

September 30, 2020

# Federal Reserve Releases Frequently Asked Questions on Final Rule for Determining “Control”

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## Federal Reserve Issues Frequently Asked Questions Relating to the Final Rule Revising the “Controlling Influence” Prong of the Federal Reserve’s Control Rules

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### SUMMARY

On September 30, 2020, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) issued four Frequently Asked Questions (the “FAQs”)<sup>1</sup> with respect to the Federal Reserve’s final rule on controlling influence adopted on January 30, 2020, which became effective today (the “Final Rule”).<sup>2</sup> Our [Memorandum to Clients](#), published on January 31, 2020, discusses the Final Rule in detail. The FAQs relate to:

1. The mechanics of the Final Rule’s total equity formula.
2. Clarification that the Federal Reserve would not require alterations to investment structures that predate the Final Rule and that represent a reasonable interpretation of the Federal Reserve’s precedent at the time the investment was made.
3. Clarification that a contractual provision that provides a first company with a reasonable and non-punitive mechanism to redeem, reduce, or restructure its investment in the second company if the second company fails to conform its activities to activity restrictions of the Bank Holding Company Act or Home Owners’ Loan Act generally would not be considered a “limiting contractual right”.
4. Analysis of market standard loan covenants as “limiting contractual rights”.

## DISCUSSION

### A. TOTAL EQUITY

Under the Final Rule, a first company is presumed to control a second company if the first company controls more than one-third of the second company's total equity. Control of total equity is calculated under a formula that uses "Issuer's Shareholders' Equity" as the denominator.<sup>3</sup>

The FAQs explain that "Issuer Shareholders' Equity" should be calculated as "the sum of Investor Common Equity<sup>4</sup> and Investor Preferred Equity<sup>5</sup> for each person that controls equity instruments of the second company". This clarification will, in many cases, solve problems with the total equity calculation for investments in companies that have historical losses or limited operating histories, and therefore negative retained earnings. The FAQs also clarify that a first company that controls less than one-third of each class of a second company's equity securities "should always control less than one-third of the total equity of the second company".

### B. EXISTING INVESTMENTS

The FAQs provide clarification that the Federal Reserve would not require alterations to investment structures that predate the Final Rule and "that represent a reasonable interpretation of [Federal Reserve] precedent at the time the structure was created". The FAQs also confirm that, consistent with the preamble to the Final Rule, the Federal Reserve does not expect to revisit investments it has already reviewed. If there are investments that a company has previously determined to be non-controlling without Federal Reserve review, but that would trigger the Final Rule's presumptions of control, the company may "contact the [Federal Reserve] staff to discuss the structure and what, if any, alterations should be made to continue to treat the structure as noncontrolling".

### C. COVENANTS THAT RESTRICT ACTIVITIES

Under the Final Rule, among other presumptions, a first company is presumed to control a second company if the first company controls five percent or more of any class of the second company's voting securities and "has any limiting contractual right with respect to the second company or any of its subsidiaries".<sup>6</sup> "Limiting contractual right" is defined as a "contractual right of the first company that would allow the first company to restrict significantly, directly or indirectly, the discretion of the second company . . . over operational and policy decisions of the second company".<sup>7</sup> Examples provided in the Final Rule include restrictions on the activities in which the second company may engage.

The FAQs affirm that a limiting contractual right includes a contractual provision that requires a second company to conform its activities to those that are permissible under the Bank Holding Company Act or the Home Owners' Loan Act. The FAQs clarify, however, that a contractual provision "that provides a first company with a reasonable and non-punitive mechanism to redeem, reduce, or restructure its investment in the second company if the second company fails to conform its activities to the activities restrictions of

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the Bank Holding Company Act or Home Owners' Loan Act generally would not be considered a limiting contractual right". These types of contractual provisions are relatively common in investments by banking organizations in nonbank companies, including financial technology companies.

### D. LOAN COVENANTS

The Final Rule's presumption relating to limiting contractual rights does not distinguish between contractual rights included in loan agreements as opposed to other contractual arrangements, such as a shareholders' agreement. As a result, market standard loan covenants may be viewed as limiting contractual rights. The FAQs reiterate that a contractual right that meets the definition of a limiting contractual right will be treated as such regardless of the "circumstances under which the right was created or the nature of the document in which the right resides" and that "loan covenants generally do not raise control concerns by themselves, but instead raise concerns when held by a first company that also controls a material percentage of the voting securities of a second company".

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### ENDNOTES

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- <sup>1</sup> Federal Reserve, Regulation Y – Frequently Asked Questions (Sept. 30, 2020), *available at* <https://www.federalreserve.gov/supervisionreg/reg-y-faqs.htm>.
- <sup>2</sup> Federal Reserve, Final Rule: Control and Divestiture Proceedings, 85 Fed. Reg. 12398 (March 2, 2020).
- <sup>3</sup> 12 C.F.R. § 225.34(b).
- <sup>4</sup> Under the Final Rule, "Investor Common Equity" is the greater of zero and the percentage of the second company's common stock controlled by the first company multiplied by the amount of the second company's GAAP equity that is not allocated to a class of preferred stock.
- <sup>5</sup> Under the Final Rule, "Investor Preferred Equity" is, for each class of preferred stock issued by the second company, the greater of zero and the percentage of the class of preferred stock controlled by the first company multiplied by the amount of the second company's GAAP equity that is allocated to the class of preferred stock.
- <sup>6</sup> 12 C.F.R. § 225.32(d)(5).
- <sup>7</sup> 12 C.F.R. § 225.31(e)(5).

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