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By electronic submission to regs.comments@federalreserve.gov

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

Re: Comment Letter on the Notice of Proposed Rulemaking Regarding Control and Divestiture Proceedings (Docket No. R-1662 and RIN 7100-AF 49)

Ladies and Gentlemen:

Davis Polk & Wardwell LLP (“**Davis Polk**”) welcomes the opportunity to comment on the notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System (the “**Federal Reserve**”) entitled *Control and Divestiture Proceedings*, published in the Federal Register on May 14, 2019 (the “**Board Proposal**”).¹ The Board Proposal would clarify and amend the Federal Reserve’s framework for making controlling influence determinations under the Bank Holding Company Act of 1956 (the “**BHC Act**”)² and the Home Owners’ Loan Act of 1933 (“**HOLA**”).³

In our view, the Board Proposal represents a significant improvement over the existing controlling influence framework. It would provide greater transparency, certainty and predictability in an important area of regulation. In some respects, the Board Proposal would make the Federal Reserve’s framework more consistent with the ordinary meaning of the words “controlling influence”⁴ as distinguished from a mere important, significant or potentially controlling influence. It would also make the Federal Reserve’s framework more consistent with the text and legislative history of the controlling influence test, as added by

¹ Federal Reserve, *Control and Divestiture Proceedings*, 84 Fed. Reg. 21,634 (May 14, 2019).

² 12 U.S.C. § 1841 *et seq.*

³ 12 U.S.C. § 1461 *et seq.* For purposes of this comment letter, we focus solely on the proposed revisions to the framework implementing the BHC Act, but our comments apply equally to the proposed revisions to the framework implementing HOLA.

⁴ 12 U.S.C. § 1841(a)(2)(C); 12 C.F.R. § 225.2(e)(1)(iii).

the 1970 amendments to the BHC Act, as well as the Federal Reserve's original framework for applying that statutory test. To the extent it does all these things, we strongly support the Board Proposal.

However, the Board Proposal also reflects an uneasy tension between the ordinary meaning of "controlling influence" and the legislative history of the controlling influence part of the BHC Act's three-part definition of control (the "**controlling influence test**") in the 1970 amendments, on the one hand, and the Federal Reserve's practice and precedents as they have evolved since 1984, on the other hand. To resolve this tension, we believe that the Board Proposal should go further in reflecting the ordinary meaning of "controlling influence" and the legislative history of the controlling influence test in the 1970 amendments, which makes it clear that both Congress and the Federal Reserve in 1970 intended for the test to reflect a standard of actual control.

In Part I of this comment letter, we describe the legislative and regulatory history of the controlling influence test. As described in Part I, we believe that adopting a final rule that interprets the controlling influence test as reflecting a standard of actual control would be more consistent with the text and legislative history of that test, as well as the Federal Reserve's original interpretation of that test. We believe that the Federal Reserve can and should revise its proposed rebuttable presumptions of control to reflect that original intent. In Part II of this comment letter, we recommend targeted changes to the Federal Reserve's proposed rebuttable presumptions of control that we believe would make those presumptions more consistent with both the ordinary meaning of the words "controlling influence," as distinguished from a lesser standard tantamount to an important, significant or potential influence, and the legislative history of the 1970 amendments, whether or not they would be completely consistent with a standard of actual control. In Part III of this comment letter, we suggest clarifications regarding the effect of the Board Proposal on existing non-controlling investments. Finally, in Part IV of this comment letter, we recommend that the Federal Reserve consider, in a future rulemaking proposal, aligning its regulations for notices of changes in control of banks, bank holding companies ("**BHCs**") and savings and loan holding companies ("**SLHCs**") (subpart E of Regulation Y and subpart D of Regulation LL) with the different levels of voting equity ownership and presumptions of control reflected in the Board Proposal.

I. A Standard of Actual Control was the Original Intent

As explained in detail below, the text and legislative history of the controlling influence test show that the test was intended to allow the Federal Reserve to make a control determination in situations of actual control, rather than to bring a mere important, significant or potentially controlling influence within the realm of "control." The Federal Reserve initially acted consistently with this view, before, perhaps unintentionally, departing from a standard of actual control in 1984. This Part I explains that history to illustrate the

shortcomings of the Federal Reserve’s current approach and how the Board Proposal, although a welcome step in the right direction, could and should be revised so that it is more consistent with the text and legislative history of the 1970 amendments.

A. Congressional Intent

1. The 1956 Control Test

As enacted, the original version of the BHC Act in 1956 incorporated the concept of control within the definitions of “bank holding company” and “subsidiary.”⁵ Those definitions did not include a controlling influence test and instead used the following bright-line tests:

- directly or indirectly owning, controlling or holding with power to vote 25% or more of the voting shares of two or more banks;
- controlling in any manner the election of a majority of the directors of two or more banks; or
- being the beneficiary of a trust that holds 25% or more of the voting shares for the beneficiary.⁶

2. The 1970 Amendments

The 1970 amendments to the BHC Act redefined “bank holding company” to include a company with only one bank subsidiary and expanded the voting equity prong to include ownership, control or the power to vote 25% or more of “any class of voting securities.”⁷ Most significantly for purposes of this comment letter, the 1970 amendments also (i) introduced a new term, “control,” within the definition of the term “bank holding company,” and (ii) defined “control” to include a controlling influence test along with the bright-line voting equity and board of directors tests.⁸

The 1970 amendments also added a controlling influence test to the definition of the term “subsidiary,” which differed slightly from the controlling influence test in the definition of “control.”⁹ Within the statutory definition of “control,” the controlling influence test is

⁵ Pub. L. No. 84-511, § 2(a), (d), 70 Stat. 133, 133–34 (1956).

⁶ The 1966 amendments to the BHC Act eliminated the trust prong. *See* Pub. L. No. 89-485, §§ 1, 4, 80 Stat. 236, 236 (1966).

⁷ Pub. L. No. 91-607, § 101(a), 84 Stat. 1760, 1760 (1970).

⁸ Pub. L. No. 91-607, § 101(a), 84 Stat. at 1760–61.

⁹ Pub. L. No. 91-607, § 101(d), 84 Stat. at 1763.

that “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 company.”¹⁰ In contrast, within the statutory definition of “subsidiary,” the controlling influence test is that “any company with respect to the management [or] policies of which such bank holding company has the *power*, directly or indirectly, *to exercise* a controlling influence, as determined by the Board, after notice and opportunity for hearing.”¹¹

It is not clear from the legislative history why Congress used different wording in the controlling influence tests within the “control” and “subsidiary” definitions. The Federal Reserve later stated in a 1977 decision that the differences in wording between the two controlling influence tests “may be primarily semantic” and interpreted both tests to require a finding of actual control rather than a finding of potential control.¹²

But regardless of the particular phrasing—“exercises” or “power to exercise”—it is clear from the legislative history that the controlling influence test was designed by Congress to give the Federal Reserve authority to treat a bank or BHC as being controlled by another company, or to treat a company as being a subsidiary of a BHC, in situations where neither of the two objective, bright-line voting equity or board of directors tests would apply, upon a formal finding of *actual control*. That is, the controlling influence test was meant to capture circumstances in which the bright-line tests were underinclusive, not to expand the underlying principle of control from actual control to potential control. Numerous statements in the legislative history of the 1970 amendments to the BHC Act support this interpretation. For example:

- In his testimony before the House of Representatives, Federal Reserve Vice Chairman James L. Robertson testified that the controlling influence test would give the Federal Reserve “the power to determine *actual control*, on the basis of pragmatism.”¹³
- Vice Chairman Robertson further explained, in response to a question from Representative Rees about which criteria the Federal Reserve would use to determine whether a company had control over another company if it had less than 25% of the voting equity of the other company: “We would have to go in and

¹⁰ 12 U.S.C. § 1841(a)(2)(C) (emphasis added).

¹¹ 12 U.S.C. § 1841(d)(3) (emphasis added).

¹² *Patagonia Corporation*, 63 Fed. Res. Bull. 288, 291–92 (1977). See *infra* Section I.B.2 for a more complete analysis of the *Patagonia* decision.

¹³ *Bank Holding Company Act Amendments: Hearing Before the H. Comm. on Banking and Currency*, 91st Cong. 235 (1969) (statement of James L. Robertson, Vice Chairman, Federal Reserve) (emphasis added).

establish in the course of the hearings, with a record that would be adequate to sustain whatever conclusion we arrived at, that there was *in reality* control.”¹⁴

- Representative Thomas W. L. Ashley, who introduced the provision that became the controlling influence test in the definition of “control” in the final legislation, said that the test would simply modify that definition “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.”¹⁵
- Similarly, Representative Wright Patman, the long-serving Chairman of the House Financial Services Committee, stated in a written release that the controlling influence test would allow the Federal Reserve “to make a finding of ‘*actual control*’ even though the holding company held less than 25% of the stock” of a bank.¹⁶
- Chairman Patman also issued a section-by-section summary of the bill that described the new controlling influence test as enabling “the Federal Reserve to determine, *on the basis of substantial evidence*, that even though a company controlled less than 25 percent of the stock of one or more banks, the company does *in fact* exercise a controlling influence over the management or policies of the bank.”¹⁷

There is no evidence in the legislative history of the 1970 amendments that Congress intended to give the Federal Reserve broad discretion to find the mere potential to exercise less than actual control—or even the exercise of less than actual control—to be a controlling influence.

We understand that some people have argued that Section 2(a)(9) of the Investment Company Act of 1940 (“**1940 Act**”) and Section 2(a)(8) of the Public Utilities Holding Company Act (“**PUHCA**”) contained controlling influence tests that had been interpreted by the courts prior to the 1970 amendments to the BHC Act to include the latent power—i.e., the potential power—to exercise control rather than a standard of actual control. According to this line of reasoning, because that case law was the backdrop against which the 1970 amendments were adopted, Congress must have intended for the controlling influence test in the new definition of control added by the 1970 amendments to the BHC Act to reflect the

¹⁴ *Id.* (emphasis added).

¹⁵ 115 Cong. Rec. 33141 (1969) (emphasis added).

¹⁶ 115 Cong. Rec. 3368 (1969) (emphasis added).

¹⁷ *Id.* (emphasis added).

same interpretation.¹⁸ But there is no mention of those statutes or that case law in the text and legislative history of the 1970 amendments, or any other affirmative evidence that Congress intended for that case law to limit, qualify or otherwise affect the interpretation of the controlling influence test in the BHC Act. Nor is it consistent with basic principles of logic. Assuming that Congress was aware of and considered the case law interpreting the controlling influence tests in the 1940 Act or the PUHCA at the time it enacted the 1970 amendments to the BHC Act, the most logical implication of the various statements about “actual,” “in reality” or “in fact” control recorded in the legislative history is that Congress rejected that case law for purposes of interpreting the new controlling influence test in the BHC Act in favor of a standard of actual control.¹⁹

We understand that other people have argued that Congress could not logically have intended for the controlling influence test to reflect a standard of actual control because that would make the controlling influence test inconsistent with the bright-line alternative test based on 25% or more of any class of voting securities. That bright-line test clearly reflects a standard of less than actual control under normal circumstances. Other people have made the related argument that construing the controlling influence test to reflect a standard of actual control is inconsistent with the *noscitur a sociis* canon of statutory construction, which instructs that “when two or more words are grouped together, and ordinarily have a similar meaning, but are not equally comprehensive, the general word will be limited and qualified by the special word.”²⁰ In the case of the statutory definition of control, the special words are the words of the two bright-line tests and the general words are the words of the controlling influence test. Therefore, under this line of reasoning, the general words of the controlling influence test should be limited and qualified by the special words of the two bright-line tests. Because the 25% of any class of voting securities test reflects a standard of less than actual control, the controlling influence test should be construed to reflect a standard of less than actual control as well.

¹⁸ Indeed, the petitioner in *Patagonia* made such an argument in an effort to persuade the Federal Reserve that it had had a controlling influence over Pima, a savings and loan association, as of the grandfathering date for purposes of a provision that grandfathered the non-banking activities of one-bank holding companies that became subject to the activities restrictions of the BHC Act by virtue of the 1970 amendments, but the Federal Reserve correctly rejected that argument in favor of a standard of actual control. See *infra* Section I.B.2.

¹⁹ See *supra* notes 13–17 and accompanying text.

²⁰ Sutherland, *Statutes and Statutory Construction*, § 47:16, at 348–51 (7th ed. 2007) (Norman J. Singer, ed.); *Logan v. United States*, 552 U.S. 23, 30–32 (2007) (applying canon to qualify meaning of general words by reference to nearby specific words); *Washington State Dep’t of Social and Health Servs. v. Guardianship Estate of Keffeler*, 537 U.S. 371, 382–85 (2003) (same); *FTC v. Ken Roberts Co.*, 276 F.3d 583, 589–90 (D.C. Cir. 2001) (same).

The problem with this line of reasoning is that the two bright-line tests point in opposite directions—the bright-line test based on 25% of any class of voting securities deems or assumes control to exist at a level of voting equity that normally does not constitute actual control, whereas the bright-line test based on the power to elect a majority of the board of directors of a company normally does reflect a standard of actual control. Congress was obviously aware of the 25% of voting securities test because that is the test that both Representatives Ashley and Patman referred to in their statements on the 1970 amendments. Had Congress intended the controlling influence test to specifically adopt a standard of “comparable control,” “proportionate control” or “the same degree of control” conferred by the 25% of voting securities test, presumably it would have specifically said as much. Instead, Representatives Ashley and Patman referred to a standard of “actual control” even if that control was based on ownership of less than 25% of voting securities. In other words, in adopting the controlling influence test, they described the degree of control necessary to satisfy the definition as being one that would—notwithstanding the level of voting equity ownership—represent actual control over the company, i.e., a standard more consistent with the second part of the definition of control (majority of the board of directors).

In our view, Congress realized that the 25% of voting equity test represented the lowest level of control in the statute. The second part of the control test, i.e., control over the election of a majority of directors, represented a higher level of control that, as noted above, normally reflects actual control. In adopting the new, third part of the definition of control, Congress specifically required a level of control comparable to the second part of the control test—i.e., actual control—even as it specifically acknowledged that the third part of the test was necessary only to capture situations of actual control that would not be captured by a test based solely on ownership of voting equity. The controlling influence test thus reflects the entirely logical recognition that it is possible to control a company through means other than ownership of voting equity—but, at least as Congress intended it, the test is meant to capture situations of actual control, not potential control or a level of control comparable to ownership of 25% of voting equity.

This conclusion is also consistent with the *noscitur a sociis* canon of statutory construction because the special words in the statutory definition of control, which include the board of directors test, are just as consistent with a standard of actual control as with a standard of less than actual control. And because construing the controlling influence test to reflect a standard of actual control is more consistent with the legislative history of the 1970 amendments as outlined above, it is the more persuasive interpretation.

We therefore believe that the statement in the preamble to the Board Proposal (the “**Preamble**”) that the controlling influence test only requires a finding of potential control²¹

²¹ See 84 Fed. Reg. at 21,636 & n.20.

is inconsistent with both the text and legislative history of the 1970 amendments. At the same time, we do not believe that the controlling influence test requires a finding of control comparable to ownership of 100% of the voting equity of a company, which the Preamble implies is the only alternative to a standard of potential control by referring to such standards as “complete domination” or “absolute control.”²² Even ownership of a majority of a company’s voting equity does not assure “complete domination” or “absolute control” of a company for the simple reason that the views and interests of other shareholders must necessarily be taken into account in shareholders’ meetings and shareholder votes. By the same token, election of a majority of directors does not assure “complete domination” or “absolute control” of a company because the views of the directors representing the minority must also be taken into account in directors’ meetings and in any actions taken by the board of directors. However, in either case, in any decision requiring a majority vote, actual control can ultimately be accomplished through a decision of the majority. As a result, standards such as “complete domination” and “absolute control” are irrelevant to the meaning of the controlling influence test. All that the 1970 amendments required to satisfy the controlling influence was “actual control”—nothing more and nothing less.

B. The Federal Reserve’s Original Approach under Regulation Y and Federal Reserve Decisions

The Federal Reserve’s original approach to implementing the controlling influence test in Regulation Y was consistent with the understanding of congressional intent described above.

1. Implementing the Controlling Influence Test—1971 Amendments to Regulation Y

In its 1971 amendments to Regulation Y, the Federal Reserve introduced in its control determination procedures a controlling influence test that required the actual exercise of a controlling influence, rather than the “power to exercise” standard in the statutory definition of “subsidiary.” Both the preamble to the proposed 1971 amendments and the final 1971 amendments to Regulation Y made it clear that the Federal Reserve required the actual *exercise* of a controlling influence.²³

²² See 84 Fed. Reg. at 21,636.

²³ *Control of a Bank or Other Company*, 36 Fed. Reg. 12,915, 12,915 (proposed July 9, 1971) (“Under [the 1970 BHC Act] amendments, any company has control over a bank or over any company if the Board determines . . . that the company directly or indirectly *exercises* a controlling influence over the management or policies of the bank or company.”) (emphasis added); *Control of a Bank or Other Company*, 36 Fed. Reg. 18,945, 18,946 (final Sept. 24, 1971) (providing procedures for control determinations “[i]n any case in which a [rebuttable] presumption [of control] applies, or in any other case in which it appears to the Board that a company *exercises* a controlling influence over the management or policies of a bank or other company”) (emphasis added).

2. *Implementing the Controlling Influence Test—Patagonia Decision*

Moreover, until 1984 the Federal Reserve acted consistently with the views described in the proposed and final 1971 amendments to Regulation Y. When the Federal Reserve confronted the difference between the wording of the controlling influence tests in the statutory definitions of “control” and “subsidiary” in 1977 in its *Patagonia* decision,²⁴ it treated both definitions as meaning situations of actual control.

In *Patagonia*, the Federal Reserve held, after notice and a hearing, that Patagonia Corporation (“**Patagonia**”) had *not* exercised or had *not* had the power to exercise *actual* control over the management or policies of Pima, a savings and loan association (“**S&L**”), as of the grandfathering date for purposes of a provision that grandfathered the non-banking activities of one-bank holding companies that became subject to the activities restrictions of the BHC Act by virtue of the 1970 amendments, even though as of that date Patagonia had owned more than 20% of the S&L’s voting securities and had three out of the S&L’s 15 directors, and even though it had actually acquired a majority of the voting shares of the S&L approximately one year after the grandfathering date. Patagonia had argued that its interest in Pima qualified for the grandfathering provision because it had exercised or at least had had the latent power to exercise a controlling influence over Pima as of the grandfathering date. Among other support for its argument, Patagonia cited case law construing the term “controlling influence” under Section 2(a)(9) of the 1940 Act and Section 2(a)(8) of the PUHCA, including a case in which the U.S. Securities and Exchange Commission (“**SEC**”) concluded that “it is [not] necessary that there be an actual exercise of a ‘controlling influence.’ It is sufficient if the power exists in a latent form.”²⁵

In rejecting Patagonia’s argument *and* the relevance of this case law, the Federal Reserve cited the different purposes of the BHC Act, as well as the clear focus on actual control in the legislative history of the BHC Act:

“There are clearly different standards to be employed in making a judgment as to whether the influence of a company in another company’s operations is significant enough that investors or consumers should be entitled to appropriate information and other protections [the purpose of the controlling influence test in the securities laws] than in determining whether the company may be considered to have been so involved with another company that it might be considered to have been engaged in that company’s business [the purpose of the BHC Act’s controlling influence test]. . . .

²⁴ *Patagonia Corporation*, 63 Fed. Res. Bull. 288 (1977).

²⁵ *Id.* at 291 (citing *The Chicago Corporation*, 28 S.E.C. 463, 468 (1948)); *id.* at 298 (“Patagonia has placed great weight upon the *Chicago Corporation* case and other cases which speak in terms of a latent power being sufficient to establish a controlling influence.”).

“The definition of subsidiary in § 2(d)(3) [of the BHC Act] speaks in terms of the ‘power to exercise’ a controlling influence. This section, however, was added by Congress to conform to § 2(a)(2)(C) of the Act, which provides that a company has control over another company if it ‘exercises’ a controlling influence. 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*. This difference is of very little importance, however, and may be primarily semantic. . . . The Board believes that the test is, therefore, whether a company may be considered to have been so influential in the affairs of a particular company as to be considered to have been engaged in that business on [the grandfathering date].”²⁶

In holding that Patagonia had *not* controlled Pima as of the grandfathering date, the Federal Reserve explained that “the record simply does not contain direct evidence that Patagonia *actually exercised* a controlling influence over Pima.”²⁷ It is therefore clear from both the result and the reasoning of *Patagonia* that the Federal Reserve did not believe in 1977 that the mere potential or latent power to exercise a controlling influence or some degree of significant influence constituted a “controlling influence” for purposes of the statutory definition of “control” or the statutory definition of “subsidiary”; its interpretation of the controlling influence test in both of these statutory terms turned on the presence or absence of actual control.

The Preamble to the Board Proposal mistakenly cites *Patagonia* for the proposition that “the Board has found that a controlling influence is possible even if the first company is not able to dictate the outcome of a significant matter under consideration.”²⁸ To support this reading of *Patagonia*, the Preamble quotes the following sentences in *Patagonia*: “[Controlling influence] does not necessarily mean that those exercising a controlling influence must be able to carry their point. A controlling influence may be effective without accomplishing this purpose fully.”²⁹ But this language was taken out of context and is clearly inconsistent with the reasoning and holding of *Patagonia*. The quoted language is from a judicial decision interpreting the controlling influence test under the PUHCA, which the petitioner in *Patagonia* had cited to support the very argument that the Federal Reserve rejected—namely, that latent control was sufficient to establish a controlling influence over Pima for purposes of qualifying for the grandfathering provision. It is not clear from the Westlaw version of *Patagonia* that the PUHCA language is a quotation from another court case rather than a statement by the Federal Reserve. However, in the formatting of the

²⁶ *Patagonia Corporation*, 63 Fed. Res. Bull. at 291–92 (emphasis added).

²⁷ *Id.* at 293 (emphasis added).

²⁸ 84 Fed. Reg. at 21,636 & n.19.

²⁹ *Patagonia Corporation*, 63 Fed. Res. Bull. at 291 (quoting *The Chicago Corporation*, 28 S.E.C. 463, 468 (1948)); see 84 Fed. Reg. at 21,636 n.19.

original Federal Reserve Bulletin, it is clear that the Federal Reserve was quoting the reasoning from a court case, which it then rejected for purposes of construing the controlling influence test under the BHC Act.³⁰

The Preamble also cites a more recent court of appeals case, *Interamericas Investments, Ltd. v. Board of Governors of the Federal Reserve System*,³¹ for the proposition that “control requires only ‘the mere potential for manipulation of a bank.’”³² But *Interamericas Investments* concerned the first part of the definition of control in the BHC Act—where a “company directly or indirectly or acting through one or more other persons owns, controls, or has the power to vote 25 per centum or more of any class of voting securities”³³—and not the controlling influence test.³⁴ As a result, *Interamericas Investments* is not relevant to the meaning of “controlling influence”: we can all agree that ownership or control of 25% of any class of voting securities does not normally constitute actual control, but it is the minimum voting equity level at which the BHC Act deems control to exist.

3. *Implementing the Controlling Influence Test—Cavendes Opinion Letter*

The Federal Reserve took a similar approach in an April 1982 opinion letter, continuing to maintain its original view that, consistent with congressional intent, a “controlling influence” may be found only where there is actual control. That opinion letter rejected an argument by Florida National Banks (“**Florida National**”) that Cavendes, a Venezuelan company, should be found to have a controlling influence over Florida National for purposes of the prior approval requirements under the BHC Act.³⁵

Florida National had argued that Cavendes should be found to have a controlling influence over it upon Cavendes’ acquisition of 24.99% of Florida National’s voting securities because Cavendes would become the single largest shareholder of Florida National and would seek board representation.³⁶ As justification, Florida National asserted that Cavendes previously had opposed Florida National management’s decisions through litigation and shareholder action, including a proxy solicitation, had contracted to sell its shares to Southeast Banking Corporation—which had the stated objective of merging with

³⁰ For access to the original Federal Reserve Bulletin version of *Patagonia*, see https://fraser.stlouisfed.org/files/docs/publications/FRB/1970s/frb_031977.pdf.

³¹ 111 F.3d 376 (5th Cir. 1997).

³² 84 Fed. Reg. at 21,646 & n.20.

³³ 12 U.S.C. § 1841(a)(2)(A).

³⁴ 111 F.3d at 383.

³⁵ Board of Governors of the Federal Reserve System, Opinion Letter to John L. Douglas, 1982 Fed. Res. Interp. Ltr. LEXIS 8 (Apr. 5, 1982).

³⁶ *Id.* at 5.

Florida National and divesting a number of Florida National subsidiaries—and had acted through a Venezuelan citizen to control additional shares of Florida National.³⁷

In rejecting Florida National’s argument, the Federal Reserve concluded that while Cavendes had actively *attempted* to exercise a controlling influence over the management and policies of Florida National, it had not been successful in *actually* doing so.³⁸ Instead, its aggressive actions merely “galvanized action by Florida National management to implement its chosen policy course and to negate successfully any influence that Cavendes has sought to exercise.”³⁹ In other words, attempted or potential control was insufficient for the Federal Reserve to find a controlling influence. Actual control was required.

C. 1984 Amendments to Regulation Y and the Federal Reserve’s Change in Approach

In 1984, the Federal Reserve departed from its original “actual control” approach to interpreting the controlling influence test, even though its original approach was more consistent with the congressional intent of the 1970 amendments, in favor of a “potential control” standard.

1. Implementing the Controlling Influence Test—1984 Amendments to Regulation Y

The Federal Reserve started the process of changing its approach from focusing on making formal findings of actual control to making informal findings of potential control when it proposed adding a regulatory definition of “control” to Regulation Y in its proposed amendments to Regulation Y in 1983.⁴⁰ Instead of proposing a regulatory definition of “control” that tracked the language of the statutory definition of “control,” the Federal Reserve proposed adding a regulatory definition of “control” that defined the controlling influence portion of the definition as “[e]xercising or having the power to exercise directly or indirectly a controlling influence over the management or policies of the bank or company,”

³⁷ *Id.*

³⁸ *Id.* at 5–6 (“The Board cannot conclude that Cavendes’ unsuccessful attempts to sway management constitute a controlling influence. On the contrary, the very fact that, on the key issue on which Cavendes has sought to exercise an influence over Florida National management, Cavendes had to resort to litigation is an important indication that a controlling influence has not been established.”).

³⁹ *Id.* at 5.

⁴⁰ *Bank Holding Companies and Change in Bank Control; Proposed Revision of Regulation Y*, 48 Fed. Reg. 23,520, 23,538 (proposed May 25, 1983). Arguably, the shift began even earlier, when the Federal Reserve issued its 1982 policy statement on nonvoting equity investments by bank holding companies. 12 C.F.R. § 225.143 (July 8, 1982).

as determined by the Federal Reserve after notice and opportunity for hearing in accordance with its procedures.⁴¹

Certain commenters on the 1983 proposal argued that for purposes of the controlling influence portion of its regulatory definition of control, the Federal Reserve should only use the actual “exercises” language from the statutory definition of control, not the “power to exercise” language from the statutory definition of the term subsidiary.⁴² In rejecting those comments in the preamble to the 1984 final rule amending Regulation Y, the Federal Reserve explained that its proposal reconciled the definitions of “control” and “subsidiary” in the BHC Act and cited *Patagonia* for the proposition that the debate over differences between those statutory definitions is “one of semantics and not substance,”⁴³ incorrectly suggesting that *Patagonia* had reconciled those differences in favor of a standard of latent or potential control when in fact *Patagonia* had done so in favor of a standard of actual control. Moreover, the Federal Reserve dropped the “exercising” language from the final regulatory definition of control without any further explanation and used only the “power to exercise” phrasing, thus deviating even farther from the statutory definition of control, which uses the word “exercises” and not the phrase “power to exercise.”⁴⁴

2. *Implementing the Controlling Influence Test—Post-1984 Ad Hoc Approach*

Far from reflecting a mere semantic difference, in practice the Federal Reserve’s substitution of the phrase “power to exercise” in its regulatory definition of control for the word “exercises” in the statutory definition of control has resulted in the controlling influence test evolving over the last 35 years from a standard of actual control to a standard of potential control. This evolution has resulted in many combinations of factors being swept in, such as business relationships, contractual rights, employee interlocks, non-voting as well as voting equity ownership and board representation that, in the aggregate, fall well short of a standard of actual control. The Federal Reserve’s interpretation of the controlling influence test has in effect become a test of the potential to exercise an influence comparable to that of a 25%

⁴¹ 48 Fed. Reg. at 23,538 (emphasis added).

⁴² *Bank Holding Companies and Change in Bank Control; Revision of Regulation Y*, 49 Fed. Reg. 794, 799 (Jan. 5, 1984) (“Some commenters objected to [the proposed regulatory definition of “control”] on the basis that section 2(a)(2)(C) [the statutory definition of “control” in the BHC Act] defines control as the actual exercise of a controlling influence, rather than the power to exercise a controlling influence.”).

⁴³ *Id.* (“The proposed revision reconciles these two sections of the BHC Act. . . . [A]s indicated in its previous decisions regarding this matter, the Board believes that, to a large extent, this debate is one of semantics and not substance. (See, e.g., *Patagonia Corporation*, 63 Federal Reserve Bulletin 288 (1977).) The critical question is whether the Board may determine in advance that, as a result of a particular transaction, a company would be able to exercise a controlling influence over a bank or other company. . . . Based on the foregoing discussion, the definition of control is being adopted as proposed.”).

⁴⁴ Compare 12 C.F.R. § 225.2(e)(1)(iii) with 12 U.S.C. § 1841(a)(2)(C).

voting shareholder, and often the standard is even lower. This result is contrary to both congressional intent and the Federal Reserve’s own interpretations prior to 1984.

Although the Federal Reserve’s 2008 policy statement on equity investments in banking organizations was intended to rationalize its post-1984 *ad hoc* approach to the controlling influence test,⁴⁵ it too is inconsistent with the congressional intent to limit the controlling influence test to instances of actual control that did not otherwise trigger either of the two objective, bright-line tests. In practice, the Federal Reserve staff has required companies to comply with more restrictive conditions than those required by the 2008 policy statement in order to avoid being deemed to have a controlling influence over another company, such as restrictive limits on business relationships that do not allow a non-controlling shareholder to develop business relationships that account for more than 1.5% to 2.5% of another company’s revenues, or even a single \$500,000 deposit—a limit that, even when aggregated with other factors, does not even approach a standard of actual control.

D. The Federal Reserve’s Current Approach and the Board Proposal

In addition to applying a lower standard of control than required by the 1970 legislative amendments and their legislative history, the Federal Reserve’s current approach to the controlling influence test suffers both from a lack of transparency and a lack of certainty. The lack of transparency results from the absence of clear, written and broadly available substantive regulations governing the application by the Federal Reserve of the controlling influence test. Although the Federal Reserve issued two policy statements on equity investments by or in banking organizations, one in 1982 and one in 2008, these policy statements gave broad, high-level guidance and tended to be short on specific content.

For example, the 2008 policy statement listed business relationships as one of the indicia of control in applying the controlling influence test.⁴⁶ Yet the only substantive guidance given by the 2008 policy statement was to state that business relationships should be “quantitatively limited and qualitatively nonmaterial,” and that the Federal Reserve would scrutinize not just the size of business relationships, but also whether they would be on market terms, non-exclusive, and terminable without penalty by the company in which the investment was made.⁴⁷ Nowhere was there any mention of the extremely low quantitative limits typically contained in the passivity commitments that the Federal Reserve generally required in connection with approving non-controlling investments in the context of, for example, Change in Bank Control Act (“**CIBC Act**”) notices—limits that could be as low as

⁴⁵ *Policy statement on equity investments in banks and bank holding companies* (Sept. 22, 2008), <https://www.federalreserve.gov/bcreg20080922b1.pdf>.

⁴⁶ *Id.*

⁴⁷ *Id.*

a single \$500,000 deposit or, in other cases, 1.5% to 2.5% of revenues. In fact, nowhere was there any mention of passivity commitments at all, yet passivity commitments were a general requirement of the Federal Reserve for non-controlling investments. And the contents of the passivity commitments, although standardized, often have not been publicly disclosed, with the Federal Reserve usually preferring to limit itself to referring in approval letters to the existence of such commitments.

Similarly, the 2008 policy statement did not refer at all to the Federal Reserve's practice of applying completely different standards of control to situations in which a banking organization or other investor is divesting control rather than making an initial non-controlling investment. Although the Federal Reserve codified as part of Regulation Y an interpretation relating to the presumption of continued control under a provision of the BHC Act that has since been repealed, that interpretation did not disclose the Federal Reserve's practice of not considering control to have been divested until and unless a banking organization or other investor had reduced its voting equity interest in a company to below 10% or even 5%.⁴⁸ The Federal Reserve has published some specific interpretations of divestitures of control, but these are fact-specific and in any event are not as easily accessible as regulations published in the Code of Federal Regulations.

This lack of transparency has produced both a lack of consistency and a lack of certainty. For example, in the case of limits on business relationships, we are aware of passivity commitments in which the limit was a single \$500,000 deposit, in which the limit was 1.5%, 2% or 2.5% of the other company's revenues, in which two different limits were calculated based on the investor's revenues and the other company's revenues, and even in which no quantitative limit was applied at all. Similarly, in the case of divestitures, we are aware of situations in which the Federal Reserve found that control had been divested at voting equity levels of ownership of less than 5%, less than 10%, and, more recently, less than 15%.⁴⁹ It is obviously very difficult for banking organizations and other investors to make any judgments, even if they consult with experienced counsel with knowledge of these precedents, about whether specific potential investments or divestitures would be viewed as non-controlling or not—and as a result, it is a common practice to approach the Federal Reserve to discuss such transactions on a case-by-case basis, with all the expenditure of both private-sector and Federal Reserve time and effort and the unpredictability of outcome that such an *ad hoc* practice implies.

⁴⁸ See 12 C.F.R. § 225.139(c)(2) (referring only to the absence of a presumption of control if officers and directors of the divesting company receive less than 25% of a bank's stock and no other shares are subject to a presumption of continued control).

⁴⁹ Letter from Mark E. Van Der Weide to Thomas C. Baxter, Jr., Esq. (July 6, 2018), https://www.federalreserve.gov/bhc_changeincontrol20180706a.pdf.

Against this background, it is no surprise that the Federal Reserve itself has conceded that the current framework is neither transparent nor predictable. As Vice Chairman for Supervision Quarles stated in the Federal Reserve’s open meeting announcing the Board Proposal, divining whether the Federal Reserve will determine that an investment is controlling under the existing framework requires “supplication to a small handful of people who have spent a long apprenticeship in the subtle hermeneutics of Federal Reserve lore, receiving the wisdom of their elders through oral tradition in the way that gnostic secrets are transmitted from shaman to novice in the culture of some tribes of the Orinoco.”⁵⁰

The Board Proposal is therefore a welcome development compared to the existing framework. First, it would provide more transparency, certainty and predictability than the Federal Reserve’s existing framework by virtue of being a published regulation and addressing such issues as the board committees on which an investor’s director representative may sit, the specific types of contractual covenants that would create a presumption of control and the specific types of provisions that would not, the specific quantitative limits on business relationships, and the conditions under which control may be divested.

Second, it would in certain respects revise the Federal Reserve’s existing framework to be more consistent with the text and legislative history of the controlling influence test added by the 1970 amendments to the BHC Act, and thus should make it easier for banking organizations to make non-controlling investments in other companies and other investors to make non-controlling investments in banking organizations. We therefore support the Board Proposal to the extent that it would:

- increase the level of voting equity ownership that benefits from a presumption of non-control from less than 5% to less than 10%;
- permit an increased level of representation on a company’s board of directors;
- relax the limits on board committee representation for an investor’s board representative(s); and
- largely eliminate the quantitative differences between the presumptions of control that apply when a banking organization is acquiring an interest in another company and when it is divesting control of a company.

Yet in our view the Board Proposal does not go far enough in making the Federal Reserve’s controlling influence test fully consistent with the standard of actual control—not

⁵⁰ Board of Governors of the Federal Reserve System, Transcript of Open Board Meeting on April 23, 2019, at 2–3, <https://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20190423.pdf>.

merely the potential ability to exercise a controlling influence—required by the statutory text of the controlling influence test and the legislative history of the 1970 amendments that added the controlling influence test to the BHC Act. Nor does the Board Proposal go far enough in making the controlling influence test fully consistent with the plain meaning of the words “controlling influence,” in contrast to such concepts as an important or significant influence, or an influence comparable to that of a holder of 25% of a company’s voting equity—none of which are consistent with either the required standard of actual control or the plain meaning of “controlling.”

The controlling influence test is properly viewed as meaning, for factors other than voting equity, including for board representation, *actual control*. As a result, in Part II of this comment letter we offer a number of concrete suggestions for ways the Federal Reserve can and should modify the Board Proposal to make it more consistent with an actual control standard or, if not fully consistent with that standard, at least more consistent with the ordinary meaning of the words “controlling influence.”

II. Specific Comments on the Proposed Rebuttable Presumptions of Control

As described below, the proposed rebuttable presumptions on (i) business relationships, (ii) total equity, (iii) investment funds, (iv) accounting consolidation and (v) divestitures are inconsistent with the ordinary meaning of the words “controlling influence” as well as the text and legislative history of the 1970 amendments. We recommend targeted changes to those proposed presumptions to make them more consistent with an actual control standard or at least the ordinary meaning of “controlling influence.” Specifically, we recommend that the Federal Reserve:

- increase the quantitative limits on business relationships;
- apply the limits on business relationships based solely on a percentage of the company’s revenues, and not expenses;
- apply the limits on business relationships to an investor and its consolidated subsidiaries, on the one hand, and to the company and its consolidated subsidiaries, on the other hand, in each case excluding unconsolidated subsidiaries;
- increase the aggregate amount of total equity (above and beyond the BHC Act’s maximum non-controlling limit of 24.9% of any class of voting securities) that an investor may own or control without triggering a rebuttable presumption of control;

- increase the voting equity threshold for the presumption of control designed specifically for an investment fund for which the investor serves as investment adviser;
- extend the exception from the Board Proposal’s presumptions of control for a registered investment company (“**RIC**”) under the Investment Company Act of 1940 (the “**RIC Exception**”) to apply to other similar types of investment funds, including a foreign equivalent of a RIC;
- increase the level of voting equity ownership at which an investor may qualify for the RIC Exception;
- align the standard of control for investment funds under the Board Proposal with the standard of control under the Volcker Rule regulations;
- create a carve-out from the accounting consolidation presumption of control for variable interest entities (“**VIEs**”) or similar entities where consolidation is based on factors other than actual or effective control;
- *not* create a presumption of control triggered by the equity method of accounting;
- eliminate any remaining differences in how controlling influence is assessed in acquisition and divestiture scenarios; and
- treat options, warrants and convertible instruments for purposes of calculating an investors’ level of equity consistently with Regulation Y, existing practice and precedents.

A. Business Relationships

Under the Board Proposal, an investor⁵¹ would be presumed to control a company⁵² if the investor or any of its subsidiaries enters into transactions or has business relationships with the company or any of its subsidiaries that generate in the aggregate total annual revenues or expenses of either (1) the investor or (2) the company, each on a consolidated basis, in excess of the following tiered percentage thresholds:

⁵¹ Throughout Parts II, III and IV of this comment letter, we use “investor” to refer to the “first company” as defined in the Board Proposal.

⁵² Throughout Parts II, III and IV of this comment letter, we use “company” to refer to the “second company” as defined in the Board Proposal.

- If the investor controls 5% or more of any class of voting securities of the company, 10% or more of total annual revenues or expenses;
- If the investor controls 10% or more of any class of voting securities of the company, 5% or more of total annual revenues or expenses; or
- If the investor controls 15% or more of any class of voting securities of the company, 2% or more of total annual revenues or expenses.⁵³

The companies that are within the scope of the limitations on business relationships include, for each of the investor and the company, its subsidiaries. Although the Board Proposal would measure the total annual revenues and expenses “on a consolidated basis,” the Board Proposal would not change the definition of “subsidiary” in Regulation Y, which therefore continues to mean in relevant part “a bank or other company that is controlled by another company.”⁵⁴ As a result, whether a company is a subsidiary of another company for purposes of measuring business relationships and applying the presumptions of control under the Board Proposal would continue to require an assessment of the same three-part test—including the controlling influence test—required by the definition of “control.”⁵⁵

In order to make the controlling influence test more consistent with a standard of actual control or at least with the plain meaning of “controlling influence,” and also to simplify the practical application of any limitations on business relationships, we recommend that the Federal Reserve:

- increase the quantitative limits on business relationships;
- apply the limits based solely on a percentage of the company’s revenues; and
- apply the limits on business relationships to an investor and its consolidated subsidiaries, on the one hand, and to the company and its consolidated

⁵³ Board Proposal, §§ 225.32(d)(4), (e)(3), and (f)(4). Throughout this comment letter, we cite to the Board Proposal’s proposed revisions to Regulation Y, but those citations apply equally to the corresponding proposed revisions to Regulation LL. The Board Proposal adds as a presumption of control for an investor with 10% or more of any class of voting securities that transactions or business relationships “are not on market terms.” Board Proposal, § 225.32(e)(3)(i). The Board Proposal does not define “market terms,” but the Federal Reserve requests comment on the standards that should apply. 84 Fed. Reg. at 21,641 (Question 9). In our view, the Federal Reserve should adopt a standard equivalent to that for covered transactions under Section 23B of the Federal Reserve Act, i.e., terms comparable to those of transactions with other unaffiliated third parties or that in good faith would be offered to unaffiliated third parties.

⁵⁴ See 12 C.F.R. § 225.2(o).

⁵⁵ 12 C.F.R. § 225.2(e)(1).

subsidiaries, on the other hand, in each case excluding unconsolidated subsidiaries.

1. Increase the Limits for Business Relationships

The Board Proposal's approach to presumptions of control reflects what may be described as a "see-saw" approach, whereby as an investor's level of voting equity ownership of a company increases, the level of other factors constituting presumptions of control must decrease. The problem with this approach in the context of business relationships is that it effectively defeats the ability of an investor and a company to enter into a strategic relationship under which an investor contributes not just voting equity capital, but also supports a company by doing a proportionate volume of business with the company. There are numerous instances of strategic equity investors that invest, for example, in up to 20% of a company's voting equity (to secure the benefits of equity accounting) and also enter into business relationships such as referral agreements or joint venture arrangements with the company relating to specific products or services. Similarly, there are instances of banking organizations and other investors seeking to establish user-owned utilities for the purpose of providing services or otherwise doing business (including, for example, clearing or settling certain payments or other financial transactions), where an investor's ownership percentage may be a function of the volume of business it does with the company. In each of these cases, the Board Proposal's current "see-saw" approach, coupled with the low percentage limits on business relationships, would force the investor and the company to choose between a higher level of contributed capital (voting equity) and an inversely lower volume of business relationships, or vice versa, to avoid a presumption of control. In our view, by effectively preventing business relationships that are proportionate to an investor's non-controlling voting equity interest in a company, this approach falls far short of a standard of actual control or the plain meaning of the term "controlling influence." It is frankly difficult to see how business relationships equal to 3% of an investor's annual revenues could in and of themselves realistically tip the scales and give an investor with a 20% voting equity stake even the potential *ability* to exercise to a controlling influence over a company.

The proposed 2%, 5% and 10% limits on business relationships are not anchored in any statutory thresholds required by the BHC Act or any other applicable statute. They are solely the product of lines drawn by the Federal Reserve for the purposes of the Board Proposal. Compared to existing practice and precedents, they may be viewed as generally less restrictive at voting equity levels between 5% and 14.9% and generally more restrictive at voting equity levels between 15% and 24.9%.

But we believe it would be more consistent with the plain meaning of the term "controlling influence" and with a standard of actual control, if the Federal Reserve substantially raised the limits at which business relationships, combined with a specific voting interest, would be deemed to trigger a presumption of control. If owning or

controlling 24.99% of any class of voting securities of a company is not enough in and of itself to give an investor actual control over the company, it is difficult to see why that level of voting equity, plus a percentage of revenues or expenses only slightly higher than 2%, 5% or 10%, would be sufficient to give an investor actual control over the company. For example, it would be more consistent with the plain meaning of the term “controlling influence” and the standard of actual control for the Federal Reserve to base its presumptions of control on an investor combining (1) a voting interest of between 15% and 24.99% in a company with business relationships accounting for more than 24.99% of the company’s total revenues, (2) a voting interest of between 10% and 14.99% in a company with business relationships accounting for more than 33.3% of the company’s total revenues and (3) a voting interest of between 5% and 9.99% in a company with business relationships accounting for more than 49.9% of the company’s total revenues. This approach would be more consistent with the text and legislative history of the 1970 amendments, while retaining a “see-saw” approach to presumptions of control. As a practical matter, of course, it is difficult to envisage too many circumstances in which smaller investors would actually account for such a disproportionately high percentage of a company’s revenues, but, if they did, they would give rise to a presumption of control.

2. Apply Limits Based Solely on the Company’s Revenues

The Federal Reserve requests comment on whether the presumptions of control relating to business relationships should incorporate limits based on the economic significance of the relationships to both the investor and the company.⁵⁶ We believe that any quantitative limits on business relationships between an investor and a company to avoid a presumption of control should be calculated based solely on the revenues that the company earns from the relationships, not based on the expenses of the company or the revenues or expenses of the investor. In our view, the only rationale for making business relationships a factor to be taken into account in assessing whether an investor exercises a controlling influence over a company is the degree to which those relationships create an economic dependence by the company on the investor that effectively gives the investor actual control over the company.

If, for example, a company was dependent for over 50% of its revenues on business relationships with its largest voting shareholder, it might well be reasonable to presume, absent a contrary showing, that the investor could exercise actual control over the company by virtue of conditioning the continuation of those business relationships on the company operating in accordance with the investor’s interests. But if business relationships between the investor and the company accounted for less than, for example, 10% of a company’s revenues and accounted for more than 50% of the investor’s revenues, it is unclear how that

⁵⁶ 84 Fed. Reg. at 21,641 (Question 7).

would give the investor any additional influence over the company. On the contrary, while it might make the investor more dependent on the company and create an incentive for the investor to closely monitor the business of the company, that dependence would not actually give the investor the power to do so—if anything it would give the company a greater ability to influence the investor.

Nor do we believe that limits on business relationships should be based on either company's expenses. Expenses obviously represent a cost rather than a benefit. While it is certainly possible that business relationships with an investor that account for a high percentage of a company's expenses may indicate a high degree of dependence by the company on the investor for certain products or services, that dependence would not necessarily translate into the investor's actual control over the company. If there is a competitive market for the investor's products or services and the company is free to contract with another service provider, it is difficult to see how the company's current high level of expenditure on the investor's products or services would give the investor actual control over the company. In our view, it is not realistic to measure the benefit of a business relationship to a company without considering the impact on a company's revenues. Because the presumption of control for business relationships would already take into account the percentage of a company's revenues attributable to those relationships, it is unnecessary to take into account the percentage of expenses *in addition* to the percentage of revenues, and any limits should be based solely on percentages of revenues.

Finally, because investments may be made in or through subsidiaries that are very small in relation to the consolidated group of which the investor or the company may be a part, the Board Proposal may have the effect of triggering a presumption of control for business relationships if the investor is a small subsidiary of, for example, a much larger top-tier BHC. Although the definition of "first company" may be interpreted as referring to the top-tier BHC on the basis that that is the relevant entity as to which a control determination would be made by the Federal Reserve, we believe that the final rule should clarify that, for purposes of calculating the relevant percentage of revenues, the percentage should be calculated as the greater of:

- the percentage of revenues of the company in which the equity investment is made (and, if the final rule still considers business relationships as a percentage of the investor's revenues to be relevant, the company making the equity investment), each on a consolidated basis; and
- the percentage of revenues of the top-tier BHC or other company of which the company is a subsidiary (and, if the final rule still considers business relationships as a percentage of the investor's revenues to be relevant, the top-tier BHC or other company of which the investor is a subsidiary), each on a consolidated basis.

3. Limit the Scope of Business Relationships to Consolidated Subsidiaries

As noted above, the proposed presumptions of control relating to business relationships would consider relationships between the investor and the company and their respective subsidiaries, with the percentages of annual revenues or expenses being calculated on a consolidated basis. To be consistent with the proposed calculation methodology for revenues and expenses, it would be logical for the Board Proposal to include within the scope of business relationships only those subsidiaries that are consolidated with the investor or the company, as applicable, for accounting and financial reporting purposes. But because the Board Proposal would not change the definition of “subsidiary” in Regulation Y for purposes of the proposed presumptions of control, as a technical matter the relevant subsidiaries for the calculation of business relationship limits would include not just consolidated subsidiaries, but subsidiaries that are controlled for purposes of the BHC Act even if they are not consolidated.

While BHCs and other entities subject to the BHC Act will already be familiar with the statutory definition of “control” and the controlling influence test, and thus with the concept of treating unconsolidated subsidiaries as subsidiaries, the controlling influence test applies equally to non-BHC investors making investments in BHCs and banks and to BHCs and their subsidiaries making investments in non-banking companies. In either case, it would be difficult and burdensome as a practical matter to identify another company’s controlled but unconsolidated subsidiaries for this purpose, particularly if the company is not itself subject to the BHC Act and therefore has never used the BHC Act definition of control—including the controlling influence test—to define its subsidiaries.

We believe that it would be more practical, and consistent with the Board Proposal’s focus on consolidated revenues and expenses, if a “subsidiary” for purposes of the business relationships presumption were limited to a consolidated subsidiary under applicable accounting principles.

B. Total Equity

The Board Proposal would create two rebuttable presumptions of control relating to the percentage of a company’s total equity owned by an investor:

- First, an investor would be presumed to control a company, regardless of its voting equity level, if the investor controls one third or more of the total equity of the company.⁵⁷
- Second, an investor would be presumed to control a company if (1) the investor controls 15% or more of any class of voting securities of the company and (2) the investor controls 25% or more of the total equity of the company.⁵⁸

Together, these presumptions are generally consistent with the 2008 policy statement and the Federal Reserve's existing practice and precedents, under which an investor with less than 15% of each class of voting securities of a company may own a combination of voting and non-voting shares that, when aggregated, represents less than one third of the total equity of a company without having a controlling influence over the company.⁵⁹ But in light of the fact that the total equity limit of 33.3% applies equally to non-voting securities as to a combination of voting and non-voting securities, even if the percentage of voting securities is at a maximum of 14.9%, which is well below the 25% threshold for control under the BHC Act, both of these presumptions fall short of a standard of actual control or the plain meaning of the term "controlling influence." The current and proposed 33.3% limit on an investor's total equity (as opposed to voting securities) is not required by the BHC Act or any other applicable statute and is purely a product of the Federal Reserve's own practice and precedents. We believe that the Federal Reserve can and should increase the aggregate amount of total equity (above and beyond the BHC Act's maximum non-controlling limit of 24.9% of any class of voting securities) that an investor may own or control without triggering a rebuttable presumption of control to be more consistent with a standard of actual control and the plain meaning of "controlling influence."

Ownership of non-voting equity provides an investor with a purely economic interest in the capital of a company that does not, in and of itself, give rise to any voting rights or governance rights. Absent any such rights, a non-voting equity instrument is a means of making a passive investment in the capital of a company that does not provide any potential or actual means to exercise control. Even if a company were, separate and apart from the terms and conditions of the non-voting equity held by an investor, to grant a large holder of non-voting equity board representation or contractual consent rights in a shareholders' agreement, those factors would be covered separately under the Board Proposal by the

⁵⁷ Board Proposal, § 225.32(c). The Board Proposal would treat total equity as including both voting and non-voting common equity, voting and non-voting preferred stock, and debt instruments and other instruments that are functionally equivalent to equity. *See* Board Proposal, § 225.34.

⁵⁸ Board Proposal, § 225.32(f)(1).

⁵⁹ *Policy statement on equity investments in banks and bank holding companies* (Sept. 22, 2008), <https://www.federalreserve.gov/bcreg20080922b1.pdf>.

presumptions of control relating to the number of director representatives and limiting contractual rights;⁶⁰ they would not be rights arising from the ownership of non-voting equity.

Consequently, we believe that it would be more consistent with the plain meaning of “controlling influence” and a standard of actual control for the Federal Reserve to raise the threshold for a presumption of control based on total equity (subject to remaining within the BHC Act’s maximum non-controlling limit of 24.9% of any class of voting securities) to more than 33.3%. The Federal Reserve could, for example, adopt a tiered framework for total equity whereby an investor with between 15% and 24.9% of voting equity would be presumed to control a company only if it had more than 33.3% of the company’s total equity, an investor with between 10% and 14.9% of voting equity would be presumed to control a company only if it had more than 40% of total equity, and an investor with less than 10% of voting equity would be presumed to control a company only if it had more than 49.9% of total equity. In fact, if an investor has no voting or governance rights whatsoever and triggers no other presumptions of control, it would be more consistent with the plain meaning of “controlling influence” and a standard of actual control for the Federal Reserve to permit an even higher level of total equity without triggering a presumption of control. For example, if an investor has no voting equity ownership, no board representation and no business relationships with a company, and has expressly granted a third party the exclusive authority to control the management and policies of the company, that investor could be permitted to hold non-voting equity in excess of 50% without triggering a presumption of control. Such an investor would have no means of potentially or actually controlling the company, regardless of how much its non-voting stake might incentivize it to closely monitor its investment in the company.

C. Investment Fund Presumption and RIC Exception

The Board Proposal includes a presumption of control designed specifically for an investment fund for which the investor serves as investment adviser (the “**Investment Fund Presumption**”) as well as an exception from the Board Proposal’s presumptions of control for a RIC. We recommend that the Federal Reserve modify and recalibrate the Investment Fund Presumption and the RIC Exception to make them consistent with a standard of actual control and the plain meaning of the term “controlling influence,” as described below.

1. Increase Voting Equity Threshold

Under the Board Proposal’s Investment Fund Presumption, an investor would be presumed to control an investment fund if (1) the investor serves as investment adviser to the

⁶⁰ Board Proposal, §§ 225.32(d)(1), (e)(2), (f)(2) (presumptions of control related to director representatives), and §§ 225.32(d)(5) (presumption of control related to limiting contractual rights).

investment fund; and (2) the investor (A) controls 5% or more of any class of voting securities of the fund or (B) 25% or more of the total equity of the fund.⁶¹ This presumption of control would not apply if the investor organized and sponsored the investment fund within the preceding 12 months, meaning that the voting and total equity ownership limits above apply only after the expiration of the permissible 12-month seeding period.⁶²

While the proposed 4.99% limitation on each class of voting securities (after the permissible seeding period) is generally consistent with Federal Reserve precedents for non-controlling investments in closed-end funds, it is more restrictive than the most recent public Federal Reserve precedent for open-end funds, which states that an investor that acts as an investment adviser to mutual funds must only reduce its interest in the fund to below 25% of the total equity and voting securities of the fund by the end of the permissible seeding period to avoid control.⁶³

But even if the Investment Fund Presumption were consistent with the Federal Reserve's own precedents, we believe that it falls far short of a standard of actual control or the plain meaning of the term "controlling influence." Although an investment adviser undoubtedly plays an important role in advising the investment fund with respect to the investment fund's decisions to make or divest investments, investment funds generally have boards of directors or similar bodies with ultimate decision-making authority. Under the Board Proposal, an investor that acts as investment adviser to an investment fund and owns less than 5% of any class of the fund's voting securities and less than 25% of the fund's total equity after a 12-month seeding period would not trigger a presumption of control if its representation on the fund's board of directors or trustees is below 50%.⁶⁴ There is no reason why the Investment Fund Presumption should be triggered at a level of voting equity ownership that is lower than the level at which the presumption of control is triggered for an operating company. In our view, the Investment Fund Presumption should instead be triggered based upon ownership of 25% or more of any class of voting securities of an investment fund, which would be more consistent with the standard applicable to operating companies and the Federal Reserve's *First Union* precedent for open-end funds.⁶⁵

⁶¹ Board Proposal, § 225.32(h)(1).

⁶² Board Proposal, § 225.32(h)(2).

⁶³ Letter to H. Rodgin Cohen, Esq. from Jennifer J. Johnson re: First Union Corporation (June 24, 1999).

⁶⁴ See 84 Fed. Reg. at 21,640 (confirming that an investor with less than 5% of any class of voting securities would not be presumed to control a company as a result of its board representation as long as its director representatives were not a majority of the board).

⁶⁵ Letter to H. Rodgin Cohen, Esq. from Jennifer J. Johnson re: First Union Corporation (June 24, 1999).

2. *Expand RIC Exception*

Under the RIC Exception, none of the rebuttable presumptions of control in the Board Proposal, including those under the Investment Fund Presumption, would apply to an investor if:

- the company is an investment company registered with the SEC under the Investment Company Act of 1940;
- the business relationships between the investor and the RIC are limited to investment advisory, custodian, transfer agent, registrar, administrative, distributor, and securities brokerage services provided by the investor to the RIC;
- director representatives of the investor or any of its subsidiaries comprise 25% or less of the board of directors or trustees of the RIC; and
- (A) the investor controls less than 5% of the outstanding securities of each class of voting securities of the RIC and less than 25% of the total equity of the RIC, or (B) the investor organized and sponsored the RIC within the preceding 12 months (i.e., the RIC is in its initial seeding period).⁶⁶

As proposed, the RIC Exception would only apply to RICs and not to other open-end investment funds, such as non-U.S. retail UCITs, which along with RICs have previously been viewed by the Federal Reserve as “mutual funds.”⁶⁷ The Federal Reserve did not provide any rationale for limiting the exception in this way, and in our view there is no justification for this limitation. The RIC Exception should be extended to apply to other similar types of investment funds, including a foreign equivalent of a RIC (i.e., a foreign public fund (“**FPF**”)), which would be more consistent with the treatment of foreign public

⁶⁶ Board Proposal, § 225.32(j).

⁶⁷ The term “mutual fund” is not explicitly defined for purposes of the BHC Act or Regulation Y, although Federal Reserve precedent has consistently found a mutual fund to be the equivalent of an “open-end” investment company (e.g., a fund that issues shares continuously or frequently) without reference to where such fund was domiciled or offered or to the legal form of the fund. *See* 12 C.F.R. § 225.125(c) (noting that open-end investment companies are “commonly referred to as ‘mutual funds’”); Mellon Bank Corp., 79 Fed. Res. Bull. 626 (1993) (defining the term “mutual funds” to mean open-end investment companies); Societe Generale, 84 Fed. Res. Bull. 680 (1998) (referring to open-end investment companies as “mutual funds”). The Federal Reserve has confirmed that the legal form of a fund should not be dispositive for determining whether or not a fund is viewed as a mutual fund. *See* Mellon Bank Corp., 80 Fed. Res. Bull. 733, 736 n.18 (1994) (discussing mutual funds as able to take the form of limited partnerships as well as corporate or trust forms).

funds in other contexts, such as the Volcker Rule,⁶⁸ and would provide consistent treatment for similar types of funds.

Just as the proposed Investment Fund Presumption falls short of a standard of actual control or the plain meaning of the term “controlling influence,” we believe that the level of voting equity ownership to qualify for the RIC Exception is too low compared to an actual control standard. It is also inconsistent with the Federal Reserve’s *First Union* precedent, under which an investor is permitted to hold up to 24.9% of a mutual fund’s voting securities after the initial seeding period without being deemed to control the fund.⁶⁹ For the same reasons given above for amending the voting equity level at which the Investment Fund Presumption is triggered, the Federal Reserve should increase the level of voting equity ownership at which an investor may qualify for the RIC Exception to below 25% of the RIC’s voting securities.

3. *Align the Board Proposal with the Volcker Rule and the Volcker Rule FAQs*

We also recommend that the Federal Reserve consider establishing a single control standard for investment funds under the Board Proposal and the analogous exclusion of various types of RICs and FPFs, and potentially other investment funds, from the definition of “banking entity” under the Volcker Rule regulations,⁷⁰ their proposed amendments published on July 17, 2018,⁷¹ and the existing Volcker Rule FAQs.⁷² For example, to the extent that any amendments to the Volcker Rule regulations would incorporate Volcker Rule FAQs 14 and 16, which clarify, among other things, that an FPF would not be a banking entity if no banking entity owned 25% or more of the FPF’s voting securities after the permitted seeding period, and that neither a RIC nor an FPF would be treated as a banking entity solely on the basis of the level of ownership of the fund’s securities by a banking entity during the permissible seeding period, which could be up to three years, those standards could similarly be incorporated into or made consistent with the final rule implementing the Board Proposal. There is no rationale of which we are aware for adopting different standards of control for investment funds under the definition of banking entity for Volcker Rule purposes and the definition of control, including the controlling influence test, for investment funds for purposes of other provisions of the BHC Act. Different standards of control, including potentially a different articulation of the controlling influence test, would be

⁶⁸ See 12 C.F.R. § 248.10(c)(1).

⁶⁹ Letter to H. Rodgin Cohen, Esq. from Jennifer J. Johnson re: First Union Corporation (June 24, 1999).

⁷⁰ 12 C.F.R. § 248.2(c).

⁷¹ 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 (July 17, 2018).

⁷² *Volcker Rule Frequently Asked Questions*, <https://www.federalreserve.gov/supervisionreg/faq.htm>.

confusing, lead to inconsistent results, and would be unnecessarily burdensome on banking organizations, other investors and the investment funds themselves. In aligning the controlling influence test in the final rule implementing the Board Proposal with the standard of control under the Volcker Rule regulations, the Federal Reserve and other relevant agencies should in all cases be guided by the standard of actual control and the plain meaning of the term “controlling influence.”

D. Accounting Consolidation and Equity Method Accounting

Under the Board Proposal, an investor would be presumed to control a company, separate and apart from the investor’s level of voting equity ownership in the company and any other presumptions of control, if the investor consolidates the company on its financial statements prepared under U.S. Generally Accepted Accounting Principles (“U.S. GAAP”).⁷³ The Federal Reserve also requests comment on whether an investor should be presumed to control a company if the investor accounts for its investment in the company using the U.S. GAAP equity method of accounting.⁷⁴

To the extent that accounting consolidation under U.S. GAAP is based on a standard of actual or effective control over the company by the investor (e.g., ownership of a majority of the voting equity of the company), such a presumption would be generally consistent with either the BHC Act’s bright-line test of 25% or more of any class of voting securities or with the legislative history of the controlling influence test as well as the plain meaning of the term “controlling influence.” However, although we are not accounting experts and thus necessarily defer to those who are, our understanding is that consolidation of certain companies under U.S. GAAP, such as VIEs, is based on factors other than actual control.⁷⁵ To the extent that this is the case, in our view there should be a carve-out from the presumption for VIEs or similar entities where consolidation is based on factors other than actual or effective control, and those entities should instead be treated as any other company for purposes of the presumptions of control in the final rule.

⁷³ Board Proposal, § 225.32(g).

⁷⁴ 84 Fed. Reg. at 21,644–45 (Question 22).

⁷⁵ For example, we understand that the holder of a variable interest is required to consolidate a VIE if it (i) has the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance and (ii) has the obligation to absorb the losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. *See* Financial Accounting Standards Board, Accounting Standards Codification § 810-25-38A. Whether the holder of a variable interest is considered to have “the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance” is assessed under applicable accounting guidance and may not be consistent with a standard of actual control.

Nor do we believe that equity method accounting under U.S. GAAP should trigger a presumption of control over a company. Our understanding is that there is a distinction under U.S. GAAP between the level of control required for full consolidation (a “controlling financial interest,” which is typically achieved through direct or indirect ownership of a majority of voting securities) and that for equity method accounting (a “significant influence,” which is presumed when there is direct or indirect ownership of 20% of voting securities).⁷⁶ This distinction clearly argues against adopting a presumption of control based on equity method accounting for the simple reason that it would otherwise create a presumption of control based on an investor’s ownership or control of 20% of any class of a company’s voting securities. This is a level of voting equity ownership that, under the Board Proposal, is not sufficient on its own to create a presumption of control.

Obviously a voting equity stake of 20% is below the BHC Act level of 25% or more at which control is deemed to exist and is even farther below any standard of voting equity ownership that would confer actual control. Under the Board Proposal there would be no presumption of control unless, in addition to the ownership of 20% of voting equity, other factors triggered a presumption of control, such as an investor’s director representatives constituting 25% or more of the company’s board, or one of its director representatives being chair of the board of directors. In short, presuming control based solely on GAAP equity method accounting would effectively mean that all of the other factors necessary to trigger a presumption of control for investors between 15% and 24.9% of voting equity would now be relevant only for investors holding between 15% and 19.9% of voting equity. An investor holding 20% of voting equity would be presumed to control a company based on that fact alone. Such a result would not only be inconsistent with the actual control standard of the legislative history of the controlling influence test, but it would also completely upend decades of the Federal Reserve’s own practice and precedents. We are unaware of any precedent in which an investor was found to exercise a controlling influence over a company based solely on its ownership of 20% of a class of voting securities of a company and no other control factor.

It is also unclear how a presumption of control triggered by equity method accounting could be rebutted. If ownership of 20% of any class of a company’s voting securities is sufficient to presume control, and if none of the other factors triggering a presumption of control under the Board Proposal are present, an investor could only rebut the presumption of control by either reducing its voting equity level below 20% or else trying to rebut the presumption based on accounting standards and criteria that would normally be applied and determined by the Financial Accounting Standards Board rather than the Federal Reserve.

⁷⁶ See Financial Accounting Standards Board, Accounting Standards Codification, Topic 810, *Consolidation*; Topic 323 Investments—Equity Method and Joint Ventures.

Finally, such a presumption would have the perverse effect of discouraging equity method accounting for investments made by banking organizations or by investors in banking organizations. If the consequence of equity method accounting is to trigger a presumption of control under the BHC Act, investors may be incentivized to structure their investments to avoid equity method accounting and, as a result, would be exposed to the risk of greater volatility in the value of their investment and thus, for a banking organization, in the amount of its regulatory capital. Investments not accounted for under the equity method would be accounted for using the fair value method, which as a general matter may result in greater volatility in the carrying value of the investment on the investor's balance sheet. This result might in turn make minority, non-controlling investments by or in banking organizations less appealing from a financial perspective, which would thus have the surely unintended consequence of discouraging rather than attracting capital to the banking sector.

E. Divestitures

The Board Proposal would significantly liberalize the Federal Reserve's existing practice and precedents for determining when a banking organization has divested control of a previously controlled company. Under the Federal Reserve's existing practice and precedents relating to the divestiture of control, a banking organization has generally been required to reduce its voting and total equity ownership in a company to 9.9% or even less in order to divest control, although a more recent precedent permitted a banking organization to divest control at a voting equity level of 14.9%.⁷⁷

Under the Board Proposal an investor may divest control of a company in one of the following ways:

- If the investor (1) controls the company by owning 25% or more of any class of voting securities or by controlling the election of a majority of the company's board of directors and (2) after the divestiture of control, the investor still owns or controls between 15% and 24.9% of any class of voting securities of the company, the investor would be presumed to control the company for two years after the divestiture (assuming no other presumptions of control are triggered).⁷⁸

⁷⁷ Letter from Mark E. Van Der Weide to Thomas C. Baxter, Jr., Esq. (July 6, 2018), https://www.federalreserve.gov/bhc_changeincontrol20180706a.pdf.

⁷⁸ Board Proposal, § 225.32(i)(1). There is an exception to the presumption of control that would apply if 15% or more of any class of voting equity is retained, as described above, if 50% or more of each class of voting securities of a company is controlled by (1) a person that is not a senior management official or director of the investor, or (2) another company that is not an affiliate of the investor. Board Proposal, § 225.32(i)(2); 84 Fed. Reg. at 21,645.

- If the investor reduces its voting equity ownership to less than 15% of each class of voting securities of a company, it would not need to wait two years to divest control of the company. Upon reducing its voting equity level to less than 15%, absent any other presumption of control, it would not be presumed to control the company.⁷⁹
- If the investor sells its entire equity stake in the company to another company (the “**buyer**”) in exchange for consideration consisting of less than 25% of each class of voting securities of the buyer and does not trigger any presumption of control with respect to the buyer, the investor would no longer be presumed to control the previously controlled company because it would no longer own any voting securities of the company.⁸⁰

While the proposed liberalization of the Federal Reserve’s divestiture practice is a welcome step in the right direction, we believe that the Federal Reserve can and should eliminate any remaining differences in how controlling influence is assessed in acquisition and divestiture scenarios so that the same principles of control apply when an investor is making a new investment or seeking to divest control of a company. There is no basis in the statutory language of the BHC Act to assess control differently in these scenarios and, although the two-year waiting period is an improvement compared to the existing practice, it is nonetheless unjustified if measured against a standard of actual control or the plain meaning of the term “controlling influence.” Either an investor controls a company under the controlling influence test or it does not. Nothing in the BHC Act itself or in the legislative history of the controlling influence test justifies using the controlling influence test as a waiting or transition period for certain divestiture scenarios. There should be a single controlling influence test, and it should apply regardless of whether an investment is an initial acquisition of a non-controlling position or a divestiture of control. Eliminating the difference in how controlling influence is assessed in acquisition and divestiture scenarios would make the Federal Reserve’s control framework more consistent with an actual control standard and the plain meaning of the words “controlling influence,” as distinguished from some alternative standard such as an important or significant controlling influence.

F. Options, Warrants and Convertible Instruments

The Board Proposal would provide that a person that controls a voting security, non-voting security, option, warrant, or other financial instrument that is convertible into, exercisable for, exchangeable for, or otherwise may become a voting security or a non-voting

⁷⁹ 84 Fed. Reg. at 21,645.

⁸⁰ *Id.*

security controls each voting security or non-voting security that could be acquired as a result of such conversion, exercise, exchange, or similar occurrence.⁸¹

The existing version of Regulation Y,⁸² and past Federal Reserve practices and precedents, take into consideration whether the investor has control over the conditions under which an option, warrant or similar instrument may be exercised (i.e., whether it may be exercised at the option of the investor) for purposes of determining whether the investor is treated as owning the underlying voting or non-voting security. Although the Federal Reserve specifically notes in the Board Proposal that “[t]he look-through approach would apply even if there were an unsatisfied condition precedent to the exercise of the options or if the options were significantly out of the money,”⁸³ it is unclear whether the apparent elimination of the distinction between conditions to exercise an option that are under the control of an investor and those that are not under the control of the investor is intentional or unintentional.

The Federal Reserve should clarify in the final rule that an investor will be considered to have control over the shares that may be issued upon exercise of an option only if the investor controls the exercise of the option. If conditions are outside the control of the holder, i.e., if they depend on actions or consents by third parties or on economic circumstances not within the control of the holder, the instrument should not be treated as giving the holder control over the underlying voting securities. In our view, such a clarification would align the Board Proposal with the existing provision of Regulation Y and the Federal Reserve’s existing practice and precedents, and would in any event be consistent with the underlying rationale for the treatment of convertible or exchangeable instruments, which is obviously predicated on the assumption that the investor is in fact able to obtain the voting or non-voting securities into which the instrument is convertible or for which it may be exchanged.

III. Clarification of Impact on Existing Non-Controlling Investments and on Passivity Commitments

Notwithstanding the Federal Reserve’s own recognition that it has a long history of making determinations whether an investor exercises a controlling influence over a company and that there has been an evolution of its framework, practice and precedents over the years, the Board Proposal does not address the question of how, if finalized, the Board Proposal

⁸¹ Board Proposal, § 225.9(a)(1); 84 Fed. Reg. at 21,648–49.

⁸² See 12 C.F.R. § 225.12(d)(1)(i) (“A company that owns, controls, or holds securities that are immediately convertible, *at the option of the holder or owner*, into voting securities of a bank or other company, controls the voting securities.”) (emphasis added).

⁸³ 84 Fed. Reg. at 21,648.

might affect existing investments that have been reviewed by the Federal Reserve and determined to be non-controlling on the basis of, among other things, criteria and passivity commitments that are stricter than the Board Proposal's presumptions of control or that might even be more liberal than the Board Proposal. We believe that it is important for the Federal Reserve to provide this clarity in a final rule, consistent with its overarching goal of providing greater transparency and consistency in this area of practice.

A. Treatment of Existing Non-Control Determinations and Passivity Commitments

The Federal Reserve should clarify what an investor with an existing non-control determination must do to obtain the benefit of the presumptions of control in the final rule that depart from historical Federal Reserve practice and precedents, especially if the investor is subject to passivity commitments. To the extent that an existing non-controlling investment is subject to a passivity commitment that is *more* restrictive than the final rule, we recommend that an investor should automatically be permitted to modify the investment in any way that would be consistent with a non-controlling investment under the final rule, even if contrary to the pre-existing passivity commitment. To the extent that an existing investment has already been the subject of a non-control determination by the Federal Reserve and is subject to a passivity commitment that is *less* restrictive than the final rule, we recommend that the investment should be grandfathered and remain a non-controlling investment, at least for as long as there is no other material change to the investment.

B. Future Passivity Commitments

Consistent with the fact that, under the Board Proposal, an investor generally would not be treated as exercising a controlling influence unless it triggered one or more of the proposed presumptions of control, the Federal Reserve should clarify in the final rule (or in its preamble) that there would not be any need for an investor to enter into passivity commitments as long as the investor does not trigger any of the rebuttable presumptions of control. Passivity commitments, to the extent they have any continuing role at all, should be limited to serving as a means of documenting any undertakings necessary to rebut a presumption of control.

IV. Impact on Change of Bank Control Regulations

Although the definition of "control" in Section 225.2(e)(1) of Regulation Y explicitly disapplies the definition for purposes of the provisions implementing the CIBC Act in Subpart E of Regulation Y, it seems clear that the final rule implementing the Board Proposal and amending the controlling influence test will invariably affect the Federal Reserve's analysis of, and action on, any CIBC Act filing made under Subpart E. A prior approval for a non-controlling investment in a bank or BHC will necessarily have to consider whether, as a result of the proposed investment, the investor would exercise a controlling influence over the

bank or BHC. For the same reason, it is equally likely that the final rule on the controlling influence test will affect how the other federal banking agencies analyze and act on CIBC Act filings made under the corresponding change in bank control provisions of their respective regulations.

It would clearly be illogical and untenable for there to be two different controlling influence tests: one for control hearings under Regulation Y (or the corresponding control hearings under Regulation LL) and one for CIBC Act proceedings if a notice is required under subpart E of Regulation Y (or subpart D of Regulation LL). Just as a final rule implementing the Board Proposal—especially if modified in line with the recommendations made in this letter—would provide welcome clarity and a measure of liberalization compared to the Federal Reserve’s existing practice and precedents, corresponding improvements can and should be made to the existing practices and precedents regarding CIBC Act proceedings. As a result, and recognizing that the Board Proposal by its terms does not propose any changes to the Federal Reserve’s CIBC Act rules, we recommend that the Federal Reserve (together with the other federal banking agencies) consider, in a future rulemaking proposal, tailoring the CIBC Act notice requirements to the different levels of voting equity ownership and presumptions of control reflected in the Board Proposal.

One of the improvements that could be made to the current CIBC Act regulations would be to recognize that an investor seeking to acquire up to 14.9% of any class of voting securities of a bank or BHC without triggering a presumption of control could be treated differently than an investor seeking to acquire up to 24.9% of any such class of voting securities. Consistent with the different treatment of investors depending on their levels of voting equity ownership under the Board Proposal, a new CIBC Act proposal could distinguish between the types of notices required by a non-bank investor seeking to acquire between 10% and 14.9% of any class of voting securities of a bank or BHC and a non-bank investor seeking to acquire between 15% and 24.9% of any such voting securities, in each case provided that the investor does not trigger any of the presumptions of control.⁸⁴ For example, a 10% to 14.9% investor could file a Schedule 13D or Schedule 13G notice pursuant to the Securities Exchange Act of 1934 (“**Exchange Act**”), as applicable, or, for an investment in a bank, BHC or SLHC not listed on a nationally recognized securities exchange and whose securities are not registered with the SEC under the Exchange Act, a notice containing equivalent information to that required under a Schedule 13D or Schedule 13G, potentially without being required to obtain the prior approval or non-objection of the relevant banking agency to acquire the securities, whereas a 15% to 24.9% investor could file the type of notice currently required under the CIBC Act regulations and be required to

⁸⁴ Consistent with the current CIBC Act regulations and the Board Proposal’s presumption of non-control, no change in bank control notice would be required by an investor owning less than 10% of the voting equity of a bank, BHC or SLHC.

obtain the relevant banking agency's prior approval or non-objection to the acquisition. This kind of tiering of information and prior approval requirements based on different levels of voting equity ownership would, in our view, reduce the burden, time and effort associated with the current change in bank control process by non-bank investors in circumstances in which they would not trigger any of the presumptions of control and thus would facilitate and attract investments in the capital of banks and BHCs by non-bank investors.

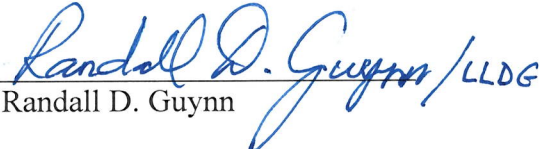
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Board of Governors of the Federal Reserve System
July 15, 2019
Page 37

Davis Polk thanks the Federal Reserve for its consideration of our comments. If you have any questions, please do not hesitate to contact Luigi L. De Ghenghi at (212) 450-4296 or Randall D. Guynn at (212) 450-4239.

Yours Sincerely,

DAVIS POLK & WARDWELL LLP

By:  /LLDG
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