

# Client Alert

October 2020

## Clear as Mud? Understanding the Fed's Change in Control Rules and Common Inadvertent Violations

The Board of Governors of the Federal Reserve System (the “Fed”), the Office of the Comptroller of the Currency (the “OCC”), and the Federal Deposit Insurance Corporation (the “FDIC”) each have regulations implementing the Change in Bank Control Act (12 U.S.C. 1817(j)) (“CIBCA”), which essentially requires a person, or group of persons, to file a notice with the banking agency and receive its clearance before acquiring “control” of a bank or bank holding company.

For bank holding companies (“BHCs”), the Fed is the federal banking agency with which the notice is filed, and for stand-alone banks the notice is filed with the bank’s primary federal regulator (FDIC, Fed, or OCC). There may also be separate approvals or notices required under applicable state law for state banks and their BHCs. Because most banks in the US have a BHC, most CIBCA filings are made with the Fed.

The purpose of this alert is to give some practical examples of situations that may create inadvertent violations of CIBCA, as well as actions BHCs and shareholders can take to avoid or remedy violations. We will focus on the Fed’s rather complicated system for determining whether a person is in control of a BHC under the CIBCA.

In our experience, many shareholders<sup>1</sup> are inadvertently violating these rules due to their complexity. Such violations may be discovered if the Fed raises the issue (e.g., when it reviews the Form Y-6 that the BHC files annually) or if the BHC makes a filing with the Fed and the inadvertent violation is discovered (e.g., filing an application in connection with an acquisition).

The technical legal exposure from such violations is severe. Moreover, violations may be deemed to exist when the BHC or bank are in less than a well-capitalized position, thereby requiring much more than an after-the-fact filing.

### **A Brief Note on the Bank Holding Company Act**

Entities<sup>2</sup> are at risk of being subject to the Bank Holding Company Act of 1956, as amended (the “BHC Act”), if the entity is deemed to be in control of a bank or BHC. In such case, the entity must obtain prior approval to become a BHC under the BHC Act. Individuals are not bank holding companies and are not subject to the BHC Act.

Among other requirements, BHCs are required by law to serve as a source of financial and managerial strength for their subsidiary banks; thus, most shareholders prefer to structure their investments to avoid becoming BHCs themselves. In general, if an entity owns or controls more than 25% of the voting common stock of a bank or BHC, that entity is required to obtain prior approval to be a BHC itself, although the Fed can find control in ownership levels as low as a 5% voting interest if other factors

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<sup>1</sup> The filing obligation is actually on the shareholder, not the BHC or bank.

<sup>2</sup> There are exclusions for testamentary trusts and family limited partnerships that meet certain requirements.

are present. On January 30, 2020, the Fed adopted a final rule for Control and Divestiture Proceedings (“Final Rule”) to clarify the Fed’s considerations when determining whether a company has the ability to exercise “control” or a “controlling influence” under the BHC Act and the Home Owners’ Loan Act. The Final Rule became effective on April 1, 2020.

This alert will focus on the CIBCA, but if you have questions regarding the Final Rule or other Fed requirements under the BHC Act, we would be happy to discuss those matters.

## **General Rule Under CIBCA**

The CIBCA and the Fed’s regulations promulgated thereunder, set out in 12 C.F.R. Part 225 (commonly called Regulation Y), provide the framework for the change in bank control rules and filings. The change in bank control rule found in 12 C.F.R. 225.41(a) generally provides that “[a]ny person acting directly or indirectly, or through or in concert with one or more persons” must give 60 days written notice to the Fed (the filing is called an Interagency Notice of Change in Control (“CIC Notice”)) before acquiring “control” of a state member bank or BHC unless the acquisition is exempt.<sup>3</sup> The Fed generally has 60 days to review and process the CIC Notice.

A “person” is defined very broadly to include an individual or any type of entity (including a trust).<sup>4</sup> In addition, 12 C.F.R. 225.41(c) conclusively defines “control” as the ability to own, control, or hold the power to vote 25% or more of any class of voting stock of the BHC. For purposes of this alert, we are focused on voting common stock, so when we discuss stock, we mean voting common stock. All of this seems pretty straight forward until you look at 12 C.F.R. 225.41(c)(2), which addresses rebuttable presumptions of control. In general, the Fed presumes that an acquisition of BHC stock constitutes “control” if, immediately after the transaction, the acquiring person (or persons acting in concert) will own, control, or hold with power to vote 10% or more of any class of voting securities of the institution, and if (1) the institution has securities registered with the Securities and Exchange Commission (the “SEC”); or (2) no other person will own, control, or hold the power to vote a greater percentage of that class of voting securities immediately after the transaction. So, it’s a two prong test.

As a practical matter, this rule means that a filing with the Fed is usually triggered if a person (or persons acting in concert) acquires as little as 10% of the BHC’s stock. If the BHC is public (i.e., has securities registered with the SEC), each person who acquires 10% or more must file with the Fed. If the BHC is privately held, if a person owns 10% or more and is the single largest shareholder, then that person must file with the Fed.

The rules get murkier when you consider what does it mean to be “acting in concert”? In general, the following parties are deemed to be “acting in concert”:

- An entity and any controlling shareholder, partner, trustee, or management official of the company, if both the company and the person own voting securities of the state member bank or BHC;
- An individual and the individual’s “immediate family,” which is broadly defined to include a person’s father, mother, stepfather, stepmother, brother, sister, stepbrother, stepsister, son, daughter, stepson, stepdaughter, grandparent, grandson, granddaughter, father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law, the

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<sup>3</sup> Please note that 12 C.F.R. 225.42 sets forth certain transactions that are exempt from the prior notice filing with the Fed (e.g., acquisitions subject to approval under the BHC Act; one-time proxy solicitations; stock dividends), and it also sets forth transactions that are exempt from the prior notice requirement but a 90 day after the fact notice is required (e.g., acquisition of shares through inheritance (not estate planning); acquisition of shares through bona fide gift (not where the gift recipient knows the gift is coming); acquisition of shares in satisfaction of a debt previously contracted).

<sup>4</sup> There is some overlap between the CIBCA and the BHC Act. But if an entity acquires control of a bank or a BHC, it will be treated as a BHC and will be exempt from filings made under CIBCA.

spouse of any of the foregoing, and the person's spouse;

- Entities under common control;
- Persons that have an agreement (whether written or otherwise) regarding the control of the BHC or the voting of the BHC's stock;
- Persons that have made, or propose to make, a joint filing under sections 13 or 14 of the Securities Exchange Act of 1934 and the SEC's rules; and
- A person and any trust for which the person serves as trustee.

### **Common Examples**

Now that we have laid the groundwork of the rule, what does all of this mean? At its simplest, it means that if any person or persons acting in concert acquire 10% or more of a BHC, there is likely a CIC Notice filing with the Fed, so the shareholder(s) should be talking with legal counsel or the Fed. Let's look at some common examples of when CIC Notice filings have been inadvertently triggered for BHCs:

- **Example 1 – Large Family Holdings.** As discussed above, the Fed's definition of "immediate family" is quite broad. Let's assume each of the following persons own 4% of the BHC's stock: (1) Grandma, (2) Grandpa, (3) Dad, (4) Mom, (5) Testamentary Trust controlled by Dad, (6) Testamentary Trust controlled by Mom, and (7) Mom's sister. On their own, 4% seems small, so these individuals may assume no filing is required under CIBCA. However, these seven individuals/trusts will likely be treated as part of the same "immediate family," so the family group must file a CIC Notice to control 25% or more of the BHC.
- **Example 2 – Stock Passed Down Through the Generations:** Let's assume Dad founded the BHC and owned 100% of the stock (so Dad was previously approved by the Fed to own 100% of the stock). Dad has three children, Son 1, Son 2, and Daughter. Over the years, Dad passes the stock down to Son 1, Son 2, and Daughter in equal parts, so now each of them and Dad own 25% of the BHC. This is likely a CIBCA violation, because before any of the stock was passed down to Son 1, Son 2, and Daughter, who are part of Dad's "immediate family," a CIC Notice should have been filed for them to join the control group with Dad.<sup>5</sup>
- **Example 3 – Estate Planning Transfers:** Let's again assume that Dad founded the BHC and owned 100% of the stock. Dad moves all of his stock into a trust, of which Dad serves as the trustee. Surely no filing is required, right, as Dad still controls the stock? Wrong – the trust should have filed a CIC Notice<sup>6</sup> to join the control group.
- **Example 4 – No Control Group Shield:** Let's assume the BHC is a private company and Dad and his three children (we will call them the "Smith Family Group") each own 10%, for a total of 40% of the BHC's stock. Let's assume there is another shareholder, Mr. Jones, who owns 15% of the BHC's stock and is the largest individual shareholder, but no one else in Mr. Jones "immediate family" owns any of the BHC's stock. In this instance, under the Fed's rules<sup>7</sup>, a CIC Notice would be required for the Smith Family

<sup>5</sup> If all of the shares were transferred by bona fide gift, then the children may not have been required to file a CIBCA Notice before the gift was made, but (a) the children would be obligated to submit similar information within 90 days after the gift was made, and (b) the children would be obligated to file a CIBCA notice before acquiring any additional percentage ownership other than by gift (such as by purchasing stock).

<sup>6</sup> This assumes the trust meets the requirements to be exempt from being a BHC. Most estate planning trusts meet the requirements, but shareholders should consult counsel familiar with these rules.

<sup>7</sup> The OCC and the FDIC interpret the CIBCA differently and those agencies likely would not require a filing by Mr. Jones under these circumstances.

Group, as the group controls over 25% of the BHC stock, and a CIC Notice is required for Mr. Jones, as he owns greater than 10% and is the single largest shareholder. The Smith Family Group's larger ownership does not "shield" Mr. Jones, and he must file a CIC Notice even though he controls fewer shares (15%) compared to the Smith Family Group (40%).

- **Example 5 – Public BHCs.** Let's assume the BHC has securities registered with the SEC and its stock is generally widely held, but the BHC has three shareholders who own 10% or more of its stock. All three of those shareholders would need to file separate CIC Notices with the Fed. There is no "single largest shareholder" requirement for public BHCs.
- **Example 6 – Reduced Ownership.** Let's assume that Mrs. Carson owns 15% of the BHC's stock and is the single largest shareholder. Mrs. Carson was previously cleared under CIBCA for this ownership. Mrs. Carson sells 6% of her stock because she needs some cash, reducing her ownership to 9% of the BHC. Mrs. Carson wins the lottery the next day, so she buys the shares back. Once Mrs. Carson decreased her ownership below 10%, the Fed requires a new CIC Notice for Mrs. Carson to once again be over 10% and the largest shareholder.
- **Example 7 – Voting Agreements.** Let's assume certain shareholders of the BHC, controlling 25% or more of the BHC's stock, have entered into an agreement whereby they all agree to vote their BHC stock in the same manner or they agree to a buy-sell or right of first refusal agreement with respect to their shares. In this case, all of these shareholders would need to file the CIC Notice as parties "acting in concert." Please note that these agreements can be considered BHCs, so it is important to consult Fed guidance before signing an agreement relating to the acquisition, voting or transfer of control of voting securities of a BHC or bank.

These are the most common examples we see with our clients, but please note the analysis is very fact specific and many other circumstances can trigger the obligations to file a CIC Notice.

### **What Does the CIC Notice Look Like?**

The CIC notice is an interagency form and is available on the websites for the OCC, the FDIC and the Fed. The notice requires certain information about the proposed transaction (shares owned pre-transaction; shares owned post-transaction; a summary of the transaction; etc.). The Fed requires the shareholder (or any shareholders who own or control 2% or more in an immediate family) to provide an Interagency Biographical and Financial Report ("IBFR"). The IBFR requires detailed personal and financial information about the shareholder. In addition, if the shareholder will own or control 5% or more of the BHC's stock, then the shareholder will have to be fingerprinted and will be subject to a background check.

### **What are the Consequences for Not Filing a CIC Notice?**

There are several potential consequences for failure to obtain Fed clearance before acquiring control of a BHC. The Fed may require divestiture if a controlling interest was acquired in violation of the CIBCA or the Fed's regulations. The Fed may also assess civil money penalties on persons who fail to file notices or who file late notices. In addition, the Fed may publicize any remedial action taken against a person who has filed a late notice.

In our experience, these remedies are usually exercised by the Fed when someone intentionally avoids filing a CIC Notice in an effort to gain control. As long as the violation were truly inadvertent, the Fed has been quite accommodating if the shareholder(s) promptly files the CIC Notice after discovering the inadvertent violation.

CIBCA issues may also arise when a BHC files an application for an acquisition or other expansionary activity. In those instances, these issues may significantly delay the application process, although we have seen some willingness for the Federal Reserve Banks to separate the processing of the CIBCA filings from the application process.

## **What Should BHCs Do to Avoid These Problems and Potential Red Flags?**

Below are a few practical suggestions for BHCs and their shareholders in resolving these issues before the Fed raises them:

- ***Be Familiar with the Change in Control Rules and Train the Board:*** Shareholders should be familiar with the CIBCA rules and applicable regulations and consult legal counsel, if needed, in connection with their investment in the BHC. To assist shareholders, the BHC could educate its shareholders (e.g., at the annual meeting) or raise the issue in a shareholder communication to put the issue on its shareholders' radar. In addition, BHC employees (e.g., the corporate secretary) should be trained on these rules, so they can look for the red flags discussed below. Finally, ownership of the BHC is often concentrated in the Board, so the BHC's Board should be trained on these rules and how they apply to their ownership in the BHC.
- ***Know the Controlling Shareholder and Review the Shareholder List:*** To assist shareholders, the BHC should be aware of who has been approved by the Fed to be in control (keeping a copy of the clearance letter from the Fed in the BHC's records is a best practice), and the BHC should review its shareholder list periodically to see if there have been any changes in the controlling shareholders or groups acting in concert. If it looks like there have been changes, the BHC should reach out to the shareholder to alert the shareholder to the potential issue.
- ***RED FLAG - Family-Owned BHCs.*** If the BHC has been in the same family for many generations, and there has not been a CIC Notice filed with the Fed in recent history, that is a red flag. The BHC should consult with the controlling family group on this issue, as a filing may be required.
- ***RED FLAG - Estate Planning Issues.*** If a significant shareholder is conducting estate planning (or the BHC is aware the shareholder is conducting (or has conducted) estate planning), this is another red flag as estate planning typically involves transferring shares into some sort of trust, which may trigger a CIC Notice.
- ***RED FLAG – Shareholder's Death.*** If a controlling shareholder has passed away, that is a red flag, as the shares will need to be distributed from the shareholder's estate, and there is a chance the distribution could require a CIC Notice or other Fed filing. If a BHC becomes aware of a death of a controlling shareholder, raising these issues with the executor of the estate is recommended.

## **Conclusion**

The CIBCA and the Fed's regulations are complex. However, they are important rules that are enforced by the Fed. Shareholders of BHCs need to understand and comply with these rules. In addition, BHCs can help their shareholders by also understanding these rules and by flagging potential issues for shareholders that the BHC may observe in the stock transfer records, reviewing the shareholders' list, or otherwise gain knowledge about. We are happy to assist any shareholder or BHC in understanding and complying with these complicated requirements.

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