Federal Reserve Issues FAQs to Clarify Aspects of Its Revised Control Framework

October 1, 2020

On Wednesday, September 30, 2020, the Federal Reserve Board (the "FRB") issued four Frequently Asked Questions ("FAQs") to clarify certain aspects of its revised framework for determining "control" under the Bank Holding Company Act ("BHC Act") and Home Owners' Loan Act ("HOLA"), which became effective on the same day.[1]

The four FAQs clarify: (1) how the denominator of the total equity calculation formula, "Issuer Shareholders' Equity," should be determined, (2) whether legacy investments that have reasonably been considered by a company as noncontrolling should be altered, (3) whether a contractual provision between a first company (*i.e.*, the investor) and a second company that requires the second company to conform its activities to the activities restrictions under the BHC Act or HOLA is considered a limiting contractual right, and (4) whether a market standard loan covenant in a loan agreement between a first company and a second company is considered a limiting contractual right. The FAQs are summarized below.

Total Equity Calculation. This FAQ should accommodate investments in emerging and early-stage companies, particularly those with negative retained earnings.

The FAQ creates something akin to a safe harbor for shareholders that control less than one-third of any class of equity by explaining that a first company that controls less than one-third of each class of equity securities of a second company should always control less than one-third of the total equity of the second company. Therefore, such a shareholder should never be presumed to control the second company under the FRB's control rule based exclusively on the rule's total equity calculation.

The FAQ achieves this result by providing a description of how to calculate "Issuer Shareholders' Equity," the denominator of the total equity calculation and a term that is undefined in the regulation. This method essentially limits the amount that negative retained earnings can reduce Issuer Shareholders' Equity.

[1] We discuss the control rule in detail here.

The FAQ also provides that FRB staff should be consulted if Issuer Shareholders' Equity would be equal to zero and the first company controls more than one-third of a class of equity securities of the second company, suggesting that staff may take a different, or case-by-case, approach to addressing total equity calculations or presumptions of control in such circumstances.

Legacy Investments. Consistent with the preamble to the control rule, the FAQ states that the FRB does not expect to revisit structures that have already been reviewed by the FRB or a Federal Reserve Bank prior to the effective date of the control rule.[2] The FAQ also reiterates that, for structures that have not been reviewed by the FRB or a Federal Reserve Bank, a company may contact FRB staff to discuss the structure and any potential alterations necessary to continue to treat the structure as noncontrolling.

However, the FAQ helpfully adds that FRB "staff would not require alterations to structures that represent a reasonable interpretation of [FRB] precedent at the time the structure was created." Although not entirely clear, we interpret this statement to mean that, in most cases, there should be no need to revisit investments made prior to the introduction of the new control presumptions.

Treatment of Activity Restrictions as Limiting Contractual Rights. The FAQ explains that, consistent with the preamble to the control rule, a contractual provision between a first company and a second company that requires the second company to conform its activities to the activities restrictions under the BHC Act or HOLA generally would be considered a limiting contractual right because such a provision limits the ability of the second company to engage in some new lines of business.[3] The ability to restrict or exert a significant influence over decisions related to "activities in which the second company may engage, including a prohibition on entering into new lines of business, making substantial changes to or discontinuing existing lines of business," is provided as an example of a limiting contractual right in the FRB's control rule.[4]

The FAQ adds—also consistent with the preamble to the control rule—that a contractual provision involving a reasonable and nonpunitive mechanism to redeem, reduce or restructure the first company's investment in the second company, if the second company fails to conform its activities to the activities restrictions of the BHC Act or HOLA, generally would not be considered a limiting contractual right.

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[2] 85 Fed. Reg. 12398, 12420 (Mar. 2, 2020).

[3] *Id*. at 12417.

[4] 12 CFR 225.31(e)(5)(i)(A).

Treatment of Loan Covenants as Limiting Contractual Rights. The FAQ acknowledges that many market standard loan covenants fall under the definition of limiting contractual right and states that such rights are limiting contractual rights.[5] In particular, the FAQ notes that the control rule does not differentiate between limiting contractual rights based on how the right was created or type of document in which the right resides.

The FAQ emphasizes, however, that loan covenants do not raise control concerns by themselves, but instead raise concerns when held by the first company that also controls a material percentage of the voting securities of the second company. The FAQ does not define "material" for this purpose. The FAQ notes that the control rule's presumption of control relating to limiting contractual rights does not apply where the first company controls less than 5% of any class of voting securities of the second company.

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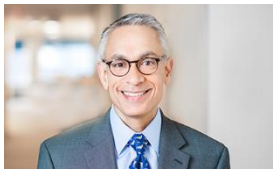

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[5] 85 Fed. Reg. at 12418.