23] In other words, we believe that the presumptions should be *safe harbors* with both a stated and meaningful Board intention to make determinations of non-control when the safe harbor is not met but the totality of the facts and circumstances does not amount to control.

This revised approach would be consistent with both the statute's structure and Congress' policy objective, while still providing the transparency and substantial degree of certainty that the Board appropriately seeks. As the Board correctly noted in 2008, "the complexity of legitimate business arrangements preclude[s] establishing rigid rules designed to cover all situations and . . . decisions regarding the presence or absence of control must take into account the specific facts and circumstances of each case."[24] As the Board further elaborated in the 2008 Policy Statement, it reviews business relationships "on a case-by-case basis *within the context of the other elements of the investment structure*."[25] Notwithstanding the value of clarity and transparency, these objectives do not provide a sufficient rationale for rigid rules creating an effective irrebutable presumption of control.

---

23 As discussed in greater detail in section IX below, the NPR would create presumptions of non-control for investments in less than 10 percent of a class of a second company's voting securities as long as the investment does not trigger one of the proposed presumptions of control. For the reasons discussed in that section, we believe the presumption of non-control should be extended to all investments that do not trigger a presumption of control.

24 2008 Policy Statement at 4; *see also* 1982 Policy Statement at 30,966 ("The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case.").

25 2008 Policy Statement at 13 (emphasis added).

As discussed in the following sections of this letter, we believe that a number of the specific criteria used to formulate the presumptions should be revised. Such revisions become even more essential if the presumptions effectively become the boundaries for non-control determinations.

A. The Board's proposed presumptions with respect to business relationships are too restrictive and would result in presumptions of control in cases where actual control is not present.

Among BPI's most serious concerns with the specific provisions of the NPR are those relating to business relationships. The still unnecessarily restrictive limits on those relationships preclude, among other things, the opportunity for bank holding companies to establish more than minor relationships with startup and early-generation companies in a rapidly changing, technology-driven world. Although we appreciate that the NPR generally constitutes an improvement in comparison to current staff positions on business relationships, we submit that the standards articulated in the NPR still fall well short of the actual control that Congress envisioned or even the ability to exercise any degree of meaningful influence.

The Board's rationale for its focus on business relationships is the concern that the first company could use the threat of withdrawing a business relationship to control the management or policies of a second company.[26]

This rationale, however, conflates influence over the business relationship into influence over management or policies. Although the presence of a significant relationship may provide the first company with some leverage to influence the terms of the business relationship itself, there is no evidence that this leverage could extend to allowing the first company to influence the second company's management or polices. That is, large customers are unlikely to influence the second company in a manner that would indicate "control," such as influencing whether the second company pays dividends, incurs debt, makes management changes, acquires another business, merges with another company, expands into a new area or takes any other significant action. Moreover, a large customer that is also a large shareholder is even less likely to be able to withdraw or reduce its business relationship with the second company, as it would not be possible to do so without harming both the value of the first company's investment and its reputation.

The Board should not restrict business relationships based on a metric such as percentages of revenues or expenses, but rather should address the actual concern articulated by the Board, *i.e.*, a first company seeking to control a second company by threatening to withdraw critical customer relationships. Put simply, the Board should address its concerns by prohibiting a first company from threatening to terminate or alter business relationships with the second company for the purpose of exercising a

---

26 *See, e.g.*, *id*. at 12-13 ("The Board historically has taken the view that a major supplier, customer, or lender to a banking organization can exercise considerable influence over the banking organization's management and policies . . . by threatening to terminate or change the terms of the business relationship.").

As discussed below, this rationale could not apply to the proposed calculation of the business relationship test in terms of the percentage of the first company's revenues or either company's expenses. A theory could perhaps be propounded that, if a second company represented a large percentage of a first company's revenues, the first company would feel compelled to intervene in the second company to preserve the relationship. The weakness of such a theory, however, is discussed below.

controlling influence over the second company's management or policies. The Board, through its examination and supervisory processes, would have sufficient information to police compliance with this restriction, and any company that believes itself threatened would be able to inform the Board of the threat.

In the event, however, that the Board nonetheless determines to implement a metrics-based restriction on business relationships in the final rule, the thresholds proposed in the NPR should be substantially revised. The percentages the Board proposed are below a level that qualifies as "quantitatively limited and qualitatively nonmaterial" in the context of the relevant share ownership levels. Under the proposed thresholds, assuming equal distributions of revenue to all customers, the first company would only have to be one of the second company's top 10, 20 or even 50 customers to trigger the presumption of control, depending on the percentage of a class of voting stock held by the first company. We do not think that a company would be willing to change a significant management, operational or strategic practice or policy out of fear that it could lose a customer that contributes only two to 10 percent of the company's revenues.

The Board seemingly recognized this fact in its historical control interpretations, which required a far more pervasive business relationship. For example, in *Amboy Bancorporation*, the Board found that there was control by a company over a second company's lending operations because the first company would underwrite and originate loans for the second company, a *de novo* bank, without limitation, which could result in the business relationship representing "most or all" of the second company's assets.[27] Similarly, in *FleetBoston*, the Board noted that proposed business relationships did not constitute a controlling influence under the Amboy precedent because "nothing in the . . . proposal or record suggests that it is possible that [the second company] would rely on [the first company] for *most or all* of its assets."[28]

We propose that any quantitative restrictions on business relationships in the final rule should, consistent with this precedent, reflect only meaningful relationships in the context of meaningful investments. Accordingly, if the Board chooses not to adopt an approach based on threats to withdraw business (as discussed above), the final rule should: (1) not include any restriction on the size of business relationships if the first company controls less than 10 percent of any class of voting securities of the second company; and (2) create a presumption of non-control if, among other factors, (x) the first company controls between 10 percent and 14.99 percent of any class of voting securities of the second company, and less than 20 percent of the second company's consolidated revenues are attributable to business relationships with the first company, or (y) the first company controls between 15 percent and 24.99 percent of any class of voting securities of the second company, and less than 10 percent of the second company's consolidated revenues are attributable to business relationships with the first company.

---

27 83 Fed. Res. Bull. 507, 508 (1997).

28 86 Fed. Res. Bull. 751, 754 n.15 (2000) (emphasis added). Similar to our suggestion, the Board required a commitment that the first company enter into a passivity commitment with the Board not to engage in business relationships other than ordinary course transactions and transactions contemplated by the proposal.

In addition to the specific percentages, we believe that the calculation of business relationships should be modified as follows:

1. The Board should evaluate business relationships based only on the revenues of the second company. The impact of business relationships on the revenues of the first company should not be relevant.

Under the NPR, business relationships would trigger presumptions of control if the total annual revenues of either of the first company or the second company attributable to the business relationships were to exceed the proposed thresholds.[29] Although the situation where the second company represents a substantial percentage of the first company's revenues is relatively unlikely to occur, it is still important to avoid a situation that does not comport with reality.

The only possible rationale of which we are aware for this "reverse" business relationship analysis is that the first company may feel compelled to intervene in the second company's affairs to protect the relationship. We suggest that any such theory (which is not articulated in the NPR) would be far-fetched. The desire to intervene in the second company's affairs is largely irrelevant unless it can be matched with the ability to intervene in those affairs.

Indeed, the very opposite dynamic is likely to apply. If the business relationships between the first company and second company are significant in relation to the *first* company's revenues, then, to the extent those relationships give any party influence, they would provide the second company influence over the first company. But that is not the purpose of the Board's analysis. Indeed, any such influence by the second company would logically act as a counterweight to any influence the first company might otherwise have with respect to the second company (*e.g.*, if the first company sought to intervene in the second company's affairs, the second company could threaten to replace the first company as a service provider).

The percentage of the first company's revenues attributable to a business relationship also is not indicative of the significance of the relationship to the second company. Depending on the relative size and operations of the two companies, business relationships that represent a large percentage of the first company's revenues could represent a miniscule percentage of the second company's revenues. As such, the first company's revenues attributable to the business relationship have no bearing on the first company's ability to exercise a controlling influence over the second company's management or policies, but rather are indicative only of the importance of the business relationship to the *first company*.

---

[29] *See, e.g.*, 84 Fed. Reg. at 21,658, proposed 12 C.F.R. § 225.32(d) (a first company is presumed to control a second company if "[t]he first company controls 5 percent or more of the outstanding securities of any class of voting securities of the second company, and . . . [t]he first company . . . enters into transactions or has business relationships with the second company . . . that generate in the aggregate 10 percent or more of the total annual revenues or expenses of the <u>first company</u> or the second company . . . .") (emphasis added).

2. The Board should not use the expenses of either the first company or the second company to evaluate business relationships. The impact of business relationships on the expenses of either company should not be relevant.

If the Board retains a metrics-based limit on business relationships in the final rule, the presumption of control should not be triggered on the basis of the size of a business relationship as measured by a percentage of expenses of either company. As just explained, the percentage of a first company's expenses could only be indicative of the importance of the business relationship to the first company. That, however, should not be relevant to an inquiry into whether the first company can exercise a controlling influence over the second company.

With respect to the second company, even if a first company is a large supplier of goods or services to a second company, such that the business relationship accounts for a significant portion of the second company's expenses, the first company would only be able to exercise actual control over the management or policies of the second company if the goods or services supplied by the first company could not be replaced without significant cost to the second company. Such circumstances are uncommon, and we note that there is substantial competition in the banking and financial services industries. We are not aware of any evidence to suggest that a customer of a bank holding company would be unable to take its business to a competing firm if it so desired.

Furthermore, a second company's *expenses* are a poor measure of the significance of the business relationship, because this measure can vary significantly based simply on the second company's business model. A company with lower overhead and insignificant expenses will necessarily attribute a greater percentage of total expenses to every expenditure with an investor than a company with greater expenses. By tying the presumption of control to the second company's expenses, the NPR could require the Board to presume control based on a factor that is unrelated to the business relationship and its actual impact to the second company. For example, under the NPR, business relationships of the same size between a bank holding company and each of two investee companies (Company X and Company Y), which have the same amount of annual revenue, could result in different controlling influence judgments if Company X is more profitable (*i.e.*, has greater revenues per dollar of expenses) than Company Y. In fact, the approach included in the NPR would disfavor an investment in the *more profitable* company (Company X) because the business relationship would comprise a greater percentage of Company X's expenses than Company Y's. Accordingly, to the extent metrics-based limits are retained for business relationships, they should be based only on the size of those relationships to the revenues of the second company.

3. Referrals and other customer-related revenues should not be included as "revenue" for purposes of any limitations on business relationships between the first company and second company.

To the extent a metrics-based limit on business relationships is retained, we believe that only the revenues arising from business relationships directly between the first company and the second company should be considered for purposes of assessing the materiality of business relationships between the companies. Revenues arising from customer referrals or other transactions[30] between the customers of the first company with the second company should not be deemed to constitute revenues between the two companies.[31]

A first company that refers a third party to a second company has no control over the amount of business provided by the third party to the second company, or whether the third party even uses the second company. The referral may be only one of multiple reasons why the third party uses the second company, or may not be a factor at all.[32] Moreover, unlike a direct revenue payment, the first company cannot terminate, or compel third parties to terminate, the business relationship between the third party and the second company. In addition, a decision to end referrals, absent underlying business reasons relating to the third party's performance, would typically be antithetical to the first company's best interests as a stockholder in the second company.

Furthermore, the Board's objectives of transparency and clarity would be contravened because the calculation of revenue attributable to referrals is subjective and complex. Assume, for example, that the first company refers a third party to the second company for one product or service, but the third party ultimately uses multiple products and services. Or, assume other common scenarios, such as the third party is referred on day one and takes a product or service three months, six months or one year later, or the third party continues to use the second company's products or services for many years after the initial referral.

These questions not only relate to the extraordinary difficulty of calculation, but also demonstrate how attenuated the relationship is between referrals and control. If the final rule retains a metrics-based presumption of control with respect to business relationships, the rule should clarify that business relationships will be calculated on the basis of revenues earned directly by the second company from its business relationships with the first company, and will not include indirect revenues that the second company may receive from customers of the first company, through referrals or otherwise.

---

30 For example, a customer of a first company that invests in a mutual fund advised by the second company likely would pay advisory, shareholder servicing, distribution or similar fees to the second company.

31 A question has existed about referral relationships since a 1987 Board determination. *See, e.g.*, *Proposed Investment by Sumitomo Bank Deemed Consistent with Bank Holding Company Act*, 73 Fed. Res. Bull. 24 (1987), 1987 WL 119118 (F.R.B.) (noting that a proposal to increase business relationships through mutual referrals raised concerns of control, and requiring a commitment from Sumitomo that neither it nor Goldman Sachs (the investee) would solicit business for the other or refer business to the other); *but see* Letter to H. Rodgin Cohen, Esq., dated April 22, 2011, *available at* https://www.federalreserve.gov/bankinforeg/LegalInterpretations/bhc_changeincontrol20110422a.pdf (determining that Mitsubishi UFJ Financial Group, Inc. would not control Morgan Stanley even though the investment was part of a global corporate and investment banking alliance between the companies).

32 The connection between such customer-generated revenues and a proper control analysis is even more attenuated where the "referral" involves the first company's merely making products or services of the second company available to the first company's customers along with the products or services of other providers.

4. Evaluating business relationships on the basis of annual revenues at a point in time fails to consider key differences in stages of a company's lifecycle; the Board should evaluate business relationships with startups, and other companies that are expected to grow significantly, over a longer horizon where business relationships with the first company may initially have a larger impact but are expected to decline significantly as the second company grows.

In many cases, bank holding companies may invest in companies that do not have significant revenues but that are expected to grow significantly after the investment, such as startups or established companies that are expanding into a new line of business. Frequently, these companies will seek to establish business relationships with their investors. Because, however, the NPR would calculate revenues on an annual basis, there could be a presumption of control even if the years immediately following the investment are an anomaly in terms of revenue attribution.[33] This approach does not allow for anticipated growth based on revenues from unrelated parties, particularly if the second company is expected to experience significant year-over-year growth as it expands its business.

If the final rule retains metrics-based restrictions on business relationships, we propose that the rule permit a limited period during which business relationships with a company that is expected to grow significantly would not be considered a control factor. We suggest a three-year period, with the potential to obtain reasonable extensions after consultation with the Board (unless, of course, the first company in fact leveraged its relationship to exercise control). If business relationships do not decrease below the thresholds set forth in the final rule by the end of the period allowed, the Board could then require the first company either to reduce its ownership in the second company or to treat the investment as a controlling investment. This approach would not only provide bank holding companies additional flexibility to invest in startups and other companies that are expected to undergo significant growth, but also would more closely align Board regulations with Congress' intent by only capturing business relationships that are more likely to be significant to the second company.

5. The final rule should provide reasonable requirements for tracking business relationships on an ongoing basis, and should provide a one-year grace period for a first company that discovers its business relationships exceed the applicable threshold to reduce its business relationships with, and/or its ownership percentage in, the second company.

Although the NPR does not explicitly require the first company to track its business relationships on an ongoing basis, we assume the Board did not intend for business relationships to be measured only at the time of investment. We propose that a first company be required to measure its business relationships on an annual basis.[34]

---

[33] *See*, 84 Fed. Reg. at 21,658, proposed 12 C.F.R. § 225.32(d)(4).

[34] Any more frequent measurement requirement would obligate the first company to seek financial information that otherwise would not be available to minority investors, a factor that the NPR provides would be indicative of control. *Id*. at 21,658, proposed 12 C.F.R. § 225.31(5)(ii)(B) (excluding from the

In addition, we note that the size of business relationships may fluctuate, frequently due to factors outside the first company's control (*e.g.*, a large customer ceases to do business with the second company). Temporary increases in the size of a business relationship do not provide a first company with the ability to exercise actual control over the second company. Moreover, if the first company were deemed to control the second company immediately after a business relationship exceeded the applicable threshold, this would suddenly, and likely unexpectedly, cause the second company to become subject to the restrictions of the BHC Act. For these reasons, in cases where a business relationship did not initially trigger a presumption of control, but was later discovered to have exceeded the applicable threshold, we propose that a first company would not be deemed to control a second company unless the second company's revenues attributable to the business relationship exceed the applicable threshold for two consecutive annual measurement periods. This would provide the first company a reasonable grace period either to reduce the size of its business relationship or divest a portion of its ownership in the second company, and realign the investment with the rule's presumptions.

B. The proposed methodology for calculating a first company's total equity investment in a second company is fundamentally flawed and leads to untoward results, particularly with respect to investments in startups or other companies that have little or negative retained earnings.

The preamble to the NPR restates the Board's view that the overall size of an equity investment is an important indicator of the degree of influence an investor may have over a second company, which is based on the assumption that, irrespective of the type of equity owned, large shareholders are able to influence the companies in which they invest.[35] As a result, the NPR incorporates strict limitations on the size of investments in "total equity" as part of the tiered presumptions.

As an initial matter, we submit that a large investment in a second company's total equity does not in and of itself result in actual control of the second company. The NPR explains the inclusion of total equity in the tiered presumptions on the basis that "investors with large equity investments have a powerful incentive to wield influence over the company in which they have invested," and that "a company is likely to pay heed to its large shareholders in order to maintain stability in its capital base, enhance its ability to raise additional equity capital in the future, and to prevent the negative market signal that may be created by the sale of a large block of equity by an unhappy shareholder."[36]

We submit that none of these concerns is indicative of actual control. The fact that a large investor has an incentive to wield influence says nothing of the importance of the investment to the

---

definition of "limiting contractual right" only a "requirement that the first company receive financial reports of the type ordinarily available to common stockholders").

If the final rule retains metrics-based restrictions on business relationships, there should be no requirement to measure business relationships on an ongoing basis (or otherwise) where business relationships of any size could not trigger a presumption of control under the proposed framework (*i.e.*, investments in less than five percent of any class of a second company's voting securities).

35 *See id*. at 21,638.

36 *Id*. at 21,643.

second company or its willingness to submit to the influence of the first company. Moreover, the mere incentive to wield influence is not the actual exercise of a controlling influence. The Board itself has determined that a first company cannot exercise actual control even when the second company admits to having "wooed" the first company because of its influence, or the first company actually attempts to control the second company but is resisted by management.[37] With respect to the concern that a second company is likely to pay heed to its large shareholders, we believe this concern is speculative, particularly with respect to nonvoting investments, which would have only limited marketability. Given the complexity of the "total equity" calculation, as discussed below, and the reality that the size of the first company's investment in the total equity of the second company does not by itself create actual control of the second company, it should no longer be a factor in the Board's control determinations, and the final rule should not include any presumptions related to total equity.

If, however, the Board determines to retain presumptions relating to total equity in the final rule, the calculation methodology must be substantially revised. The Board's calculation methodology for total equity is based on an analysis that is flawed in its application to a number of situations, and, as a direct result, will inflate, often wildly, a first company's financial or economic position and influence. This potential for unreasonable inflation is especially troublesome for investments in companies with limited operating histories, companies that have experienced losses in the past and companies that have or expect to have multiple rounds of equity financing. In such cases, the NPR's methodology for calculating "total equity" will often significantly overstate the "overall size" of an investment and the identity of a "large" shareholder.

As a result, the Board's proposed calculation methodology will unreasonably prohibit otherwise permissible non-controlling investments, and thereby impede the flow of capital in the marketplace.

In addition, the NPR formula for calculating a first company's total equity percentage in a second company applies directly only to an organization that (i) is a stock corporation and (ii) prepares financial statements pursuant to U.S. GAAP. With respect to other types of organizations, (*e.g.*, limited liability companies or partnerships and non-U.S. organizations), the NPR provides only that the calculations of the first company's total equity will be "calculated so as to be reasonably consistent" with the mechanics prescribed for stock companies while taking into account the legal form of the second company and the accounting system it uses.[38] The methodology we propose below would have the benefit of eliminating any ambiguity with respect to these other types of organizations, as it could be applied consistently across a variety of investment structures, while, at the same time, providing an accurate reflection of the realities of a first company's investments.

1. Flaws in the NPR's calculation methodology.

The NPR's methodology is designed to determine a percentage of the value of a first company's investment in a second company—in relation to the value of all other equity investments in the second

---

[37] *See Patagonia Corp.*, 63 Fed. Res. Bull. 288, 292 (1977); Letter to John L. Douglas, Esq., from the Secretary of the Board, dated April 5, 1982.

[38] 84 Fed. Reg. at 21,660, proposed 12 C.F.R. § 225.34(a).

company—at a given time. Through a series of calculations, amounts assigned to the first company's investment in the second company (Investor Common Equity[39] and Investor Preferred Equity[40]) are divided by the second company's "Issuer Shareholders' Equity." Retained earnings (and accumulated losses) and other changes to equity capital not specifically allocated to preferred stock would be included in the amount of equity allocated to common stock. All classes of common (voting and nonvoting) would be treated as a single class. If a company has issued different classes of common stock with different "economic interests per share," an adjustment would be made to the number of shares of common stock "to equalize the economic interest per share."[41]

Under this calculation, dividends paid and/or losses would reduce only the common equity in the numerator and the Issuer Shareholders' Equity in the denominator, which would result in a first company holding preferred stock being attributed a higher percentage of the second company's total equity. That is, Investor Preferred Equity would not be reduced by losses and other reductions in capital, but the denominator, *i.e.*, the Issuer Shareholders' Equity, would be reduced by accumulated losses or other reductions in capital.[42]

For example, assume a first company wishes to make an investment in Company X, an "early-generation" financial technology firm. Prior to the investment, Company X's balance sheet reflected the following equity:

Preferred Stock Series A 100 Shares @$1,000	$100,000
Preferred Stock Series B 100 Shares @$1,000	$100,000
Common Stock 100,000 Shares Issued/Outstanding ($0.10 par)	$ 10,000
Retained Earnings (as a result of operating losses)	($110,000)
Total Shareholders' Equity	$100,000

Before the first company's investment in Company X, *both* the Series A holder and the Series B holder would be deemed to control 100 percent of Company X's Issuer Shareholders' Equity under the Board's proposed formula:

39 Investor Common Equity is defined as the greater of (i) zero and (ii) the investor's percentage of issued and outstanding shares of common stock multiplied by the amount of shareholders' equity of the second company not allocated to preferred stock under US GAAP. *Id.*, proposed 12 C.F.R. § 225.34(b)(2).

40 Investor Preferred Equity is defined as the greater of (i) zero and (ii) the investor's percentage of issued and outstanding shares of a class of preferred stock multiplied by the amount of shareholders' equity of the second company allocated to the class of preferred stock under US GAAP. The calculation would be completed for each class of the second company's preferred stock owned by the First Company. *Id.*, proposed 12 C.F.R. § 225.34(b)(3).

41 *Id.* at 21,650 n.79.

42 Reductions in a company's total equity capital result from the payment of cash dividends as well as losses experienced by the company over time.

Investor Common Equity	$0
Investor Preferred Equity (100/100*$100,000)	$100,000
Total Equity Percentage ($100,000/$100,000)	100%

In other words, before the first company has made its investment, the NPR would require attribution of a total of 200 percent of the total Issuer Shareholders' Equity, and would result in both the Series A and Series B holders being presumed to control Company X.[43]

This result becomes even more absurd with the addition of other investors, or if Company X has additional losses. Assume that the first company wishes to acquire 10 percent of Company X's equity with Company X being valued at $1 million post-investment.[44] The first company intends to acquire 100 shares of new Preferred Stock Series C, which is nonvoting, at $1,000 per share for a total of $100,000. The first company's interest would be converted to 10 percent of Company X's common shares upon an initial public offering of Company X's equity or the sale of Company X to a third party.

Immediately after the investment in the Series C Preferred, Company X's balance sheet would reflect the following equity:

Preferred Stock Series A 100 Shares @$1,000	$100,000
Preferred Stock Series B 100 Shares @$1,000	$100,000
Preferred Stock Series C 100 Shares @$1,000	$100,000
Common Stock 100,000 Shares Issued/Outstanding ($0.10 par)	$ 10,000
Retained Earnings	$(110,000)
Total Shareholders' Equity	$200,000

Under the NPR's proposed methodology, the first company's 10 percent investment would reflect a total equity percentage as follows:

Investor Common Equity	$0
Investor Preferred Equity (100/100*$100,000)	$100,000
Total Equity Percentage ($100,000/$200,000)	50%

43 In effect, the NPR's proposed methodology would appear to view equity with a liquidation preference as giving its holder a greater ability than a holder of common stock to influence the management and policies of a second company. For example, under the NPR, the holder of preferred stock that votes together with the common stock on all matters would be viewed as having a greater percentage of the second company's total equity notwithstanding the actual voting power attributable to such preferred stock. We do not believe that a right in liquidation provides any influence over a second company while it is a going concern. In fact, the NPR's proposed total equity calculation for any company with low or negative GAAP shareholders' equity will necessarily be dominated by the preferred classes, whether or not the preferred shares are convertible or carry any voting or governance rights. This is especially illogical in the case of nonvoting, nonconvertible preferred stock, which issuers and investors view as similar to a debt instrument with no control rights.

44 A valuation of $1 million of a company with GAAP shareholders' equity of $100,000 could reflect the projected value of the company's earnings power, which would not be reflected in historical cost accounting.

The first company's investment in Company X would be deemed to result in a total equity percentage of 50 percent, and therefore would result in the first company being presumed to control Company X without regard to business relationships, directors, business terms, officer interlocks or any other factor in the proposed framework. Moreover, the Series A and Series B holders would also each control 50 percent of Company X's total equity, and would therefore also be presumed to control Company X. If Company X were to have suffered an additional $100,000 in operating losses prior to the investment, then each of the first company, the Series A holder and the Series B holder would own *100 percent* of Company X's Issuer Shareholders' Equity.

Similar results can occur even if retained earnings are positive. Assume that Company X's balance sheet reflected the following equity after an investment by the first company to acquire the Preferred Stock Series B, or 10 percent of Company X, at a post-investment valuation of $1 million:

Preferred Stock Series A 100 Shares @$1,000	$100,000
Preferred Stock Series B 100 Shares @$1,000	$100,000
Common Stock 100,000 Shares Issued/Outstanding ($0.10 par)	$ 10,000
Retained Earnings	$ 100
Total Shareholders' Equity	$210,100

After the investment, the first company (as the Series B holder) and the Series A holder would each hold a total equity percentage calculated as follows (and, as a result, would each be presumed to control Company X):

Investor Common Equity	$0
Investor Preferred Equity (100/100*$100,000)	$100,000
Total Equity Percentage ($100,000/$210,100)	47.6%

GAAP equity value on a company's balance sheet is not how investors measure the value of their investments or decide the price they should pay. The market value of an investment, including in a bank or other financial institution, can differ substantially from the GAAP book value. For investments in nonfinancial companies, GAAP value of equity will often not bear any relationship at all to market value, and in the case of early-stage companies, almost never does. Investors are much more likely to consider what they are paying for their shares relative to the post-money valuation of the company.

2. Recommended changes.

If the Board determines to proceed with total equity as a factor in determining controlling influence, we offer the following recommended methodologies that could be used depending on the facts of the investment. These methodologies would be applied depending on (1) if the first company's investment is only in the second company's voting equity and (2) all other investments.

a. Calculation methodology.

First, the total equity calculation should be required only if an investor holds "nonvoting equity." If the first company holds only voting equity, there should be no need to calculate total equity in addition to the calculation of ownership of any class of voting securities to determine what power such holdings provide to the first company. The calculation of the percentage of any class of voting securities is based on generally static numbers—the number of votes that can be cast by the first company and the total number of votes that may be cast on the same matter. Such a calculation provides a reliable mechanism to determine the actual influence a first company could have over the second company's management and policy decisions through voting power that results from the size of the first company's investment. In addition, for the reasons discussed in section III.I below, a calculation of total equity should not be required if there is a significantly larger holder of the second company's voting equity, as a significant voting position would allow such shareholder to control the second company regardless of the amount of total equity held by the first company.

Second, in cases where the first company controls equity instruments other than voting stock, the Board should calculate total equity based on a "common stock equivalent method." This method would be applied by calculating the first company's total equity by dividing (1) the sum of common shares and common share equivalents (*i.e.*, instruments that by their terms are convertible into a number of common shares, such as convertible preferred stock) controlled by the first company, and the number of common shares that are equivalent to the value of any other equity instrument(s) the first company controls that are not by their terms convertible to common equity at any time (*e.g.*, nonconvertible preferred stock), by (2) the sum of the second company's issued and outstanding common shares and common share equivalents, and the number of common shares that are equivalent to the value of all other equity instruments of the second company that are not by their terms convertible to common equity at any time. This method would require the first company to calculate the value of its investment in equity instruments other than common shares and common share equivalents, and "convert" the investment into an equivalent number of common shares based on the investment's value.

We believe this methodology reflects the first company's relative economic interest in the second company, whereas the NPR's calculation methodology does not. This "common equivalent" method is a better measure of how "large" the first company's investment is from the second company's viewpoint, and therefore the amount of influence the first company could potentially have over the second company. Presumably, if a first company and a second company each agree to business terms whereby the first company pays $1 million for an interest in the second company at a post-money valuation of $10 million, then each party views the first company as purchasing a 10 percent interest in the second company. Such a valuation would not, however, be reflected in a second company's GAAP financial statements, which are based on historical cost, nor would the first company regard the GAAP book value of the second company's equity as determinative when making its investment decision. As a result, the "common equivalent" method would provide a better measure than under the NPR's proposed methodology to determine the size of the first company's actual equity ownership and any related influence the first company may have.

The value of the first company's investment in equity instruments other than common shares and common share equivalents would be determined by the first company in good faith and subject to its established investment policies and procedures. The first company would be required to document the methodology for determining the valuation as well as any data supporting such a valuation, which could include investment banking materials and the presence of other investors making similar or comparable investments. We recognize that, even within these boundaries, there is an element of judgment and subjectivity, but submit that this is preferable to a nominally objective methodology that would frequently produce an absurd result.

b. Timing of calculation.

The NPR would require a first company to calculate its total equity interest in a second company each time the first company "acquires control over or ceases to control equity instruments of the second company."[45] We believe that this calculation generally should apply only where a first company *acquires* control over equity instruments of a second company. There should be no general requirement for the calculation at any time the first company "ceases to control equity instruments" of the second company, unless a first company ceases to control equity instruments of a second company that the first company is deemed to control for BHC Act purposes. Otherwise, a control presumption could be triggered at a time when a first company is actually reducing the size of its investment in, and therefore the significance of its potential influence over, the second company.

In addition, because the NPR requires a first company to calculate its total equity interest in a second company only when the first company acquires or ceases to *control equity instruments* of the second company, the NPR can be read not to permit a first company that is divesting control of a second company to do so through the dilution of its equity interests. For example, if a first company were to control 40 percent of the total equity of a second company through a series of preferred stock, and the second company issued additional shares of the same series that diluted the first company's interest to less than 25 percent of total equity, the first company could not re-calculate its ownership percentage because it did not acquire or cease to control an equity instrument of the second company. As a result, even though the first company would no longer trigger a presumption of control, it is still treated as if it controlled the second company by owning 40 percent of the second company's total equity. The final rule should therefore confirm that a first company that is divesting control of the second company may calculate its total equity percentage at any time the second company's Issuer Shareholders' Equity is increased.

c. Consideration of debt instruments and other interests in total equity.

The NPR provides that certain debt and other instruments (*e.g.*, profit-sharing interests) that are "considered functionally equivalent to equity" would be included as equity for purposes of calculating total equity.[46] The Board's rationale for this treatment is to "prevent evasion that the Board has encountered in prior cases."[47] With respect to debt instruments, the NPR acknowledges that "it would be unusual for debt to be considered functionally equivalent to equity," and the NPR provides a list of factors that could cause a debt instrument to be considered functionally equivalent to equity.[48] These factors are, however, quite broad and leave substantial uncertainty as to whether a variety of instruments, many of which have little or no characteristics of equity, would be treated as equity, including subordinated debt.

---

[45] 84 Fed. Reg. at 21,660, proposed 12 C.F.R. § 225.34(e).

[46] *Id.*, proposed 12 C.F.R. § 225.34(c).

[47] *Id*. at 21,651.

[48] *Id*. at 21,651. We also note that the listed factors, particularly treatment as equity under tax laws or accounting standards, inadequacy of the equity underlying the debt and issuances of debt that are not on market terms could make it impossible for a first company to lend to, or buy debt of, a troubled company.

We are particularly concerned with the suggestion in the NPR that subordinated debt is inherently equity-like.[49] This is inconsistent with the NPR's general assertion that "it would be unusual for debt to be considered functionally equivalent to equity." Subordinated debt is not rare or unusual, and the Board should not treat it as equity unless it includes one or more of the other characteristics of equity outlined in the proposed 12 C.F.R. § 225.34(c)(3). Moreover, any sort of presumption that subordinated debt is equity-like would also be inconsistent with the Board's long-standing position on subordinated debt.[50]

Moreover, the NPR is inconsistent with the Board's historical practice with respect to profit-sharing interests. For example, the Board previously determined that a first company's receipt of carried interest based on the performance of an investment in the second company was not an equity interest in the second company.[51] This is apparently in conflict with the NPR's treatment of profit-sharing interests as equity.[52] We believe that profit-sharing interests have little, if any, potential for control. Because such an interest is solely a right to a distribution dependent on future profitability, which may never be realized, it is difficult to see how a first company holder of such an interest could use the threat of a sale or other disruptive activities to influence the second company.

For these reasons, the Board should not include the existence of instruments that are "functionally equivalent to equity" in the calculation of total equity.

With respect to the potential for evasion, we note that debt and other relationships could be considered in the analysis of the contractual powers a first company has over the second company under the tiered presumptions (*i.e.*, whether the contractual relationships for such instruments grant the first company contractual rights that are indicative of actual control).[53] This should eliminate evasion concern with respect to including "equity-like" instruments in the calculation of total equity.

---

49 *Id*. at 21,660, proposed 12 C.F.R. § 225.34(c)(3)(ii) (providing that "subordination to other debt instruments issued by the second company," is an "equity-like characteristic" that could trigger equity treatment).

50 *See, e.g.*, *NationsBank*, 80 Fed. Res. Bull. 154 (F.R.B.), 1994 WL 41860 (determining that a NationsBank subsidiary could provide "substantial senior and subordinated debt financing to certain companies" together with warrants of up to 24.9 percent of the borrower's voting shares, subject to conditions that NationsBank would not own any equity in any of the borrowers and would not exercise the warrants without Board approval); *Wells Fargo & Company*, Order Approving Notice to Engage in Certain Lending Activities (Dec. 13, 1995) at n.2, 1995 WL 737965 (F.R.B.) (permitting a bank holding company to engage in financing transactions coupled with an equity investment in the borrower, apparently without treating the debt as equity).

51 Letter to Gary Rice, Esq., dated July 18, 2007. We note that the Volcker Rule similarly excludes carried interest (*i.e.*, "restricted profit interest" as defined in the Volcker Rule) from the definition of "ownership interest" with respect to covered funds. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,536, 5,709 (Jan. 31, 2014).

52 The NPR position on profit-sharing interests also creates general uncertainty regarding other instruments the Board historically has not treated as equity.

53 We note that standard, market-term loan covenants of the kind described in section III.C.2 below would not be provisions of the type that would cause a debt instrument to be indicative of control.

Should the Board determine to continue to include "equity-like" instruments in the calculation of total equity, it should only do so in cases where such instruments are coupled with an actual equity position of more than five percent of the second company's equity capital.

d. Treatment of interests not derived from the second company's earnings.

The NPR is silent on whether certain special interests, such as tax equity, would be included in the calculation of total equity. We submit that such interests should not be considered an investment in the second company's total equity. Such interests do not provide the first company full economic exposure to the second company, as a true equity investment would, but are intended to provide the first company some other benefit in exchange for its investment. For example, tax equity provides the first company the right to claim the second company's tax credits in exchange for cash financing. In effect, the second company is monetizing its tax credits by selling or trading them to the first company. The first company has no claim to anything other than a tax benefit as a result of this investment, and therefore would not be able to exercise a controlling influence over the second company. For these reasons, the final rule should clarify that tax equity and other special interests that are not derived from the second company's earnings will not be treated as equity.

e. Investments in parent companies of a second company.

We submit that the inclusion of any portion of a parent company's investment in a second company should occur only if the first company controls the parent company. A pro rata approach in circumstances where the first company does not control the parent of the second company, as included in the NPR, is precluded by Section 2(g)(1) of the BHC Act, which provides that only "shares owned or controlled by [a] *subsidiary* of a bank holding company shall be deemed to be owned or controlled by such bank holding company."[54] Such an approach also contravenes logical analysis of control. If the first company does not otherwise control the second company, the first company cannot be deemed to control shares held by the second company in one or more third companies.

C. The scope of contractual limitations that would result in a presumption of control are too broad.

1. The NPR's definition of "limiting contractual rights" would capture contractual terms that bank holding companies and FBOs include to preserve the basic conditions under which the investment was made (which contributes to overall safety and soundness), to protect the investor's reputation and to maintain compliance with applicable legal and regulatory requirements.

Under the Board's post-1982 practice, certain contractual rights, such as a first company's ability to veto one or more significant operational or policy decisions of a second company, have raised controlling influence concerns. The NPR would significantly expand this practice by creating a presumption that a first company controls a second company if the first company owns five percent or

54 12 U.S.C. § 1841(g)(1) (emphasis added).

more of any class of the second company's voting securities and "has *any* limiting contractual right with respect to the second company or any of its subsidiaries . . . ."[55]

As an initial concern, the Board would define "limiting contractual right" as any right that allows the first company to restrict or to exert significant influence over decisions related to an enumerated list of potential activities, but it does not define the meaning of "significant influence" nor does it limit the scope of the definition to the enumerated list of activities. Such open-ended language contravenes the principles of certainty and transparency that the Board intended the NPR to advance, and confers virtually unlimited discretion to Board staff to interpret the impact of contractual provisions in the context of controlling influence determinations. The Board, therefore, should limit the scope of the definition of "limiting contractual right" to an enumerated list of rights that provide actual control.

Even if the final rule is limited to an enumerated list of "limiting contractual rights," the NPR would define "limiting contractual right" to include contractual terms that are not used to allow the first company to control the second company, but rather to allow the first company to protect against certain legal or regulatory risks, or to preserve the basic conditions under which the investment was made. Specifically, the NPR includes in the definition of "limiting contractual right" restrictions on (1) the second company's ability to enter into new lines of business; (2) how the second company directs the proceeds of the first company's investment; (3) the second company's ability to incur debt above specified limits or if the additional debt would cause the second company to fail to maintain a specified financial ratio; (4) the second company's ability to "amend the terms of any equity or debt securities issued by the second company"; and (5) the second company's ability to "significantly alter [its] accounting methods and policies, or its regulatory, tax, or liability status."[56]

These are contractual terms that are frequently required by investors as protectionary measures to prevent the company from significantly altering the terms under which the investment was made, or from creating significant reputational risks for the investor.

For example, engaging in significant lines of business that were not foreseen at the time of the investment would undermine the factual basis on which an investor conducted its analysis regarding whether or not an investment should be made. This analysis is even more important for bank and financial holding companies and FBOs, which must ensure that their investments comply with the BHC Act. A financial holding company could make a non-controlling investment in a financial company under Section 4(k) of the BHC Act, but if the company were to engage in a new line of business that was not "financial in nature," the investment would no longer be permissible or could jeopardize the financial holding company's reputation. A similar problem could arise if the second company sought to control a bank. Likewise, if a second company were free to direct the proceeds of the first company's investment without restriction, it could materially alter the terms of the investment by using the funds in a manner that is materially different from the use for which the funds were solicited and/or in a manner that creates significant reputational issues for the first company.

---

55 84 Fed. Reg. at 21,658–59, proposed 12 C.F.R. § 225.32(d)(5) (emphasis added).

56 *Id*. at 21,657, proposed 12 C.F.R. § 225.31(e)(5).

With respect to restrictions on the incurrence of debt, if the second company were free to incur additional debt without limitation, the second company could significantly alter the terms of the first company's investment by, for example, incurring so much debt that the first company would not be able to receive a return of its capital in a liquidation scenario, including any liquidation preference or other return that was negotiated at the time of investment. There could also be reputational risk for the first company if the second company were to become financially troubled because of over-leverage.

Moreover, as noted above, the NPR would define "limiting contractual right" to include restrictions on the second company's ability to amend the terms of *any* of its equity or debt securities. Read literally, this would mean that the first company could not protect the basic terms of its investment by retaining the right to approve changes, including those that would significantly and adversely affect the rights of the first company, to the very class of securities in which the first company invested. This would significantly affect the soundness of the investment, because the first company could never assure that the terms of its securities would remain substantially the same over time.

Finally, covenants that limit the second company's ability to alter its accounting policies or regulatory, tax, or liability status are consistent with sound business practices and are intended to prevent the second company from altering its status in a way that would be materially adverse to the first company. Indeed, the NPR would exclude from the definition of "limiting contractual right" covenants that are designed to preserve the second company's "tax status or benefits" (*e.g.*, preservation of the second company's status as an S corporation).[57] This is in apparent conflict with the NPR's inclusion in the definition of "limiting contractual right" of covenants that restrict the second company's ability to significantly alter its tax status.

We do not believe that any of the contractual restrictions described above provide actual control over the second company. The second company remains free to carry out and manage its existing business without any undue influence from its investors. Restrictions of the kind described above merely assure that the second company cannot alter the basic conditions under which the investment was made or create legal and regulatory issues for the first company.

Moreover, the exclusion of certain covenants from the definition of "limiting contractual right" may not be broad enough to allow the first company to protect the fundamental terms of its investments or its legal and regulatory status. First, the NPR would not permit a first company to limit the second company's ability to amend its articles of incorporation or bylaws, "other than in a way that is solely defensive for the first company."[58] Historically, the Board has permitted the first company to have consent rights over such changes if they would significantly and adversely affect the rights or interests of the first company.[59] We believe the Board intended to retain this practice in the NPR. "Solely

57 *Id.* at 21,658, proposed 12 C.F.R. § 225.31(e)(5)(ii)(J).

58 *Id.*, proposed 12 C.F.R. § 225.31(e)(5)(i)(J).

59 *See, e.g.*, Board Interpretive Letter of Aug. 24, 2005, 2005 WL 5408992 (F.R.B.) (determining that a first company would not "control" a second company under the BHC Act, even though the first company had an effective veto right over the second company's ability to "amend any provision of its certificate of

defensive," however, is ambiguous and could be read more narrowly than "significantly and adversely affects." The final rule should, therefore, more clearly articulate the scope of permissible covenants in this regard in a manner that is consistent with the Board's current practice.

Second, the NPR would permit the first company to receive financial reports "of the type ordinarily available to common stockholders."[60] We believe this provision should be expanded to include information "necessary or appropriate to allow the first company to properly account for its investment or monitor compliance with applicable legal or regulatory requirements." For example, a first company that uses the equity method of accounting may need special information from the second company to account for its investment (including early access to financial reports). In addition, an investor should be able to obtain information necessary to monitor compliance with applicable law.[61] Moreover, a first company should be able to obtain all financial information that holders of the same class or priority receive.

We also note that the NPR would create presumptions of control based on contractual rights that do not create actual control. In particular, standard commercial terms in venture financings could cause a first company to be presumed to control a second company, even in circumstances where the first company could not unilaterally exercise contractual rights or determine whether they are exercised. For example, a contractual provision that restricts the ability of the second company to merge absent the approval of a majority of preferred shareholders could create a presumption of control under the NPR's definition of "limiting contractual right," even if multiple investors had such approval rights and one or more investors held a greater percentage of preferred stock than the first company. Accordingly, the final rule should provide that "limiting contractual rights" will not trigger a presumption of control, provided that (1) the contractual right is a standard, "market" term for the type of investment being made; (2) the first company may not unilaterally exercise such right (*i.e.*, at least one investor other than the first company must exercise the same right); and (3) to the extent that the exercise of such a right requires the consensus of a certain percentage of holders of the instrument, the first company is not the largest holder of such right in determining the consensus. In all events, in such a consensus situation, the right should not be deemed a limiting contractual right if the first company represents less than 25 percent of the total instruments entitled to exercise the contractual right.

We note one other issue that potentially arises from the NPR's definition of "limiting contractual right." The NPR would define "limiting contractual right" to include any right that would allow the first company to "restrict or exert significant influence over decisions related to . . . the second company's payment of dividends on *any class* of securities . . . ."[62] This potentially could be read to be in conflict with the NPR's definition of (and the Board's historical practice relating to) "nonvoting securities," which

---

incorporation if such action could *significantly and adversely affect* the rights or preferences of the preferred shareholders") (emphasis added).

60 84 Fed. Reg. at 21,658, proposed 12 C.F.R. § 225.31(e)(5)(ii)((B).

61 For example, financial information not typically available to common shareholders may be necessary to monitor compliance with Section 4 of the BHC Act or federal or state laws that require filings when investors' and their affiliates' ownership levels exceed certain thresholds.

62 84 Fed. Reg. at 21,658, proposed 12 C.F.R. § 225.31(e)(5)(G) (emphasis added).

include securities that grant the holder the right to vote on "the payment of dividends by the issuing company when preferred dividends are in arrears."[63] As a result, it may not be possible for an investor to hold both a limited amount of nonvoting preferred stock and voting stock. Assume that (1) a company holds a second company's nonvoting preferred shares representing 10 percent of the second company's equity, (2) the terms of the preferred stock provide that the second company may not issue dividends on its common shares while dividends on the preferred shares are in arrears without the approval of the preferred shareholder, and (3) the first company also owned as little as five percent of a class of the second company's voting securities representing another 4.5 percent of the second company's total equity. The first company would be presumed to control the second because it would control five percent or more of a class of the second company's voting securities and would have a contractual right to restrict or exert a significant influence over certain decisions related to the "payment of dividends on any class of securities." In that case, the ownership of nonvoting preferred stock equal to 10 percent of the second company's equity and total stock ownership representing 14.5 percent of the second company's total equity would have the anomalous result of constituting control, whereas ownership of 24.9 percent of the second company's voting stock (and no additional investment in the second company's preferred stock), representing over 22 percent of the second company's total equity, would not. We believe this may be an unintended consequence, and the final rule should provide that the definition of "limiting contractual right" does not include standard preferred terms.

2. The NPR's presumption of control relating to "limiting contractual rights" would capture standard loan covenants that do not provide a first company the ability to exercise actual control.

The NPR would also appear to expand meaningfully the Board's existing approach to contractual limitations in loan documents. A number of examples of "limiting contractual rights" set forth in the NPR, including restrictions on the second company's ability to merge or consolidate, or to acquire or liquidate subsidiaries, and requirements that the second company maintain certain financial targets or limits, are standard market terms for loan documents. Although the NPR does recognize that "standard debtor-creditor covenants . . . [do not] by themselves raise controlling influence concerns,"[64] the NPR goes on both (1) to state that such covenants would raise controlling influence concerns "when a company [also] has a material voting ownership interest,"[65] and (2) to define "material" very broadly to include as little as a five percent voting interest.[66] On this basis, the NPR would create a presumption of control if a first company holds as little as five percent or more of any class of a second company's voting securities and the first company also has any "limiting contractual rights," even if those rights arise from standard terms in loan documents.[67]

---

63 *Id*. at 21,655, proposed 12 C.F.R. § 225.2(q)(2)(i).

64 *Id*. at 21,638.

65 *Id*. at 21,642.

66 *Id*.

67 *Id*. at 21,657–58, proposed 12 C.F.R. § 225.31(e)(5).

We respectfully submit that this approach is inconsistent with the Board's originally stated rationale for restricting contractual covenants. This rationale was to prevent investors from substituting "contractual agreements for rights *normally achieved through voting shares*."[68] Loan agreements entered into on market terms, however, are not such substitutes; to the contrary, they simply provide rights that are ordinarily obtained by lenders regardless of whether the lender also holds a portion of the borrower's voting stock. Indeed, the Board has recognized this distinction between covenants in loan documents and covenants tied to equity investments, noting that a lender is not in the same position to influence a company because the company can simply prepay the loan to avoid any influence the borrower may have.[69] Because of such prepayment rights, standard loan covenants do not raise the same concerns as other contractual covenants that cannot be eliminated by the second company, and therefore should not implicate the Board's rationale for restricting the use of contractual covenants.

Unless modified, the NPR's approach would effectively prohibit a bank from making a loan to any company in which an affiliate has made an investment of five percent or more. If a loan could not include standard covenants that protect the bank's interest, there would be safety and soundness concerns and potentially issues under Sections 23A and 23B of the Federal Reserve Act.[70] For all these reasons, the NPR should not include "standard debtor-creditor covenants" in the definition of "limiting contractual right" unless the loan agreement prohibits the second company from prepaying the loan.

At the very least, loan covenants should not be considered part of the control analysis if (1) the loan covenants were of the type typically found in arm's-length debt arrangements of the same type, (2) there were multiple lenders to the second company or (3) the loan was made separately from the equity investment. In any event, we believe that the definition of "material voting interest" for this purpose should be raised to 15 percent, or at least 10 percent.

D. Although we generally support the Board's proposal with respect to director appointees, we have two primary concerns with the approach.

1. In appropriate circumstances, the final rule should not classify a second company's director as a representative of the first company solely because such director was nominated or proposed to serve by the first company.

The NPR would include in the definition of "director representative" any individual that serves on the board of directors of a second company who "was nominated or proposed to serve by the first

---

68 1982 Policy Statement at 30,966 (emphasis added).

69 *See, e.g.*, *id*. at 30,967 ("Another step to avoid control [with respect to contractual covenants] is the right of the acquiree to 'call' the equity investment and options and warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right makes such investments or agreements *more like a loan* in which the borrower has the right to escape covenants *and avoid the lender's influence by prepaying the loan*.") (emphasis added).

70 For example, if a bank holding company or its non-bank subsidiary were to acquire five percent of a second company's voting shares, and the second company were deemed to be controlled as a result of covenants in a loan between the holding company's banking subsidiary and the second company, then the loan would immediately create a "covered transaction" subject to Section 23A of the Federal Reserve Act. The bank's inability to obtain normal contractual terms could create an issue under Section 23B.

company."[71] The NPR explains that this definition would attribute to the first company all directors proposed by the first company, "whether by exercise of a contractual right *or otherwise*."[72] In certain cases this definition would include directors that should be attributed to the first company, such as a director appointed by the first company in accordance with a shareholders' agreement. The definition is, however, overly broad and would attribute director representation to the first company in cases where the director is not subject to any influence from the first company.

a. The final rule should not classify directors or general partners of a mutual fund or other investment vehicle as the first company's "director representatives," if the directors or general partners are independent of the first company.

The NPR's definition of "director representative" is a particular concern for mutual funds and other investment vehicles or partnerships that are sponsored and advised by a bank holding company. In many cases, independent directors or general partners are initially selected by the investment adviser when the fund or investment vehicle is formed,[73] who are later ratified by the fund's shareholders after the fund has been seeded. This process does not permit the investment adviser to exercise a controlling influence over the investment vehicle, but allows a bank holding company to sponsor and advise the vehicle during the seeding period, while also assuring independent directors or independent general partners are in place to oversee the operation of the investment vehicle. These directors or general partners are not subject to the adviser's influence, and, in many cases, have the power to remove the investment adviser with or without cause. Nonetheless, the NPR would apparently permanently attribute these representatives to the investment adviser, despite the presence of a robust independence standard for directors.

To avoid these results, the final rule should clarify that directors or general partners of a mutual fund or other investment vehicle who are independent of the investment adviser (*i.e.*, they would not be attributed to the investment adviser under proposed 12 C.F.R. §§ 225.31(e)(2)(i)(B) through (D)) will not be deemed to be the adviser's "director representatives," even though they may initially be selected by the investment adviser. Directors or general partners who are not independent of the investment adviser, and who could therefore remain subject to the adviser's influence, would still be deemed to be the adviser's "director representatives" under proposed 12 C.F.R. §§ 225.31(e)(2)(i)(B) through (D). We believe these provisions would serve to avoid any potential evasion by attributing to the investment adviser any of the investment vehicle's directors or general partners who are not independent at the time their service as a director begins or who have served as employees or directors of the investment adviser within the previous two years (or, if our proposal described in section III.D.2 below is adopted, 12 months in the case of former independent directors of the investment adviser).

---

71 84 Fed. Reg. at 21,657, proposed 12 C.F.R. § 225.31(e)(2)(i)(A).

72 *Id*. at 21,653 (emphasis added).

73 By law, at least 40 percent of the fund's board of directors must be independent of the adviser. 15 U.S.C. § 80a-10(a). In practice, this percentage is much higher and the boards of nearly all funds consist of at least a majority of independent directors.

b. The final rule should confirm that director representatives who were not actually nominated by the first company will not be attributed to the first company.

The NPR's definition of "director representative" is so broad that it could potentially be read to attribute director representatives to a first company in circumstances where the first company has not, and could not, exercise more than a minor influence, much less actual control, over the selection of the directors. For example, if a first company suggests a name to a second company's nominating committee, the NPR could be read to provide that the individual was "proposed to serve by the first company," even if the individual were independent of the first company, nominated through the second company's nomination process and elected by the second company's shareholders. The final rule should confirm that directors who are merely "suggested" by the first company (as opposed to being formally nominated by the first company) would not be deemed to be director representatives of the first company. To guard against evasion, a person "suggested" by a first company could be limited to an individual who has not served as an officer, director, employee or principal shareholder of the first company for two years and has not in the prior three years served as a director of any other company at the suggestion of the first company.

2. In attributing directors of a second company to a first company, the final rule should distinguish between former independent directors of the first company and former employees of the first company.

The proposed rule's definition of "director representative" includes any individual who has not only served as an employee of the first company during the immediately preceding two years, but who also served as an independent director during this period.[74] We believe that a distinction should be made between former employees and former independent directors. The very purpose of an independent director is to provide outside challenge to, and oversight of, an organization's management team rather than to be part of the management team. Accordingly, a first company's former independent director's service on a second company's board should not raise the same concerns as a former employee's service. If, however, the Board determines any "cooling off" period is necessary for an independent director, we believe a shorter period would be appropriate. We recommend that a former independent director of the first company should be deemed to be a "director representative" of the first company only if the director had served as a director of the first company during the immediately preceding 12 months.

E. The final rule should not create a presumption of control because a second company is consolidated on the balance sheet of the first company under U.S. GAAP.

The final rule should not include consolidation of a company under U.S. GAAP (or comparable financial accounting standards in other jurisdictions) as a rebuttable presumption of control. The use of a GAAP approach in the "controlling influence" framework introduces a concept that is established by an unrelated standard-setting body to achieve different objectives, and which could change at any time in the future without the need to consider how such changes could affect the Board's control framework.[75] The

---

[74] 84 Fed. Reg. at 21,657, proposed 12 C.F.R. § 225.31(e)(2)(i)(C).

[75] For example, the Financial Accounting Standards Board's ("FASB") mission—namely, "to establish and improve financial accounting and reporting standards to provide useful information to investors and other

BHC Act's "controlling influence" standard, in contrast, is intended to further the policies underlying the BHC Act, including the separation of banking and commerce. It is, therefore, unsurprising that creating a presumption of control under the BHC Act's "controlling influence" standard that is based on GAAP consolidation would have unintended effects and severe adverse consequences for banking organizations.

These effects are particularly acute with respect to entities that must be consolidated as an accounting convention under U.S. GAAP, but that are not actually controlled, such as variable interest entities, asset-backed commercial paper conduits ("ABCP Conduits"), structured finance vehicles and similar passive investment arrangements (collectively, "VIEs"). VIE consolidation under GAAP is driven not by the ability to influence the management or policies of the VIE, but by the services provided to the VIE and exposure to the associated upside or downside.[76] A presumption based on GAAP consolidation would expand significantly the universe of a banking organization's potential controlled entities, principally because of the inclusion of VIEs.

The GAAP approach to consolidation of VIEs often requires that they be consolidated notwithstanding the inability of the holder of an interest in the VIE to exercise control over the entity. For example, a loan servicer that holds subordinated securities in the VIE has a variable interest in the performance of the entity but does not dictate the entity's policies and managerial framework, which are established in the entity's foundational documents and cannot be changed by the servicer. Yet, a GAAP consolidation requirement that automatically equates a bank holding company's VIE interest with BHC Act control would subject a bank holding company with such an interest to responsibility for the VIE's compliance under the BHC Act and potentially otherwise. A presumption that consolidated VIEs are controlled would increase the regulatory costs of participating in VIE structures, and may even be prohibitive. For example, inclusion of VIEs in holding company structures due to presuming control of such VIEs because of GAAP consolidation could result in an increased regulatory categorization under the Board's proposed framework for tailoring enhanced prudential standards, and increased capital and liquidity requirements. In the case of FBOs, presuming control of VIEs due to GAAP consolidation could result in triggering the requirement that an FBO form an IHC—an expensive and complicated prospect, especially given the "cliff effect" introduced by the FBO tailoring proposal. This would ultimately result in reduced stability, supply and liquidity in the markets for structured products. The

users of financial reports and educate stakeholders on how to most effectively understand and implement those standards" (FASB, *FASB Mission, available at* https://www.fasb.org/facts/)—does not require, and, indeed, would not even permit, FASB to consider the safety and soundness of the U.S. financial system, or to promote consistency in the regulation of banking entities. If FASB were to modify its standards for consolidation (or the equity method of accounting, which is discussed below), the scope of non-controlling investments could potentially change. As a result, non-controlling investments could become controlling, and banking organizations could be required to undertake extensive analyses of its investments to accommodate any accounting changes. Moreover, FASB accounting pronouncements can actually work at cross-purposes with the Board's policy objectives, as illustrated by FASB's pro-cyclical current expected credit losses ("CECL") standard.

76 *See* FASB, ASC 810-10-05.

result may be to drive more structured financing activity out of the banking sector and create higher levels of systemic risk.[77]

We also note that if a VIE is consolidated under GAAP, it is reflected in the consolidated liquidity and capital standards that apply to banking organizations. We believe this is sufficient from the Board's supervisory perspective. Because the risks relating to the VIE factor into the banking organization's capital and liquidity requirements, it is not necessary to treat the VIE as controlled such that it becomes an affiliate of the banking organization for a variety of other regulatory purposes.

Outside the VIE context, application of U.S. GAAP consolidation to the control analysis is unnecessary. U.S. GAAP consolidation, which generally is triggered by greater than 50 percent voting ownership of an entity, subsumes the 25 percent voting quantitative prong of the BHC Act control definition. For similar reasons, the final rule should not include presumptions of control relating to consolidation under any other accounting standard (*e.g.*, IFRS).

F. The final rule should not create a presumption of control because of equity accounting.

The NPR poses the question whether the presumption of control should be applied when the first company accounts for a second company using the equity method of accounting. We firmly believe that it should not for three basic reasons. First, the underlying standards are different. The BHC Act requires a controlling influence, whereas equity accounting requires only a "significant influence."[78]

---

77 We also understand that the Board has made informal determinations that ABCP Conduits to which an FBO provides administrative services and other support (such as credit and liquidity) would not be "subsidiaries" (*i.e.*, they would not be considered "controlled" by the FBO) for purposes of Regulation YY, provided (1) the FBO has no ownership interest and (2) the conduit has all independent directors, managers, trustees or members. Mindful of these Board views, FBOs generally structure ABCP Conduits so that the FBO does not hold equity or voting interests of the ABCP Conduit or have the ability to appoint any of the ABCP Conduit's directors. The FBO, however, is frequently required to account for ABCP Conduits as consolidated VIEs because of the administrative services and the liquidity and/or credit facilities the FBO provides to the conduit. The NPR would upset this long-standing practice relating to ABCP Conduits by presuming that they are controlled by the FBO if they are consolidated under GAAP accounting. As a result, the NPR could be read to require ABCP Conduits to be included in the total U.S. non-branch assets of the FBO for purposes of determining the $50 billion non-branch asset threshold under Regulation YY. This would be contrary to the Board's previous interpretations, and would result in substantial costs to FBOs, which could result in FBOs substantially reducing, or exiting from, this business in the U.S., which would, in turn, reduce the availability of low-cost working capital for U.S. businesses.

We note that the Structured Finance Association ("SFA") has submitted a comment letter that addresses the NPR's GAAP consolidation proposal as it relate to ABCP Conduits. BPI wishes to express its support for the SFA's letter and its proposal for excluding ABCP Conduits from the presumption relating to GAAP consolidation. As discussed in this section, we believe strongly that the final rule should not retain a presumption of control based on accounting consolidation. If, however, the Board determines to include such a presumption in the final rule, it should not be extended to ABCP Conduits.

78 FASB, ASC 323-10.

Second, equity accounting is an accounting construct that has no relation to the objectives of bank regulators, and should not act as a substitute for regulatory analysis.

Third, significant influence is presumed to exist for equity accounting purposes when a company has an investment of 20 percent or more in the voting stock of the investee, without regard to other factors. Currently, and under the NPR, however, the Board does not and would not assume that a first company has a "controlling influence" over a second company based solely on the first company's ownership of 20-24.9 percent of the voting stock of the second company. Additional indicia of "control" would be required. As a result, a first company may own a sufficient amount of voting stock in a second company to trigger the presumption for application of the equity method of accounting, while at the same time not meeting the standards in the NPR (or as applied historically) to be deemed to have a "controlling influence" over the second company.[79] Likewise, the test for whether a "significant influence" exists below the 20 percent voting threshold is a judgment that is made without regard to the BHC Act's "controlling influence" standard, which could result in the application of the equity method of accounting in cases where there is no "control" for BHC Act purposes. For example, the equity method of accounting may apply in circumstances where the first company controls 14.9 percent of the second company's voting stock and has the right to appoint two members to the second company's 10-member board. This, however, would not result in a presumption of control under the NPR.

Simply stated, the U.S. GAAP standards for application of the equity method of accounting cannot fairly be compared to the BHC Act's "controlling influence" standard. It is not surprising, then, that the Board previously determined that a first company may properly account for its investment in a second company under the equity method of accounting and, at the same time, not control the second company for BHC Act purposes.[80] For similar reasons, it is not surprising that establishing such a rebuttable presumption would produce truly absurd results, in large part because equity accounting is not related to control in fact. For example, a bank holding company with a 20 percent common stock interest in a second company and no directors or management interlocks, or any other indicium of control, would be presumed to control the second company. Yet, a bank holding company that had a 19.99 percent voting stock interest, a five percent nonvoting interest and a management interlock would correctly not trigger a presumption of control. Conflating equity accounting with controlling influence would be particularly problematic for FBOs, which would be required to place all companies for which they use the equity method under their IHCs.

---

79 Likewise, the standards under GAAP for *rebutting* the presumption of equity method accounting when an investor owns 20-24.9 percent of the voting stock in another company are also more stringent than the Board's current or proposed standards for affirmatively establishing that a "controlling influence" exists for BHC Act purposes. Overcoming the GAAP presumption requires predominant evidence to the contrary, as evidenced by specific factors included in the Accounting Standards Codification. The Board does not, and does not propose to, require the establishment of such onerous conditions for a company to demonstrate "noncontrol" for BHC Act purposes in a similar situation.

80 *See* Letter to H. Rodgin Cohen, Esq., dated April 22, 2011, *available at* https://www.federalreserve.gov/bankinforeg/LegalInterpretations/bhc_changeincontrol20110422a.pdf (determining that Mitsubishi UFJ Financial Group, Inc. would not control Morgan Stanley even though it would account for the investment under the equity method of accounting).

In summary, adoption of a presumption of control based on equity accounting would have the practical effect of lowering the statutory 25 percent standard for control to 20 percent. We assume the Board could not have intended such a result.

G. The final rule should clarify the application of the control framework with respect to VIEs.

1. The final rule should confirm that holding certain interests in a VIE and/or having the right to perform certain administrative functions do not trigger a presumption of control over the VIE.

VIEs frequently are established as passive vehicles that conduct no business other than to hold a static pool of assets.[81] Bank holding companies typically accomplish this by establishing a bankruptcy-remote trust structure with a third-party trustee. The bank holding company sells a static pool of loans to the trust, which issues debt securities to investors with a junior tranche holding the residual interests, but, as noted above, the VIE generally is consolidated with the bank holding company under U.S. GAAP.[82] In some cases, the bank holding company that sponsored the trust may have the right to remove the trustee and/or name a successor trustee. Because the bank holding company may retain the right to remove the trustee, there have been long-standing questions of whether the bank holding company would "control" the VIE. We believe the Board's framework for analyzing "control" is inappropriate in these circumstances, and that the Board should confirm that certain factors that would result in a presumption of control over an operating company would not be applicable to such VIEs.

As noted in section III.E above, the risks related to a VIE that is consolidated under U.S. GAAP are already reflected in the consolidated liquidity and capital standards that apply to banking organizations, and there is no reason to treat the VIE as an affiliate of the banking organization for other regulatory purposes. This is particularly true for passive VIEs, given the static nature of their assets. Moreover, because the VIE does not purchase and sell assets, or have any other operations, the trustee performs only administrative functions. Therefore, the power to appoint or replace the trustee does not provide the first company with the same degree of influence that such a right would provide with respect to an operating company.[83] For these reasons, the Board should confirm that none of the following factors, alone or in combination, would trigger a presumption of control with respect to passive VIEs that are related to a static pool of assets and that are consolidated with the first company under U.S. GAAP: (1) holding the power to appoint or replace the trustee of the VIE; (2) holding debt securities issued by the

---

81 That is, the pool of assets in the VIE generally remains the same over time. Certain assets may infrequently move out of the pool, such as when a loan is paid or foreclosed, but the VIE does not purchase additional assets or have a general right to sell assets.

82 Other than as required by risk retention rules, third-party investors typically would hold these residual interests.

83 We note that the Board appears to have recognized the unique nature of certain VIEs and the general inability of bank and financial holding companies and FBOs to control such entities. *See, e.g.*, Instructions for Preparation of Changes in Organizational Structure FR Y-10 at NBK-2 (noting that VIEs "generally are not reportable on the FR Y-10" because the reporting entity generally does not directly or indirectly control the VIE).

VIE (which, in some cases, particularly with respect to more junior tranches, might be considered "equity" under the NPR); (3) holding the residual, common equity tranche of the VIE; and (4) holding more than 33 percent of the VIE's nonvoting equity where a management agreement or similar contract explicitly grants an unaffiliated entity control over the VIE's policies and operations.

2. If the final rule retains the presumption of control for entities that are consolidated on the first company's balance sheet under U.S. GAAP, the Board should confirm that variable interests in VIEs are not "ownership interests" for purposes of the intermediate holding company ("IHC") requirement.

Each FBO that is subject to the IHC requirement must hold its "ownership interest" in any U.S. "subsidiary" through its U.S. IHC.[84] A subsidiary of the FBO is any company that the FBO "controls," as control is defined under Section 2(a) of the BHC Act.[85] "Ownership interest," however, is not defined for purposes of the Board's Regulation YY. If the Board determines to retain a presumption of control in cases where an entity is consolidated on the first company's balance sheet under U.S. GAAP,[86] the Board should confirm that ownership interests in a VIE include only the common equity of the VIE and do not include variable interests in the VIE that trigger U.S. GAAP consolidation. For example, an FBO that provides a liquidity or credit facility to a VIE from a U.S. branch (and therefore holds a "variable interest" in the VIE) could be required to consolidate the VIE on its balance sheet, even though there is no actual control and the interest does not represent actual ownership of the VIE. If the credit facility were deemed to be an "ownership interest," it is not clear if Regulation YY would require the banking organization to move the credit facility to the IHC or how that would be accomplished (at least not without significant cost to the FBO). For these reasons, the Board should confirm that, in these cases, the variable interest would not be considered an "ownership interest" for purposes of the IHC requirement.

H. The final rule should substantially revise the presumptions of control relating to investment funds.

1. The final rule should revise the exception for registered investment companies ("RICs"), including by increasing the amount of voting securities that the first company may hold and creating similar exceptions for foreign equivalents.[87]

Under the NPR, there is a limited exception from all presumptions of control if the second company is a RIC and other criteria are satisfied, including: (1) the only business relationships between

---

84 12 U.S.C. § 252.153.

85 12 U.S.C. §§ 252.153(f) and (z).

86 And, for the reasons discussed in section III.E above, we believe the Board should not retain this presumption.

87 The Volcker Rule includes a definition of "foreign public funds" or "FPFs" that is intended, by exempting FPFs from the definition of "covered funds," to provide treatment of FPFs that is similar to the treatment of RICs. 79 Fed. Reg. at 5,673. Because this exemption was implemented for the specific purpose of clarifying the scope of the definition of "covered fund," it contains requirements that may fail to include certain foreign funds that are equivalent to RICs with respect to how they should be viewed in a "control"

the first company and the RIC are investment advisory, custodian, transfer agent, registrar, administrative,[88] distributor and securities brokerage services provided by the first company; (2) representatives of the first company occupy 25 percent or less of the RIC's board; and (3) the first company controls less than five percent of each class of the RIC's voting securities and less than 25 percent of the RIC's total equity (or the RIC is still within the permitted seeding period).[89]

The Board notes in the NPR that these criteria are intended to preserve the Board's precedents relating to control over RICs.[90] We respectfully submit that these criteria are, in fact, at variance with important Board precedent and should be revised.

First, the Board's precedent has permitted much greater ownership of voting securities than the NPR would allow. In a 1999 letter (the "Fund Letter"), in which the Board analyzed whether a first company could provide the initial capitalization to mutual funds that it advised without being deemed to control those funds, the Board determined that the first company would not control the funds it advised and sponsored because (1) a majority of the directors of each fund would be independent of the first company, (2) the first company would not be able to control the election of directors of the funds in which it owned shares, and (3) within a six-month seeding period, the first company would own less than *25 percent of the voting shares* of any mutual fund to which it provided initial capitalization.[91] Furthermore, the Board has recognized in the context of the Volcker Rule that a first company could control up to 24.9 percent of a RIC's (or foreign equivalent's) voting shares, and provide investment advisory, administrative and other services, without being deemed to control the RIC (or foreign equivalent).[92]

Permitting ownership of up to 24.9 percent of the fund's voting securities is consistent with the operations of RICs and their foreign equivalents. Under the Investment Company Act of 1940, at least 40

---

analysis. As a result, in this letter we use the term "foreign equivalents" to refer to public funds that are registered outside the U.S., that are similar in scope and formation to RICs and that are subject to ongoing regulation in the country of registration, regardless of whether the fund qualifies as an FPF.

88 We note that the NPR does not define "administrative" services. The final rule should clarify that the scope of administrative services includes services provided by the first company to the investment fund as a non-discretionary trustee. When acting in this capacity, the trustee solely provides ministerial and administrative services that have no effect on the fund's performance, and does not have the authority to exercise any discretion with respect to the fund's assets or investments.

89 84 Fed. Reg. at 21,659, proposed 12 C.F.R. § 225.32(j).

90 *Id*. at 21,646.

91 Letter to H. Rodgin Cohen, Esq., dated June 24, 1999, *available at* https://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/1999/19990624/ (the "Fund Letter").

92 79 Fed. Reg. at 5,732 ("[T]he final rule incorporates these different concepts of control in part by providing that, for purposes of section 13 of the BHC Act and the final rule, a [RIC], SEC-regulated business development company, and a foreign public fund . . . will not be considered to be an affiliate of the banking entity if the banking entity owns, controls, or holds with the power to vote less than 25 percent of the voting shares of the company or fund, and provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund . . . .").

percent of the fund's board of directors must not be "interested persons" (*i.e.*, among other independence requirements, at least 40 percent must be persons who are unrelated to the investment adviser), and, in practice, a majority independent board is the norm.[93] Furthermore, an investment adviser cannot legally act as an adviser to the RIC unless it is pursuant to a written agreement that (1) provides that it may be terminated at any time, without penalty, by the RIC's board, and (2) is approved annually by a majority of disinterested (*i.e.*, unrelated to the investment adviser) directors.[94] As a result, the first company could not exercise actual control over a RIC or its foreign equivalent through holding less than 25 percent of the RIC's voting stock, even if the ownership position were combined with service as the RIC's investment adviser.

Second, with respect to the first company's board representation, as noted, the Fund Letter only required that a majority of the fund's board be independent of the first company. This is consistent with the Board's earlier precedent, which focused on whether director interlocks would impair the independence of the fund's board.[95] For the reasons noted above, and as acknowledged by the Board in the Fund Letter and in *Commerzbank AG*, it would not be possible for a first company to exercise control over the fund's board (*i.e.*, it could not impair the board's independence) by appointing less than a majority of the fund's directors.

For these reasons, we propose that the criteria in the proposed exception be revised such that a first company would not be presumed to control a RIC, unless the first company (1) has business relationships with the RIC other than the first company's provision of investment advisory, custodian, transfer agent, registrar, administrative (including non-discretionary trustee relationships), distributor and securities brokerage services; (2) owns 25 percent or more of any class of the RIC's voting securities (other than during the permitted seeding period);[96] or (3) has the power to appoint a majority of the RIC's board (or a majority of the RIC's board is otherwise not independent of the first company).

In addition, the NPR's "RIC exception," including its limitations, should apply to foreign equivalents (as that term is defined above), such as retail UCITS. The NPR does not provide, and we are not aware of, any rationale for limiting the exception to U.S. funds. If certain factors would not result in a first company exercising a controlling influence over a RIC, there is no reasonable basis to conclude that those same factors would result in the first company's control of a foreign equivalent. For these reasons, the final rule should confirm that the "RIC exception" applies both to RICs and their foreign equivalents.

---

[93] 15 U.S.C. § 80a-10(a).

[94] 15 U.S.C. §§ 80a-15(a) and (c).

[95] *See, e.g.*, *Commerzbank AG*, 83 Fed. Res. Bull. 678, 680 (1997) (permitting Commerzbank's chief executive officer to serve as the chairman of the four-member boards of the funds Commerzbank advised; in reaching its determination, the Board noted this was permissible because it would not impair the independence of the funds' boards of trustees, citing requirements of the Investment Company Act of 1940 that only disinterested board members may vote on the funds' investment advisory and other major contracts).

[96] The NPR would permit a one-year seeding period. Our comments on the proposed one-year seeding period are addressed in section III.H.3 below.

2. **In the case of private investment funds that are "non-covered" funds for purposes of the Volcker Rule and that have a governance structure similar to that of RICs, the final rule should expand the RIC exception to apply to such funds, or, at the very least, increase the percentage of any class of voting securities of such a fund that an investment adviser must control to trigger the presumption of control.**

The controlling influence analysis under the BHC Act is, and should be, based on the facts and circumstances surrounding the relationship between a first company and a fund it advises, and not the legal status of the fund. Accordingly, the "RIC exception," including its limitations, should apply to "non-covered" private funds that have a governance structure similar to that of RICs (*i.e.*, the fund is managed by an independent board that has the power to remove the investment adviser) ("Comparable Private Funds").[97] In such circumstances, the investment adviser to Comparable Private Funds is unable to exercise a greater degree of influence than it would be able to exercise with respect to a registered fund.

Moreover, the NPR would create a presumption of control in cases where an investment adviser controls five percent or more of any class of voting securities of a fund it advises.[98] We submit that the presumption's five percent level of investment is too low. If the RIC exception is not extended to apply to Comparable Private Funds, the percentage should, as proposed for RICs in the preceding section, be increased to 24.9 percent (or, at a minimum, 14.9 percent) with respect to Comparable Private Funds. The fact that a bank holding company is an adviser to a fund should not require that the standard ownership test of control be reduced by 80 percent, from 25 percent to just five percent. Ownership of voting equity at that level does not give rise to actual control where, as the Board recognized in the Fund Letter, the adviser does not have the ability to control the election of the fund's board, the fund's board would be independent of the adviser and the fund's directors have the power remove the investment adviser.

In the NPR, the Board notes that:

> [t]he proposed presumption of control for service as an investment advisor to an investment fund is intended to be consistent with the Board's precedents regarding when an investment advisor controls an advised investment fund under the BHC Act and the Glass-Steagall Act.[99]

The Board cites to the Fund Letter as the relevant precedent. As discussed above, however, the proposed presumption at the five percent level is not consistent with this precedent, which would permit an investment adviser to own up to 24.9 percent of a fund it advises without being deemed to control the fund.

---

97 The limitation to "non-covered" funds is intended to restrict this exception only to funds that are not "covered funds" for purposes of the Volcker Rule. *See* 79 Fed. Reg. at 5,787, §___.10(b) (defining "covered fund").

98 84 Fed. Reg. at 21,659, proposed 12 C.F.R. § 225.32(h). This presumption would not apply during the permitted seeding period.

99 *Id.* at 21,644.

3. We support the Board's proposal to provide a seeding period for investment funds, but the Board's proposed one-year period is too short and should be aligned with the Agencies' guidance under the Volcker Rule.

As noted above, the NPR's presumption of control over an investment fund would not apply if the investment adviser organized and sponsored the investment fund within the preceding 12 months.[100] This exception is intended to allow an investment adviser that provides the initial capitalization for a fund it advises to avoid triggering the presumption of control during the fund's initial seeding period.[101]

The concept of a seeding period in this context is consistent with the Board's historical practice,[102] but the proposed period is too short. The seeding period under the Volcker Rule (for proprietary trading and covered fund investment restrictions) provides flexibility so that a banking entity can provide the fund with initial equity to permit the fund to test the market and attract investors. Under the Volcker Rule, the seeding period for covered funds is a *minimum* of one year after the date of establishment of the fund,[103] and a banking entity may make an application to the Board to extend the seeding period for up to two additional years.[104] Moreover, the Board (and the other Agencies) expressly provided that an application is not necessary for RICs and FPFs to receive an extended seeding period:

> The staffs of the Agencies understand that the seeding period for an entity that is a RIC or FPF may take some time, for example, three years, the maximum period of time expressly permitted for seeding a covered fund under the implementing rules. . . . Accordingly, staff of the Agencies would not advise the Agencies to treat a RIC or FPF as a banking entity solely on the basis of the level of ownership of the RIC or FPF by a banking entity during a seeding period *or expect an application to be submitted to the Board to determine the length of the seeding period.*[105]

The Agencies further noted that the three-year period referenced in the FAQ was an example, and that, in certain cases, the seeding period can vary depending on the type of fund.[106]

---

[100] *Id*. at 21,659, proposed 12 C.F.R. § 225.32(h)(2).

[101] *Id*. at 21,644.

[102] *See, e.g.*, Letter to H. Rodgin Cohen, Esq., dated June 24, 1999, *available at* https://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/1999/19990624/ (providing for a six-month seeding period).

[103] 12 C.F.R. § 248.12(a)(2).

[104] 12 C.F.R. § 248.12(e).

[105] Board of Governors of the Federal Reserve System, Volcker Rule Frequently Asked Questions (2015), *available at* https://www.federalreserve.gov/supervisionreg/faq.htm#16 (emphasis added).

[106] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33,432, 33,443 (July 17, 2018) ("Recognizing that the length of a seeding period can vary, the staffs provided an example of three years, the maximum period of time expressly permitted for seeding a covered fund under the 2013 final rule, without setting any maximum prescribed period for a RIC or FPF seeding period."). Board staff have confirmed in conversations with BPI representatives and member institutions that the three-year seeding

The final rule should conform the proposed Regulation Y seeding period to the Volcker Rule seeding periods for RICs and FPFs for several reasons.[107] First, the factors that provided for a seeding period of longer than one year in the Volcker Rule context are equally applicable in this context. A banking entity typically invests a limited amount of its own capital in a fund as part of organizing the fund in order to establish the fund's investment performance, so that the fund can then be marketed to unaffiliated investors.[108] As the Board has recognized in connection with RICs and FPFs, a one-year seeding period would be too short to establish an investment record for many types of funds. As noted by commenters on the Volcker Rule and as recognized by the Agencies' 2018 proposed revision to the Volcker Rule, the duration of the investment record investors typically demand depends on a number of factors, but the market generally requires a record of greater than one year.[109] Investment advisers that would be subject to the Board's final rule must be able to develop these investment records for their funds to remain competitive with those of other firms that are not subject to the BHC Act.

Second, if the NPR's permissible seeding period is not brought into conformance with the Volcker Rule, the result will be that, as a practical matter, investment advisers subject to the Board's control framework will no longer be able to avail themselves of the Volcker Rule's congressionally authorized extension process with respect to covered funds. Even if such an extension were permissible under the Volcker Rule, the investment adviser would only have one year to reduce its ownership in the fund to less than five percent to avoid triggering the proposed presumption of control. If the investment adviser were unable to reduce its ownership within the NPR's one-year seeding period, the investment fund could become unmarketable, or at least uncompetitive, due to the restrictions on its activities that the BHC Act could impose, even if the investment adviser were still within the Volcker Rule seeding period.

For these reasons, the final rule should conform to the Volcker Rule's provisions on seeding for RICs, foreign equivalent funds and Comparable Private Funds.

Finally, we believe that the seeding period should be available for so-called "authorized participants." Authorized participants are broker-dealers that engage in market-making activities with respect to exchange traded funds ("ETFs") and are integral to the creation of liquidity in the ETF market, including through the provision of capital during a seeding period. The Board has recognized the importance of permitting banking organizations to act as authorized participants. For example, the Agencies noted in the preamble to the Volcker Rule that a banking organization would be permitted to "seed" an ETF in accordance with the market-making exclusion, because preventing or restricting a banking entity from acting as an authorized participant for an ETF would "impact the functioning of the

period referenced in the above FAQ was not intended to represent a limit on the length of the seeding period that may be used by a RIC or FPF.

107 We also believe that there should be the same seeding period for all foreign equivalent funds and Comparable Private Funds.

108 79 Fed. Reg. at 5,723.

109 *Id.*; 83 Fed. Reg. at 33,549 ("Some funds will need a 3-year performance track record, and sometimes longer, to be distributed through certain intermediaries or to attract sufficient investor interest.").

ETF market."[110] The proposal to extend the seeding period to authorized participants would be consistent both with the Board's considerations relating to the Volcker Rule and the position taken by banking organizations under the Volcker Rule that a broker-dealer subsidiary of the banking organization may provide a seeding investment to an ETF in which the banking organization is an "authorized participant," but is not an investment adviser.

4. The final rule should confirm that, consistent with the BHC Act, the requirement that shares held in a fiduciary capacity must be held "without sole discretionary authority to exercise voting rights" to avoid triggering a presumption of control applies only to investments made under Section 3 (and not Section 4) of the BHC Act.

The NPR would not apply the proposed presumptions of control to the extent a second company's securities are held by the first company "in a fiduciary capacity," provided that the first company does not have "sole discretionary authority to exercise voting rights."[111] In limiting the fiduciary exemption, however, to the absence of discretionary voting rights, the NPR does not appear to incorporate the key statutory distinction between investments made under Section 3 of the BHC Act and investments made under Section 4.

Under the BHC Act and Regulation Y, a company controlling a *bank's* voting shares is not deemed to be a bank holding company "by virtue of its ownership or control of shares in a fiduciary capacity" unless the company has sole discretionary authority to exercise voting rights with respect to the bank shares.[112] The BHC Act applies this restriction of having sole discretionary authority to exercise voting rights solely to investments in shares of a bank.[113] We are not aware of any instance in which the Board has sought to extend this limitation and determined that shares held pursuant to Section 4's fiduciary exemption would give rise to a control determination because the shares were held with sole discretionary authority to exercise voting rights. Including such a requirement would be inconsistent with both the plain language of the BHC Act, which does not include such a limitation within the fiduciary exception under Section 4 of the BHC Act,[114] and fundamental principles of statutory construction.[115]

---

110 79 Fed. Reg. at 5,608. During the seeding period, the ETF would not be deemed a banking entity for purposes of the Volcker Rule.

111 84 Fed. Reg. at 21,659, proposed 12 C.F.R. § 225.32(k).

112 12 U.S.C. § 1841(a)(5)(A); 12 C.F.R. § 225.12(a).

113 This restriction also applies to shares of bank holding companies. *See, e.g.*, Board Interpretive Letter of Nov. 25, 1975, 1975 WL 28276 (F.R.B.) (requiring an application under Section 3 of the BHC Act for the acquisition of 6.5 percent of the voting stock of a bank holding company in a fiduciary capacity with sole discretionary voting rights, because the acquisition was an indirect acquisition of more than five percent of the holding company's banking subsidiary).

114 12 U.S.C. § 1843(c)(4).

115 *See, e.g.*, *Nat'l Ass'n of Mfrs.* v. *DOD*, 138 S. Ct. 617, 631 (2018); *Russello* v. *United States*, 464 U.S. 16, 23 (1983) ("Where Congress includes particular language in one section of a statute but omits it in another

We assume that the Board did not intend for shares held in a fiduciary capacity to create presumptions of control with respect to investments in companies that are not banking organizations. The final rule should confirm that the "sole discretionary authority to exercise voting power" limitation on the fiduciary exception applies only to shares of banks and bank holding companies.[116]

5. The final rule should provide that the divestiture presumption does not apply to investment funds that are controlled outside the permitted seeding period.

Under the NPR, a first company that reduced its voting equity investment in a second company would (assuming the investment does not trigger another of the NPR's presumptions of control) only be presumed to continue to control the second company if the first company's ownership position was 15 percent or more of any class of voting securities of the second company within two years of the divestiture.[117] There is a limited exception to this presumption if a party unrelated to the first company controls 50 percent or more of each class of the second company's voting securities.[118]

We are generally supportive of the Board's revised approach, and believe that the Board's position on divestiture of control (sometimes referred to as a "teardown") has been far too restrictive. Nonetheless, we believe that the presumption is too broad in one respect. The requisite reduction should only be to below 25 percent (rather than 15 percent) in the case of investment funds that a first company previously controlled (*e.g.*, because it held 25 percent or more of a class of the fund's voting securities outside of the seeding period).

As explained in the NPR, the Board "typically has applied a stricter standard for determining noncontrol in divestiture cases than cases where a company seeks to establish a new noncontrolling investment."[119] The Board's rationale for this treatment is that "a company that has long controlled

---

section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (internal quotation marks and brackets omitted).

116 The NPR should explicitly incorporate the BHC Act's terms in one other respect related to fiduciary activities. Sections 3(a)(5)(A)(i) and 4(c)(4) of the BHC Act, which cross-reference Section 2(g)(2) of the BHC Act, exclude from the fiduciary exception shares that are controlled as a fiduciary for the benefit of the company, its subsidiaries, or their shareholders, members or employees. The BHC Act, however, also expressly provides that the Board may determine that the attribution of such shares to the company "is not appropriate in light of the facts and circumstances of the case and the purposes of [the BHC Act]." *See* 12 U.S.C. § 1841(g)(2). Accordingly, proposed 12 C.F.R. §§ 225.22(e)(2)(iii) and (iv), as set forth in the NPR, should be modified to include the ability of the Board to determine that the attribution of shares described in such sections to the company should not apply based on the facts and circumstances of the case and the purposes of the BHC Act.

117 84 Fed. Reg. at 21,659, proposed 12 C.F.R. § 225.32(i).

118 *Id.*

119 *Id.* at 21,645.

another company might be capable of controlling that company even after a substantial divestiture."[120] We respectfully submit that this rationale is inapplicable to investment funds.

The Board has "long recognized that the concept of control is different for funds than operating companies."[121] Indeed, the NPR appears to recognize this difference by providing a separate presumption of control for investment funds that are advised by the first company, and by providing a blanket exception from all presumptions of control for RICs that meet certain criteria. Compared to operating companies, there are few, if any, management or policy decisions over which a shareholder could exercise control. As a result, the Board's concern that a first company that formerly controlled a second company could continue to control the second company after a divestiture below 25 percent is not warranted with respect to investment funds.

For these reasons, we submit that the final rule should revise the divestiture presumption with respect to investment funds, and provide that a first company would no longer control an investment fund upon the first company's ownership percentage being reduced to a level that would not trigger another presumption of control.

I. The presence of a larger shareholder of a second company should create a presumption that a first company does not control the second company.

The Board's earliest interpretations of the controlling influence standard recognized that a company did not control a second company if a larger shareholder or group of shareholders was present.[122] For example, the courts have endorsed the Board's determination that a company was not able to exercise a controlling influence even though the company owned more than 16 percent of an investee bank and the company's two shareholders collectively owned more than 50 percent of the same bank in their individual capacities because "the stock owned by [the company's shareholders was] sufficient to give those shareholders outright control" of the investee bank, and thereby preclude controlling influence by the company.[123] In another case, the Board found that a company which held approximately 20 percent of a second company's voting stock, controlled 20 percent of the second company's board, was attempting to purchase the remainder of the second company's stock and maintained business relationships with the second company could not exercise a controlling influence over the second company because the second company's president controlled more than 56 percent of the second company's voting stock.[124]

---

120 *Id*.

121 79 Fed. Reg. at 5,732; *see also* the Fund Letter.

122 We note that the Board continues to recognize the impact of the presence of a larger shareholder in its regulations promulgated under the CIBC Act. In those regulations, the normal 10 percent presumption of control is not triggered if another person has the power to vote a greater percentage of that class of securities. 12 C.F.R. § 225.41(c)(2).

123 *Vickars-Henry Corp*. v. *Board of Governors of the Federal Reserve System*, 629 F. 2d 629 (9th Cir. 1980).

124 *Patagonia Corporation*, 63 Fed. Res. Bull. 288 (1977); s*ee also, NBC Co.*, 60 Fed. Res. Bull. 782 (1974) ("Applicant seeks to acquire less than a majority interest [in the company] and, as a result, upon

The Board has also reached similar determinations in cases where a second company's management was backed by a shareholder or group of shareholders holding at least as many shares as the first company, but that did not control a majority of the second company's voting stock. For example, the Board has determined that a company holding 24.99 percent of a second company's voting stock did not control the second company even though the first company sought board representation, opposed and attempted to block a major corporate action and undertook efforts to force a sale of the second company. The Board based its decision on the fact that "management of [the second company] [was] apparently supported by a block of voting shares of [the second company] amounting to at least as much as, and potentially larger than, the amount of shares that would be held by [the first company]."[125]

The Board's historical position is logical, particularly in light of Congress' intent to make the controlling influence standard a standard of actual control. For example, and contrary to practical business considerations, if a shareholder owned 10 percent of a company's voting stock and had business relationships with the company that accounted for five percent of the company's revenues, then the NPR would presume that this shareholder controls the company even if 40 percent of the voting stock were held by a single shareholder.

For these reasons, the final rule should include a presumption of non-control in all cases where an unrelated shareholder or group of shareholders would hold the power to vote (1) at least 25 percent of the class of the second company's voting securities that is held by the first company, or (2) a 50 percent greater percentage of the second company's voting securities than is held by the first company (*e.g.*, if the first company held 10 percent, the third-party investor must hold at least 15 percent).[126]

IV. The final rule should confirm that the rule applies prospectively (*i.e.*, only to investments made after the final rule's effective date).

The NPR is silent on whether the proposed regulations would apply only prospectively to investments made after the final rule's effective date. We assume that this would be the case, because the application of the proposed framework retroactively to investments that were determined in good faith to be non-controlling would have significant adverse effects on banking organizations and their investees. If existing investments that were previously determined in good faith to be non-controlling were now presumed to be controlling investments under the proposed framework, then banking organizations would be required to divest their investments, which, in many cases, may be illiquid or could be sold only at a substantial loss. The alternative of subjecting the investee to all the limitations of the BHC Act would generally not be feasible for the very reason the second company could not, or was not, willing to accept

consummation of the proposal Applicant would not be in a position of control from which to significantly influence [the company's] management" because a controlling shareholder owned more than 50 percent of the company's shares.). Greater detail on the facts of these Board decisions is included in section II in connection with the discussion of the Board's historical practice.

125 Letter to John L. Douglas, Esq., from the Secretary of the Board, dated April 5, 1982 at 5.

126 This, of course, assumes that the first company holds less than 25 percent of any class of the second company's voting securities, does not have the ability to elect a majority of the second company's directors and does not have covenants or other contractual rights that would give the first company actual control over the second company.

these limitations at the outset. In addition, the first company would, as discussed above, be forced into the often-untenable position of being responsible for legal and regulatory compliance where it lacks the ability to oversee compliance. For these reasons, we assume that the final rule would apply only to future investments, and recommend that the final rule include a statement to that effect in order to avoid any possible confusion.

V. The final rule should confirm the application of the presumption of non-control to investments made under Section 4(c)(6) of the BHC Act.

We assume that the presumption of non-control for an investment in less than five percent of any class of voting securities of a second company would also create a presumption that the investment would be deemed to be a "passive" investment for purposes of the BHC Act's Section 4(c)(6) exemption.[127] The NPR is not, however, explicit on this point. Bank holding companies rely substantially on this exemption, particularly with respect to investments in FinTech companies. Any potential ambiguity could potentially be seen as creating a need for bank holding companies to reassess many existing investments and cast doubt on new investments. Moreover, such ambiguity would contravene the Board's stated purposes in issuing the NPR (*i.e.*, to increase transparency and consistency).[128] For these reasons, the final rule should confirm that the presumption of non-control for an investment in less than five percent of any class of voting securities of a second company would also create a presumption that the investment would be deemed to be a "passive" investment for purposes of the Section 4(c)(6) exemption.

VI. The Board should revise its treatment of warrants and other convertible instruments to (1) recognize circumstances in which exercise or conversion is restricted or is only a remote possibility; (2) treat warrants and other convertible instruments on as as-converted basis only if they can be exercised within 60 days; and (3) apply such treatment equally to convertible instruments held by the first company and other investors.[129]

The NPR would treat options, warrants and convertible instruments on a "look-through" basis that assumes the holder of a convertible instrument holds the number of shares for which the warrant or option could be exercised.[130] This approach would apply "even if there were an unsatisfied condition

---

[127] 12 U.S.C. § 1843(c)(6). Under Section 4(c)(6) of the BHC Act, bank holding companies are permitted to invest in "shares of any company which do not include more than 5 per centum of the outstanding voting shares of such company." Under longstanding Board interpretations, to qualify for the Section 4(c)(6) exemption, the investment must also be a "passive," non-controlling investment. *See, e.g., FRRS 4-189*, 2011 WL 1895531 ("The Board believes that 4(c)(6) should properly be interpreted as creating an exemption from the general prohibitions in section 4 on ownership of stock in nonbank companies only for passive investments . . . ."); *see also* Letter to Timothy J Mayopoulos, Esq., dated Aug. 22, 2007, *available at* https://www.federalreserve.gov/boarddocs/legalint/bhc_changeincontrol/2007/20070822.pdf.

[128] 84 Fed. Reg. at 21,635.

[129] Although the NPR refers to its analysis of these instruments as a "look-through," and we use that terminology in this letter, we believe that the term "as-converted" or "as-if" would provide greater clarity.

[130] 84 Fed. Reg. at 21,656, proposed 12 C.F.R. § 225.9(a)(1) ("A person that controls a voting security, nonvoting security, option, warrant, or other financial instrument that is convertible into, exercisable for, exchangeable for, or otherwise may become a voting security or a nonvoting security controls each voting

precedent to the exercise of the options, including the passage of a considerable period of time, or if the options were significantly out of the money."[131] Moreover, the NPR would continue to apply the "look-through" approach solely to the company for which the control determination is being made, *i.e.*, no other holder of options or warrants would be assumed to have exercised its options.[132] We believe that this treatment of options and warrants is overly broad and unfairly penalizes investments in convertible instruments. Furthermore, it extends beyond Regulation Y's current standard, which assumes that the holder of convertible instruments controls the voting securities into which such instruments are "*immediately* convertible, at the option of the holder or owner."[133] Therefore, the final rule should substantially revise this approach.

The proposed "look-through" approach is flawed because it ignores fundamental differences in the way various instruments operate depending on their terms and the various facts and circumstances. For example, options cannot give rise to actual control if they cannot or, as a practical matter, would not be exercised by the investor, including because they are significantly out of the money or cannot be exercised until a designated future date, or could only be exercised upon the occurrence of an event that is remote or outside the hands of the investor (*e.g.*, an initial public offering of the second company, the second company's maintenance of profitability over a specified time horizon, external capital raises, etc.). The options have no voting rights prior to exercise, and, in these cases, the investor cannot exercise its options (or, with respect to options that are significantly out of the money, exercise such options as a matter of economic viability) or make a credible threat to exercise its options to gain voting rights or otherwise obtain control of the investee.

For these reasons, the final rule should not apply the "look-through" approach to convertible instruments unless, as of any date, they (1) could be freely exercised by the holder within 60 days; (2) are not significantly out of the money (*i.e.*, the market price is more than 15 percent below the applicable strike price) (for example, the "look-through" approach would apply to an option with a strike price of $25 only if the underlying stock were currently priced at $21.25 or more); and (3) are not subject to the satisfaction of a condition outside the control of the holder.[134]

---

security or nonvoting security that could be acquired as a result of such conversion, exercise, exchange, or similar occurrence.").

131 *Id.* at 21,648. The NPR does not define the phrase "significantly out of the money." For purposes of this letter, we consider an option to be "significantly out of the money" when the market price is more than 15 percent below the strike price.

132 *Id.* at 21,656, proposed 12 C.F.R. § 225.9(a)(6) ("For purposes of determining the percentage of a class of voting securities or the total equity percentage of a company controlled by a person that controls a [convertible] financial instrument . . .: (A) The voting securities or nonvoting securities controlled by the person [as a result of the "look-through" approach] are deemed to be issued and outstanding, and (B) Any voting securities or nonvoting securities controlled by [any other person] are not deemed to be issued and outstanding . . . .").

133 12 C.F.R. § 225.31(d)(1)(i).

134 We note that, in cases of instruments that may convert into a variable number of securities, the final rule should provide that the number of securities that would be controlled as a result of the "look-through" approach would be equal to the number of securities into which the instrument could actually convert as of

In addition, the Board's current practice of assuming the exercise of only the first company's options (and not the exercise of any other investor's options) is distortive, resulting in the Board assuming that the first company has the power to exercise a greater influence than is actually possible and leads to an overstatement of the amount of equity the first company would actually be likely to control. If other investors are able to exercise their own warrants and options, then that places them in a position to obtain shares and oppose any influence the first company may have. Therefore, the final rule should calculate a first company's percentages of total equity and voting equity in a second company by applying the "look-through" approach to all convertible instruments to which the approach would apply if such instruments were held by the first company (*i.e.*, those that are not significantly out of the money, are not subject to conditions outside the control of the holder and can be freely converted by the holder within 60 days), and not just to those instruments that the first company holds.

VII. The final rule should revise the treatment of "nonvoting securities" to conform to the Board's historical practice with respect to preferred stock, and to eliminate potential conflicts with other provisions of the NPR.

Under the NPR, a security would not be treated as a voting security if (among other limitations):

> The securities do not entitle the holder, by statute, charter, or in any manner, to select or to vote for the selection of directors, trustees, or partners (or persons exercising similar functions) of the issuing company.[135]

We are generally supportive of the Board's proposed definition of "nonvoting securities," particularly with respect to the ability of a first company to have defensive rights commonly associated with limited partnership and LLC membership interests.[136] Although this definition is generally consistent with, and, in some respects, liberalizes, the Board's historical treatment of nonvoting securities, it does not incorporate important precedent. Specifically, the NPR does not address the Board's historical position regarding preferred stock that would grant preferred shareholders the ability to vote to elect two directors to a second company's board if preferred dividends are in arrears for six or more quarters.[137]

---

the date of any determination. This would allow the Board to identify when the investor effectively holds the equivalent of shares of the investee's stock as opposed to a financial instrument that does not grant the same rights or powers as the investee's stock, and would, therefore, tailor the final rule to identify situations of actual control.

135 84 Fed. Reg. at 21,655, proposed 12 C.F.R. § 225.2(q)(2)(iii).

136 *Id*. The proposed definition would include a limited exception to the general limitation on the ability to vote for the selection of directors, trustees or partners. "[L]imited partnership interests or membership interests in limited liability companies are not voting securities due to voting rights that are limited solely to voting for the removal of a general partner or managing member (or persons exercising similar functions at the company) for cause, to replace a general partner or managing member (or persons exercising similar functions at the company) due to incapacitation or following the removal of such person, or to continue or dissolve the company after removal of the general partner or managing member (or persons exercising similar functions at the company)." As noted, we are particularly supportive of this approach, which would allow banking organizations to maintain customary and important protective rights that do not result in a controlling influence over the second company's policies or management.

137 *See, e.g.*, FRB Interpretive Letter (Feb. 6, 1984), 1984 WL 264817 (F.R.B.) (determining that the first company's ownership of preferred stock that granted the first company the right to vote to elect two

The Board has long recognized that such rights do not create a class of voting securities until such rights may in fact be exercised.[138] The NPR, however, could be read to require such preferred stock to be treated as a voting security from the time of issuance because it would allow the first company to vote for the selection of two directors of the second company, albeit under specific and remote circumstances. For these reasons, we propose that the final rule should include in the definition of nonvoting securities preferred stock that has the right to elect two directors of the second company if dividends become in arrears for six or more quarters.[139]

VIII. The Board should not use the final rule's "control" framework to interpret issues of control under the CIBC Act because of differences in objectives and consequences.

It is our understanding that the Board does not intend the NPR to apply to the definition of "control" under the CIBC Act.[140] We think that this dichotomy is appropriate in view of both the different objectives of the statutes and the different consequences of a determination of control. We further believe that the Board should provide separate guidance on three key aspects of the CIBC Act definition of control.

The BHC Act was adopted primarily to ensure that control of banking organizations is exercised in a safe and sound manner and to enforce the separation between banking and commerce.[141] In contrast,

---

directors if dividends became in arrears for six or more consecutive quarters did not result in the first company's control of voting securities of the second company). This view is also consistent with the New York Stock Exchange's requirements for preferred stock, which provide that preferred stock "should have the right to elect a minimum of two directors upon default of the equivalent of six quarterly dividends." New York Stock Exchange, *Listed Company Manual* at 313.00(C).

138 *See, e.g.*, *id.*; Bank Holding Companies and Change in Bank Control; Revision to Regulation Y, Final Rule, 49 Fed. Reg. 794, 800 (Jan. 5, 1984) ("With respect to nonvoting preferred stock that has the right to elect directors upon failure to pay preferred dividends, . . . such nonvoting stock would be considered a voting security *only at the time the right to vote arises*.") (emphasis added).

139 Although, as noted, the Board's historical practice has been to treat such shares as voting once the right to elect directors may in fact be exercised, we do not believe that the mere election of two directors (assuming the directors would constitute less than 25 percent of the board membership) would allow a first company to exercise a controlling influence over a second company. Indeed, the Board has recognized this fact in the NPR by permitting a first company that controls up to 24.9 percent of a second company's common stock to appoint less than 25 percent of the second company's board of directors, even if that would constitute more than a single director. Accordingly, we submit that preferred shares with "springing" rights to elect two directors when dividends become significantly in arrears should not be treated as voting securities, even if a first company may currently exercise such rights (provided that such a right cannot be exercised to appoint 25 percent or more of the second company's board).

140 We note that proposed 12 C.F.R. § 225.9 regarding control over securities would apply to "control" determinations both under the BHC Act and the CIBC Act. Our comments on § 225.9 are addressed in section VI above. For the reasons discussed in this section, the Board should not apply § 225.9 to the CIBC Act, but should consider, in light of the applicable policy considerations, whether a different approach than the one we have recommended in section VI above is appropriate for determinations made under the CIBC Act.

141 *See* 84 Fed. Reg. at 21,635 (noting that, in administering the BHC Act control framework, the Board has focused on "the two key purposes of the BHC Act," namely to (1) "ensure that companies that acquire

the CIBC Act was designed to provide the regulators with an opportunity to pre-clear persons who would assume control of a bank in order to assure that the bank was protected against depredations by those persons to the detriment of the bank and the customers and communities the bank served.[142]

Consistent with these different objectives, a finding of control produces very different consequences under the two statutes. The existence of control under the CIBC Act simply requires that the potentially-controlling person file a notice and obtain prior approval (technically, the absence of disapproval). In contrast, existence of control under the BHC Act not only requires prior approval, but can often be disabling because the potentially-controlling company engages in activities that are not permissible for a company controlling a bank (*i.e.*, a bank holding company).

This differentiation in terms of objectives and consequences is reinforced by the differences in the statutory language and regulations. The definition of control under the BHC Act requires the actual "exercise" of a controlling influence.[143] In contrast, the CIBC Act adopts the broader concept of the "power" to exercise a controlling influence, whether or not it is exercised.[144]

Likewise, Regulation Y defines control for purposes of the CIBC Act to include "acting in concert" and then broadly defines "acting in concert" to include "knowing participation in a joint activity" or "parallel action towards a common goal of acquiring control."[145] In contrast, neither the BHC Act nor Regulation Y in relation to the BHC Act uses the concept of acting in concert. The closest approximation is the use of the term "association," which is not defined in the BHC Act or Regulation Y. It is defined in interpretative statements, however, to require a more formal arrangement than "parallel action."[146]

In these circumstances, there is every reason to abide by the terms of the two statutes and the Board's regulations, and distinguish between the concepts of control under the BHC Act and CIBC Act.

A more expansive definition of control is appropriate under the CIBC Act so that the Board (and other federal banking agencies) can review in advance share acquisitions and related developments that would place persons in a position to do harm to a bank. As noted, such a review is in no way preclusive for the potential shareholder(s) unless they create risk of harm to the bank or are unwilling to provide, on

---

control of banks have the financial strength and managerial ability to exercise control in a safe and sound manner" and (2) "separate banking from commerce by preventing companies with commercial interests from exercising control over banking organizations and by restricting nonbanking activities of banking organizations"; *see also Bank Holding Company Act Amendments: Hearing on H.R. 6778 Before H. Comm. on Banking & Currency*, 91st Cong. 85 (1969).

142 *The Safe Banking Act of 1977: Hearing on H.R. 9086 Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the H. Comm. on Banking, Finance and Urban Affairs*, 95th Cong. 2089 (1977).

143 12 U.S.C. § 1841(a)(2)(C).

144 12 U.S.C. § 1817(j)(8)(B).

145 12 CFR §§ 225.41(c)(1), 225.41(b)(2).

146 *See, e.g., FRRS 4-415, 4-420* and *4-425.*

a confidential basis, information that would enable the banking agency to make an informed determination about potential harm to the bank.

Accordingly, we propose that the final guidance adopt three new standards for control under the CIBC Act so that its objectives can be fulfilled.

The first standard addresses the so-called “wolfpack” approach whereby loose confederations of activist investors work together to force sales of banks. In a number of activist campaigns, the same activist investors purchase the stock of the bank and support the lead activist in a proxy contest for board seats or for other corporate action.

There may not be formal agreement among the activists, but, as the Board’s Regulation Y makes clear, there need not be an actual agreement for two or more parties to be acting in concert and therefore subject to the CIBC Act’s notice requirements. “Parallel action” is sufficient.

Although simply voting in favor of an activist’s position is not parallel action, what the wolfpack does is something substantially more. The members of the wolfpack purchase stock in the target bank at or around the same time and then support one of their member’s overt efforts to force the sale of the bank.

We recognize that “parallel action” is difficult to define, but believe that it would be useful for the Federal Reserve Board to provide a list of representative factors it would consider in determining whether multiple persons are acting in concert or parallel. These could include: (i) communications between the persons regarding banking organizations in which the persons have invested or propose to invest (other than normal course proxy solicitation); (ii) the frequency with which such persons have made investments above *de minimis* amounts in the same banking organization; and (iii) the frequency with which one such person has commenced a proxy contest at a banking organization and the other person has supported the proxy context.

The second standard would expand the presumption of control in Section 225.41(c)(2) of Regulation Y to include any person (or persons acting in concert) who has stock ownership of 5-10 percent of a class of voting stock of a bank and has either three or more representatives on the bank’s board or representatives who constitute 25 percent or more of the bank’s board.

The third standard would expand the presumption of control in Section 225.41(c)(2) of Regulation Y to include any person (or persons acting in concert) that controls five percent or more of the second company’s voting securities and (i) has a director representative serving on any of the executive committee, audit committee, compensation committee or nominating and governance committee, or (ii) has a director representative serving as the chair of any board committee.

IX. The final rule should clarify that a presumption of non-control will apply with respect to every investment to which a presumption of control is not applicable.

The NPR would establish a rebuttable presumption of non-control of a company in cases where a company controls less than 10 percent of any class of a second company's voting securities and is not otherwise presumed to control the second company under the NPR's presumptions of control.[147]

The Board's stated purpose in issuing the NPR was to "clarify whether certain common fact patterns are likely to give rise to a controlling influence" so as to "substantially increase the transparency and consistency of the Board's control framework."[148] By including the proposed presumption of non-control with respect to smaller investments in voting equity, the Board has provided more certainty for banking organizations by setting forth the circumstances in which the Board generally would not determine that a company has the power to exercise a controlling influence over a second company. However, by not including a similar presumption for investments in voting equity of 10-24.99 percent that meet the Board's standards, the NPR only sets forth the circumstances in which the Board generally would find a controlling influence without elucidating the circumstances in which it would not. In fact, by including a presumption of non-control only for smaller investments in voting equity, the NPR could be read to imply that a company could be well within the limits set forth in the presumptions of control for a larger investment, but nevertheless not have certainty that the investment is non-controlling.

For the reasons set forth in section III above, we believe the final rule should provide a framework of safe harbors under which non-controlling investments could be made. If, however, the Board retains the NPR's structure, then for the reasons set forth in the preceding paragraphs, the final rule should provide that voting equity investments of 5-24.99 percent (rather than 10 percent or less) that do not result in a presumption of control under the NPR's framework would at least benefit from a presumption of non-control.

With respect to voting equity investments of less than five percent, we believe the current language of Regulation Y should be retained.[149] Both the BHC Act and Regulation Y provide for a presumption of non-control if voting equity is less than five percent. The NPR, however, would apply this presumption only in cases where a presumption of control is not triggered. This is inconsistent with the BHC Act, which places the burden on the Board of rebutting the presumption of non-control through a notice and hearing process. Notwithstanding this clear statutory framework, the NPR would allow the Board to shift its burden of rebutting the presumption of non-control to any first company that, for example, held 33 percent or more of a second company's total equity. We believe this is contrary to the framework Congress enacted, and the final rule should, therefore, retain the Board's current presumption

---

147 84 Fed. Reg. at 21,659.

148 *Id*. at 21,635.

149 12 C.F.R. § 225.31(e) ("In any proceeding under this section, there is a presumption that any company that directly or indirectly owns, controls, or has power to vote less than 5 percent of the outstanding shares of any class of voting securities of a bank or other company does not have control over that bank or other company.").

of non-control for investments in less than five percent of any class of a second company's voting securities.

We recognize that there may be some risk of purposeful evasion. The Board could address that concern by including language in the final rule along the following lines:

> Although, as a result of this presumption, it would be the Board's responsibility to initiate proceedings to determine whether there is control of the second company, the presumption would not preclude the Board, in egregious circumstances, from taking action against the first company for evasion of the BHC Act.

Finally, we note our support of the Board's statement that it would continue to have the ability to determine whether a first company controls a second company based on the specific facts and circumstances of the investment:

> Notwithstanding the presumptions of control or noncontrol, the Board may or may not find there to be a controlling influence based on the facts and circumstances presented by a particular case. However, the Board generally would not expect to find that a company controls another company unless the first company triggers a presumption of control with respect to the second company.[150]

Although establishing clearer "rules of the road" for investments is a positive step, it is not possible to address in a rulemaking all the situations where, based on the specific facts and circumstances of the case, actual control does not exist.

X. The final rule should confirm that passivity commitments will no longer be necessary in connection with future BHC Act filings.

Although contrary to the Board's practice for the 12 years after the enactment of the BHC Act's controlling influence standard, since 1982 the Board subsequently has frequently required a company to enter into a number of "passivity commitments" as a condition to the Board's concurrence that the first company does not control the second company. These included, among others, commitments not to (i) maintain interlocking directors or management representation, (ii) propose directors in opposition to management's proposed directors, (iii) solicit proxies, (iv) attempt to influence dividend policies, loan and credit decisions, or a wider range of operational, management or policy decisions, (v) engage in business relationships (subject to very minor exceptions), (vi) threaten to dispose of shares if the board of the investee did not act in a designated way and (vii) enter into joint ventures.[151]

Because the NPR does not mention passivity commitments, we assume that this omission was intentional and that the Board plans no longer to use passivity commitments in connection with determinations of control under the BHC Act. To avoid confusion, the final rule should confirm expressly that the Board will no longer require passivity commitments in connection with control determinations under the BHC Act.

150 84 Fed. Reg. at 21,637.

151 *See, e.g.*, Board letter to Thomas M. Shoaff, Esq., dated April 30, 1986 (investment by Lincoln National Corporation in Lincoln Financial Corporation).

The final rule should confirm that firms may continue to rely on existing passivity commitments, but should also provide for a mechanism for investors to request relief from existing commitments where relief from those commitments would be consistent with the presumptions set forth in the final rule.

XI. Additional issues.

We also recommend the following changes to the proposed rule to enhance clarity and ensure the rule is interpreted in a manner consistent with its intent:

A. The Board should promote consistency among its regulations by extending its "control" framework beyond control proceedings under Regulation Y to other regulations, including Regulation O and Regulation W.

The statutory definitions of "control" in Sections 22(h) and 23A of the Federal Reserve Act both include a "controlling influence" prong that is the same as in the BHC Act. For consistency and certainty of compliance, we recommend that the Board replace the presumptions of control in Regulation W and Regulation O with the presumptions established by the final rule. We note that the qualified financial contracts ("QFC") reporting rule imports the BHC Act control definition and includes for the controlling influence prong entities that the Board has deemed to be controlled under Regulation Y.[152] If the consolidation presumption is retained, we note that it would automatically flow through to the QFC rule.

B. The final rule should not calculate a first company's ownership of a class of voting securities based on the number of shares "controlled" by the first company, but based only on the first company's actual percentage of *voting* rights.

The NPR would require a company to calculate the percentage it controls of a class of a second company's voting securities as the *greater* of:

> (1) [t]he quotient . . . of the number of shares of the class of voting securities held by [the first company], divided by the number of shares of the class of voting securities that are issued and outstanding . . .; and (2) [t]he quotient . . . of the number of votes that may be cast by [the first company] on the voting securities controlled by [the first company], divided by the total votes that are legally entitled to be cast by the issued and outstanding shares of the class of voting securities . . . .[153]

The NPR explains that this calculation is intended to be consistent with the Board's practice of "recognizing both the proportion of shares of a class controlled by an investor and the proportion of voting power within the class controlled by the investor," and would account for instances in which "some shares have outsized voting power compared to other shares in the same class [of voting securities]," as the class of voting securities is determined under the BHC Act.[154]

The language of the NPR's calculation of the first company's percentage of a voting class, however, could potentially be read to have the presumably unintended consequence of rendering

152 12 C.F.R. § 148.2(b)(3).

153 84 Fed. Reg. at 21,656, proposed 12 C.F.R. § 225.2(u).

154 *Id*. at 21,650.

ineffective charter provisions that a number of banking institutions have implemented to (1) limit voting rights to 4.9 percent of any class of voting securities that would otherwise represent more than 4.9 percent of the voting class and (2) impose transfer and conversion restrictions to assure that the securities remain nonvoting (other than conversion in the limited circumstances set forth in proposed 12 C.F.R. § 225.9(a)). Under these provisions, any securities held by the first company and its transferees that would represent in excess of 4.9 percent of the voting power on any matter (other than the limited matters on which "nonvoting securities" are entitled to vote) are restructured by operation of the second company's charter to become nonvoting. We assume that the NPR is not intended to cause these provisions to be ineffective and that charter provisions that appropriately restructure the voting rights of a security will continue to be effective. Therefore, we recommend that the final rule clarify that any number of shares of a class of voting securities that become nonvoting shares by operation of such prohibitions on voting would not be included in either the numerator or the denominator of the calculation, as they are, by definition, nonvoting securities.

C. The final rule should clarify that a first company does not "control" shares of a class of voting securities solely because it has the power to dispose of such shares if the shares are held (1) in a fiduciary capacity with investment discretion; (2) as collateral subject to a repurchase agreement; or (3) as collateral that may be rehypothecated.

The NPR would deem a bank or other company to "control voting securities or assets owned, controlled, or held, directly or indirectly . . . [t]hat the bank or other company has the power to vote *or to dispose of* . . . ."[155] The phrase "to dispose of" is overly broad and could be read to include a number of situations in which a company does not actually control the shares of another company. In particular, the final rule should clarify that "to dispose of" does not include shares that are held:

- in a fiduciary capacity with investment discretion;
- as collateral subject to a repurchase agreement; or
- as collateral that may be rehypothecated.

In the first case, the power of the company to dispose of the shares is encompassed within the fiduciary exception under Section 3 or Section 4 of the BHC Act, as applicable, and such shares should not be attributed to the company consistently with those exceptions. In the latter two cases, the first company would not be able to use the shares to exercise any meaningful degree of influence over a second company. As a result, the company should not be deemed to "control" such shares.

D. The final rule should clarify the treatment of "dribble out" provisions.

Under the NPR, a first company would not be deemed to control voting securities of a second company through control of a financial instrument that by its terms (1) "may not . . . become voting securities in the hands of the [first company]" and (2) "is *only* transferable" in a number of limited

[155] *Id*. at 21,655, proposed 12 C.F.R. § 225.2(e)(2)(ii).

circumstances (*e.g.*, a widespread public distribution or a transfer of less than two percent of a class of the second company's voting securities).[156]

Under current practice, many banking organizations include provisions that permit the transfer of nonvoting instruments without limit on the number of shares that may be transferred as long as the shares remain nonvoting in the hands of the transferee (and its subsequent transferees), and all such shares are aggregated with those held by the banking organization for purposes of calculating the banking organization's ownership in the second company. Such shares would only be convertible by a transferee in one of the limited circumstances described in the NPR as not creating control over voting securities. The NPR could be read, however, to require that such shares be treated as voting shares because, by their terms, they are not "only" transferable in the circumstances described in the NPR. Any such interpretation would create substantial illiquidity for nonvoting securities (and, by extension, many non-controlling investment positions).

We assume that, for the foregoing reasons, the NPR was not intended to provide that ownership of such interests would be deemed to be control over voting securities. The final rule should clarify that a first company would not be deemed to control voting securities if it transfers nonvoting securities that remain nonvoting in the hands of the transferee (and any subsequent transferees), until the securities are transferred in one of the limited circumstances described in the proposed 12 C.F.R. § 225.9(a)(3)(ii).

E. The final rule should provide for a longer time period to respond to preliminary determinations of control.

Under Regulation Y and the NPR, a first company would have only 30 days to respond to a preliminary determination of control.[157] We submit that this does not provide sufficient time for the first company to provide a meaningful response, and is inconsistent with the notice and hearing process required by the BHC Act. Although the NPR purports to provide presumptions of control that can be rebutted, if the Board does not provide for a meaningful notice and hearing procedure, then the presumptions in effect become firm rules, as the first company would not have an effective opportunity to rebut the presumptions. As a result, a 30-day response period is not consistent with the BHC Act or the NPR's framework of presumptions. For these reasons, the final rule should provide at least 60 days for a first company to respond to a preliminary determination of control.

XII. Treatment of Historical Practices.

Throughout this letter we have assumed that the Board did not intend for the NPR to upset long-standing practices among many banking organizations, changes to which would cause significant and unwarranted disruption in the banking industry. In particular, we assume the NPR would not change existing practice in four important areas.

---

[156] *Id*. at 21,656, proposed 12 C.F.R. § 225.9(a)(3) (emphasis added).

[157] *Id*. at 21,657, proposed 12 C.F.R. § 225.31(b)(1).

First, portfolio investments held pursuant to the BHC Act's merchant banking authority are not treated as "subsidiaries" for purposes of the BHC Act and the Board's Regulation Y, regardless of whether the portfolio company is deemed to be "controlled."[158]

Second, for similar reasons as those relating to portfolio investments held under the merchant banking authority, companies that are held by a bank holding company's small business investment company ("SBIC") subsidiary pursuant to the Small Business Investment Act of 1958 and Section 4(c)(5) of the BHC Act are not treated as "subsidiaries" for purposes of the BHC Act and the Board's Regulation Y.[159]

Third, shares or other ownership interests in non-banking organizations held by a financial holding company subsidiary in an underwriting, securities dealing or market-making capacity pursuant to Section 4(k)(4)(E) of the BHC Act are not aggregated with shares held by the financial holding company in any other capacity, such as for purposes of Section 4(c)(6) of the BHC Act, and are excluded from any calculation to determine whether the financial holding company "controls" the organization for purposes of the BHC Act (including, for example, to determine whether the organization is a "banking entity" under the Volcker Rule).[160]

Fourth, shares or other ownership interests in a company that are "controlled" in a first company's capacity as investment adviser (such as, for example, by the first company's power to vote or dispose of the shares on behalf of its investment advisory clients, including an investment fund) are treated as shares "acquired in good faith in a fiduciary capacity," and are not aggregated with shares held by the banking organization in the same company in any other capacity in accordance with the BHC Act.[161]

---

158 Section 4(k)(4)(H) of the BHC Act permits financial holding companies to make portfolio investments, including controlling investments, in companies that the financial holding company would not otherwise be permitted to control. 12 U.S.C. § 1843(k)(4)(H). Section 4(k)(4)(I) of the BHC Act provides similar authority for investments made by insurance companies. 12 U.S.C. § 1843(k)(4)(I).

159 The Board has long held that bank holding companies are permitted to own SBICs under Section 4(c)(5) of the BHC Act. *See, e.g.*, Board Interpretive Letter of June 27, 1978, 1978 WL 33810 (F.R.B.) (determining that bank holding companies may invest in SBICs under Section 4(c)(5) of the BHC Act to the extent permitted by national banks (*i.e.*, up to 100 percent of the voting stock of the SBIC)).

160 145 *Cong. Rec.* E2308, Conference Report on S. 900 Gramm-Leach-Bliley Act, Speech of Rep. John J. LaFalce (Nov. 8, 1999) ("[V]oting securities held by a securities affiliate of a financial holding company in an underwriting, dealing or market-making capacity *would not need to be aggregated with any shares* that may be held by other affiliates of the financial holding company. This is necessary under the bill so that bank-affiliated securities firms can conduct securities activities in the same manner as and to the same extent as their non-bank affiliated competitors, which is one of the principal objectives of the legislation.") (emphasis added); *see also* 65 Fed. Reg. 14,433, 14,435 (March 17, 2000) ("Securities underwriting activities conducted under section 4(k)(4)(E) rather than section 4(c)(8) may be conducted without regard to the 25 percent revenue limitation that is applicable to section 20 subsidiaries of bank holding companies that engage in securities underwriting and dealing under section 4(c)(8). *In addition, dealing may be done without regard to the 5 percent limitation on ownership of voting securities*.") (emphasis added).

161 *See* 12 C.F.R. §§ 225.12(a) and .22(d) (providing that restrictions on the acquisition of certain shares do not apply to shares "acquired . . . in good faith or in a fiduciary capacity"). The United States Supreme Court

XIII. Technical corrections and clarifications.

A list of technical corrections and clarifications for the Board's consideration has been provided as Appendix A.

* * *

The Bank Policy Institute appreciates the opportunity to provide its comments, and would welcome the opportunity to discuss them further with you. If you have any questions, please contact the undersigned by phone at (646) 736-3960 or by email at *Gregg.Rozansky@bpi.com*.

Respectfully submitted,

Gregg Rozansky
Senior Vice President,
Senior Associate General Counsel
Bank Policy Institute

cc: Michael S. Gibson
Mark E. Van Der Weide
Laurie S. Schaffer
Alison Thro
Greg Frischmann
Mark Buresh
Brian Phillips
(Board of Governors of the Federal Reserve System)

---

has long recognized that investment advisers are acting as fiduciaries and that the investment advisory relationship is of a fiduciary nature. *See, e.g.*, *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 US 180 (1963). In addition, the Comptroller of the Currency's regulations expressly recognize the fiduciary nature of the investment advisory relationship. 12 C.F.R. § 9.2(e) ("Fiduciary capacity means: . . . investment adviser, if the bank receives a fee for its investment advice; [or] any capacity in which the bank possesses investment discretion on behalf of another . . . .").

We note that, in accordance with the BHC Act, shares held in a fiduciary capacity do not include shares held or controlled for the benefit of the first company, or its shareholders or employees (*e.g.*, shares held by an investment fund that is controlled by the first company). *See* 12 U.S.C. § 1843(c)(4).

APPENDIX A

Technical Issues and Clarifications

To improve the clarity and accuracy of the final rule, we propose that the final rule and accompanying release clarify the following items:

A. Total equity thresholds above 25 percent.

The NPR would establish thresholds for a first company's total equity investment in a second company of 33 percent for investments in 14.99 percent or less of any class of the second company's voting securities. However, the preamble to the NPR reiterates the Board's view in the 2008 Policy Statement, *i.e.*, that "[t]he Board continues to believe that, *in most circumstances,* an investor that owns 25 percent or more of the total equity of a company owns enough of the capital resources of the company to have a controlling influence over the management or policies of the company."[1] This statement appears inconsistent with the NPR, which would not presume control for investments of up to one third of total equity in three of the four proposed ownership categories. Accordingly, if the final rule retains a presumption related to total equity, the discussion in the final rulemaking release should clarify that investments of up to one third of total equity generally do not result in the exercise of controlling influence, unless coupled with an investment in voting equity of 15 percent or more of a class of voting securities.

B. Technical corrections.

- The list of examples of equity-like debt instruments in proposed 12 C.F.R. § 225.34(c)(3)[2] includes a numbering error where "(ii)" is used twice in succession.

---

1 84 Fed. Reg. at 21,643 (emphasis added).

2 *Id.* at 21,660.