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Keep Your Eye on the Control Act Ball, But Make Sure It is the Right Ball!

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The old baseball adage "keep your eye on the ball" presumes that you know where to look for the ball. This concept becomes more difficult if you have balls traveling at you from several different directions simultaneously. When it comes to avoiding violations of the Change in Bank Control Act of 1978, as amended (Control Act), the same analogy applies. Over the past few years, we have seen a number of situations play out where community bank directors have focused on the wrong ownership calculation and unknowingly crossed the 10 percent stock ownership threshold, running afoul of the Control Act. This article will focus on keeping your eye on the correct Control Act ball.

Regulatory Backdrop

As a reminder, the magic number for the Control Act is 10 percent of the voting securities of an institution. Prior to crossing that threshold, an individual must provide prior notice to the relevant federal regulator. Additionally, state law often has similar control statutes. For example, the California Financial Code requires prior approval for acquisitions of 10 percent or more of the voting securities of a California state financial institution.

The confusion in complying with the Control Act ownership threshold often arises from the fact that stock ownership is counted in different ways for different purposes. For instance, when the bank's management and director share ownership percentages are tabulated in the bank's proxy statement, the SEC's definition of "beneficial ownership" is the most common measure, even for institutions not subject to SEC reporting. Under the SEC's definition of "beneficial ownership," a beneficial owner generally includes a person who directly or indirectly controls shares, and includes any equity awards that will vest within 60 days.i[1] Further, the SEC's Compliance and Disclosure Interpretations have indicated that the attribution of spousal or household ownership should be evaluated on a case-by-case basis, rather than by presumption.ii[2]

This is contrasted to the Control Act's computation of securities ownership which applies a much broader definition. Pursuant to the Federal Reserve's Regulation Y, the computation must include shares held by any immediate family member, defined to include spouses and children, but also stepchildren, siblings, stepsiblings, in-laws of various levels, grandparents, grandchildren and the spouses of those listed.iii[3] Moreover, not only are equity awards (e.g., stock options, restricted stock, etc.), or other securities convertible into voting equity exercisable within the next 60 days counted, but all equity awards or convertible securities, whether exercisable or not, count.iv[4]

Two Common Pitfalls or Traps for the Unwary

First, a shareholder must consider the universe of shares under his or her direct control. However, the analysis must not stop there. All equity awards or securities convertible into voting equity, regardless of exercisability, must be included in the computation. \This will likely result in a larger calculation than is disclosed on the bank's proxy statement.

Second, the shareholder must include in their stock ownership shares held by all persons who are presumed to be acting in concert, which includes immediate family members. While the term "immediate family" may have a somewhat limited connotation in general conversation, as mentioned previously, the definition in the federal regulatory scheme is very broad. A shareholder must not only factor in the persons they would commonly consider as part of their "immediate family," but they must also flex and extend this concept to include all shareholding relatives up to the grandparent level and down to the grandchild level, including all stepsiblings, stepchildren, in-laws and their spouses. In many closely held institutions, this analysis will yield a much different calculation of share ownership than what is reflected in a bank's proxy statement and must be considered very seriously to ensure compliance with the Control Act and state control statutes.

Consequences of Violating the Change in Control Statute

At best, a violation of the Control Act might be met with a stipulation to sell down the share ownership to a permissible level, or impede the bank's timing to secure regulatory approval for some contemplated bank action until the violation is resolved. At worst, crossing that control threshold could trigger significant monetary penalties and other serious sanctions. The severity of the punishment often has to do with how willful the violation appears to be and how quickly it is brought to the attention of the regulators.

Action Plan

The first step in any compliance plan is becoming aware of the issues and keeping current on the wide variety of statutes and regulations that apply to your particular institution. We have tried to keep this discussion simple for purposes of fostering general awareness of the issue, but these change of control issues can be very complicated and often play on a number of other factors which are not discussed here. A second step is developing an internal mechanism for regularly tracking ownership levels in conformance with the applicable control regulations. One such plan might include developing an appropriate

Director and Officer Questionnaire to be circulated and completed on an annual basis. And through this process, if you happen to uncover a problem at your institution, it is imperative that you promptly consult counsel and consider contacting the regulators immediately. Remember, don't just keep your eye on the ball, keep your eye on the right ball for the given situation.

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i[1] See generally, Rule 13d-3 of the Securities Exchange Act of 1934.i
[2] See the SEC's Interpretations of Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 105.05.i
[3] 12 CFR § 225.41(b)(b3).i
[4] 12 CFR § 225.31(d).