American Bankers Association
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Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Control and Divestiture Proceedings – Docket No. R-1662 and RIN 7100-AF 49

Ladies and Gentlemen:

The American Bankers Association[1] (ABA) appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System (Federal Reserve or Board) on a proposal that would revise the Federal Reserve's regulations on determinations of whether an investor bank or company (investor) "exercises a controlling influence" over another bank or company (company) for purposes of the Bank Holding Company Act of 1956, as amended (BHCA), or the Home Owners' Loan Act of 1933, as amended (HOLA).[2] The Board is soliciting public comment on proposed amendments to Regulation Y (implementing the BHCA) and Regulation LL (implementing the HOLA) (control regulations) that are intended to clarify and make transparent the types of relationships the Federal Reserve historically has viewed as supporting a determination that an investor controls a company (Proposal).[3] This would include significantly expanding the number and description of presumptions of control that are used in making such determinations.

We commend the Federal Reserve on its efforts to amend the control regulations by codifying the Federal Reserve's collection of interpretations in this area – published and unpublished – as well as its existing practices and precedents. This would improve significantly the current regulatory framework governing control determinations by providing greater clarity, transparency, and compliance certainty on whether an investor controls a company. In particular, the Proposal would sharpen the boundaries of permissible business relationships that do not result in control, thereby reducing the regulatory burden and costs associated with structuring, securing, and protecting investments that avoid control of a company. We believe

[1] The American Bankers Association is the voice of the nation's $18 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard nearly $14 trillion in deposits, and extend more than $10 trillion in loans. Learn more at www.aba.com.
[2] *See* 12 U.S.C. § 1841 *et seq.* (2019) (BHCA); 12 U.S.C. § 1461 *et seq.* (2019) (HOLA).
[3] *See* Federal Reserve, Control and Divestiture Proceedings, 84 *Fed. Reg.* 21,634 (2019). Regulation Y and Regulation LL are parallel rules that govern the Federal Reserve's control determinations. *See* 12 C.F.R. Part 225 (2019) (Regulation Y) and Part 238 (2019) (Regulation LL).

this will encourage and facilitate investments both in community banks seeking to raise capital to support their lending and investment operations as well as in financial technology (fintech) and other start-up companies.

The Proposal, however, raises a number of concerns on control determinations that may unnecessarily impede or disrupt the Federal Reserve's efforts at achieving genuine regulatory reforms in this area. We identify these concerns below, together with recommendations on how these concerns can effectively be addressed. If implemented, these recommendations would work toward the sound functioning of the Board's control regulations as intended and as applied, and away from the "Delphic and hermetic process" that the Board is seeking to avoid.[4] This will promote the Proposal's overarching objective of providing all involved with "clearer rules of the road for control determinations [that] will responsibly reduce regulatory burden."[5]

I. Background.

The concept of "control" is a fundamental underpinning of the BHCA and HOLA. Under the BHCA, an investor has "control" over a company in any of the following three ways:

(i) directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25% or more of any class of the company's voting securities (voting interest);

(ii) controls in any manner the election of a majority of the company's directors; or

(iii) directly or indirectly exercises a controlling influence over the company's management or policies.[6]

The HOLA includes a substantially similar definition of control.[7] Investors determined by the Federal Reserve to "control" a bank or savings association must register and become regulated as a BHCA or SLHC, or divest their investment.[8] Divestiture also may be required where the Federal Reserve determines that an investor bank or BHC/SLHC "controls" a nonbank company that is impermissible under applicable law for such investor to own or control.[9]

The Proposal addresses the third prong – whether an investor "exercises a controlling influence" over a company's management or policies (controlling influence prong). Unlike the first two prongs, which are subject to a bright-line test, the controlling influence prong involves a facts-and-circumstances determination. In particular, under the controlling influence prong, the Federal Reserve will identify and analyze a series of factors it considers relevant – such as an

[4] *See* Federal Reserve Press Release, *Federal Reserve Board Invites Public Comment on Proposal to Simplify and Increase the Transparency of Rules for Determining Control of a Banking Organization* (April 23, 2019).
[5] *See id.*
[6] *See* BHCA, 12 U.S.C. § 1841(a)(2).
[7] *See* HOLA, 12 U.S.C. § 1467a(a)(2).
[8] *See* 12 U.S.C. § 1844(a) (BHCs); 12 U.S.C. § 1467a(b) (SLHCs). The investor may choose to contest the Federal Reserve's preliminary finding on control, which may be followed by a hearing (or other proceeding) that results in a final order concerning the Board's initial determination. *See* 12 C.F.R. § 225.31(b) & (c).
[9] *See* 12 U.S.C. § 1843(a).

investor's voting and total equity ownership, management interlocks, and business relationships with a company – to determine whether that investor "exercises a controlling influence," and therefore, has or obtains control over such company.[10] The Board's deliberations are made with the understanding that an investor which seeks to avert status as a BHC or SLHC (and the significant regulatory responsibilities, restrictions, and costs that attach) will attempt to structure its investment to avoid the statutory definition of control.

Nevertheless, the facts-and-circumstances nature of the Federal Reserve's decision-making process, combined with the myriad of possible business relationships between an investor and a company, often make it extremely difficult for an investor to determine with certainty and confidence that a particular investment in a company would not constitute "control" of the company. This is made more complicated and challenging by a number of the Federal Reserve's ad hoc determinations that rely on (or are influenced by) decades of unpublished agency decisions, and on past and present unrecorded and unstated Federal Reserve perspectives and practices concerning the controlling influence prong. The Federal Reserve's initiative, therefore, is a welcome development. The Proposal not only unveils Board policy that has been extracted from the shadowy depths of agency lore, but also provides a template for control determinations that will better equip investors to gauge investment strategies that are or may be subject to the BHCA/HOLA regulatory scheme.

II. The Proposal and Its Benefits.

According to the Board, the Proposal is intended "to provide bank holding companies, savings and loan holding companies, depository institutions, investors, and the public with a better understanding of the facts and circumstances that the Board generally considers most relevant when assessing controlling influence."[11] Specifically, the Proposal lays out a number of factors used to determine whether an investor exercises a controlling influence over a company, including: (i) ownership or control of a company's total voting and non-voting equity stock; (ii) the ability to elect, and become involved in the operations of, the company's board of directors; (iii) the number and seniority of officer and employee interlocks; (iv) contractual powers and management agreements; (v) proxy solicitation involvement; and (vi) the extent and terms of the business relationships. To assist investors and other interested parties on how the Proposal would operate, the Federal Reserve has provided a one-page chart (Presumption of Control Chart) that lays out the presumptions of control based on the above-described factors.[12] The chart summarizes the permissible level of investment and involvement in a company without triggering a presumption of control in that company.

We welcome and support the Federal Reserve's proposed regulatory reforms. They would contribute meaningfully to the goal of regulatory transparency, clarity, and compliance certainty, which in turn would encourage private investment in the banking industry while also providing banking organizations the opportunity to invest in fintech and other companies that support the business of banking. The Proposal's more notable regulatory reforms include the following:

[10] *See* 12 C.F.R. § 225.31 (2019) (Control Proceedings).
[11] 84 *Fed. Reg. at* 21,634.
[12] *See* Federal Reserve Memorandum: Notice of Proposed Rulemaking to Revise the Board's Rules for Determining Whether a Company Has Control Over Another Company, Appendix A (Apr. 16, 2019).

- ***Public Review and Input into Federal Regulatory Control Framework.*** The Proposal brings out into the public domain for review and input the Board's compendium of work on the controlling influence prong. As Vice Chair Quarles explained, "The [P]roposal would place substantially all of the Board's control positions into a comprehensive public regulatory proposal and allow public comment on those positions to improve their content and consistency."[13]

- ***Expanded Number of Rebuttable Presumptions of Control.*** By retrieving and organizing the Board's past decisions, precedents, and practices on the controlling influence prong, the Proposal greatly expands the number of rebuttable presumptions of control, thus clarifying the bases upon which a presumption of control would be found.[14]

- ***Flexible Business Relationships Where Voting Interest Is Less than 5%.*** Under the Proposal, an investor that can limit its voting interest in a company at less than 5% would generally have no limits placed on the nature and extent of business relationships, management interlocks, and restrictive covenants with a company (although a management agreement between the investor and company could trigger a presumption of control). This is particularly helpful for investments that typically are structured to avoid control over a nonbanking company by capping voting equity ownership at just under 5%.[15]

- ***Non-Control Presumption Raised from 5% to 10% of Voting Interest.*** The Proposal raises the allowable level of voting interest that benefits from a presumption of "non-control" from just under 5% (*i.e.*, up to 4.99%) to just under 10% (up to 9.99%), assuming that no other presumptions of control are triggered.[16] As a result, an investor generally would be able to engage in a variety of business relationships with a company without being deemed to control the company under the BHCA/SLHA and Board regulations, so long as the investor's voting interest in the company remains below 10%.

- ***Reduced Rigidity of Divestiture Standards.*** Under current divestiture proceedings, the Federal Reserve generally requires an investor to reduce its equity stake in the controlled company to less than a 10% voting interest. Under the Proposal, such an investor would be allowed to retain up to a 15% voting interest (or up to a 24.9% voting interest with a two-year waiting period until divestiture is considered achieved), thus easing the Board's rigid divestiture requirements.[17]

- ***Presumption of Control Not Based Solely on Size of Equity Stake.*** In contrast to current Board practice, the Proposal would not apply a presumption of control that is based

[13] *See* Federal Reserve Press Release, n. 4, *supra*.
[14] *See* Federal Reserve, Presumption of Control Chart.
[15] *See* 12 U.S.C. § 1843.
[16] For example, for a finding of "non-control" to be present where the investor holds a 9.99% voting equity interest in the company, the investor can have no more than one management interlock with the company and the permissible interlock cannot be the chief executive officer position. Moreover, no other presumption of control factors may be triggered. *See* Federal Reserve, Presumption of Control Chart.
[17] 84 *Fed. Reg.* at 21,659.

solely on the size of the equity stake in the company, where an investor holds up to 24.9% of the company's voting securities, but another unaffiliated investor owns or controls a majority of the company's voting stock.[18]

- ***Increased Board Representation Without Triggering Presumption of Control.*** The Proposal allows for the possibility of increased investor representation on a company's board of directors, from the general precedent of one director, to either just under 50% or just under 25% of the board (depending on the level of voting interest). This would allow an investor to place multiple directors on the board of a company that has a large board membership.[19]

III. Issues Raised and Proposed Revisions.

In spite of the benefits described above, certain aspects of the Proposal raise significant issues which, if not addressed, would unnecessarily undercut and conflict with the Board's goal of achieving improved regulatory functioning and efficiencies, enhanced supervision, and salutary cost reductions in agency supervision and industry compliance. Our comments include recommendations that aim to resolve these issues while preserving the Proposal's underlying regulatory reforms.

A. Exclude from the Presumption of Control Certain Holdings of Securities that Do Not Amount to an Investor's Actual "Exercise of a Controlling Influence" over a Company's Management and Policies.

Under the controlling influence prong, the BHCA (and by extension, the HOLA) states that an investor has "control" over a company if such investor "directly or indirectly *exercises a controlling influence* over the management or policies" of the company.[20] In other words, for an investor to be deemed to "control" a company for purposes of the controlling influence prong, the investor must *exert* an *actual* controlling influence over the company's management or policies. This reading is consistent with text and legislative history of the BHCA, which focuses on whether an investor's influence over a company amounts to *genuine* control.[21] Moreover, this plain-language reading is apparently how the Federal Reserve staff originally had interpreted and applied the controlling influence prong.[22]

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[18] *See id.*
[19] *See id.*
[20] 12 U.S.C. § 1841(a)(2)(C) (BHCA); 12 U.S.C. § 1467a(a)(2)(D). [Emphasis added.]
[21] *See Bank Holding Company Act Amendments: Hearing Before the House Committee on Banking and Currency*, 91st Cong. 235 (1969); 115 Cong. Rec. 33,141; 115 Cong. Rec. 3368 (congressional statements supporting plain-language reading of the controlling influence prong).
[22] *See, e.g.*, Patagonia Corporation, 63 Fed. Res. Bull. 288 (1977) (holding that the investor did not have the degree of influence over a savings association's management or policies amounting to actual control, even though the investor was actively seeking to acquire a majority stake in the savings association's voting securities); Opinion Letter, Board of Governors of the Federal Reserve System to John L. Douglas, 1982 Fed. Res. Interp. Ltr. (Apr. 5, 1982) (rejecting company's argument that because investor had actively attempted to exercise a controlling influence over company through proxy solicitations among other things, investor should be deemed to have a controlling influence over company upon acquiring 24.99% of company's voting securities, and holding that while investor *attempted* to exercise a controlling influence over company, it had not been successful in *actually* doing so).

Under the Proposal, however, the Board interprets the controlling influence prong as it had in later agency decisions and as codified in the Board's regulations and subsequent policy statements, by referring to an investor's *potential ability* to exercise a controlling influence over a company, rather than an exercise of actual control. The Proposal would continue to enforce this "look-through" approach, in which an investor would be deemed to control all securities that the investor *could* control upon the exercise of any options or warrants, and all securities that the investor *could* control as a result of the conversion or exchange of a convertible instrument controlled by the investor, rather than the securities actually controlled.[23] Moreover, "[t]he look-through 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."[24] For purposes of calculating the percentage of voting securities or total equity, the Board generally would deem an investor to control the percentage resulting from the exercise of the person's options, assuming that no other parties elected to exercise their options.[25]

We continue to believe that this "look-through" approach is an aggressive, very narrow reading that conflicts with the plain text of the BHCA. As a result, this interpretation unnecessarily curtails and reduces investments in banks and companies, and lessens the ability of investors to protect and preserve such investments. In particular, this overbroad view of "controlling influence" (i) negatively impacts the ability of banks, particularly midsize and community banks, to engage in capital-raising efforts; (ii) has an inhibiting, reverberating effect on compliance with other Federal Reserve regulations, such as Regulation W and the Volcker Rule; and (iii) diminishes the appeal of BHCA section 4 investments (*i.e.,* investments in nonbanking companies) that would be made as part of strategic, collaborative efforts with fintech companies, investments that are critical for business generation, innovation, and competition within the banking and financial services industry. These adverse impacts are inconsistent with the Federal Reserve's stated goal to enhance Board accountability and reduce regulatory burden.[26]

The Board, therefore, should amend the Proposal to exclude from the presumption of control certain holdings of securities (such as options, warrants, and convertible instruments) that do *not* amount to an investor's *actual* exercise of controlling influence over a company. This recommendation builds upon the foundational step that the Proposal should not apply the "look-through" approach to options, warrants, and convertible instruments unless, as of any date, they (i) could be freely exercised by the investor within 60 days, (ii) are in the money, and (iii) are not subject to the satisfaction of a condition outside the control of the investor. In order to allay any Board concerns over such action and as a matter of supervisory policy, the Board could add a "reservation of authority" provision that would allow it at any time to examine a potential controlling influence situation based on all of the factors of a particular investment.

[23] *See* 12 C.F.R. § 225.9 (Control Over Securities) (Proposed), 84 *Fed. Reg.* at 21,656-57.
[24] 84 *Fed. Reg.* at 21,648.
[25] *See id.*
[26] *See* Federal Reserve Press Release, Federal Chairman Jerome H. Powell's Opening Statement on Proposal to Revise the Board's Control Rules (Apr. 23, 2019).

B. Increase the Proposed Business Relationships Revenue/Expense Thresholds.

Among the most fact-intensive factors the Board considers under the controlling influence prong is the size and nature of the business relationship between the investor and the company. The Federal Reserve historically has taken the position that a major supplier, customer, lender, or other investor could exercise sizeable influence over a company's management or policies, particularly when the business relationship is responsible for a substantial share of the revenues or expenses of either the investor or the company.[27] This may provide an incentive for the investor to exercise a controlling influence over the company, especially when coupled with a significant investment in the company's voting securities.

The Proposal, therefore, provides that a presumption of control arises when (i) an investor controls a 5% or more voting interest in the company and has business relationships with the company that generate in the aggregate at least 10% of the total annual revenues or expenses of the investor or company, (ii) an investor controls a 10% or more voting interest in the company and has business relationships generating at least 5% of the total annual revenues or expenses of the investor or company, or (iii) an investor controls a 15% or more voting interest in the company and has business relationships generating at least 2% or more of total annual revenues or expenses of the investor or company. The Board has stated that although its precedents have varied significantly when evaluating business relationships (based on the facts and circumstances presented), these proposed threshold amounts generally comport with prior Federal Reserve decisions and "may be more permissive than certain other precedents."[28]

Nevertheless, the proposed thresholds are too low and do not take into account those business relationships that do not implicate a controlling influence. For example, under the Proposal, an investor with a 15% voting interest in a company may be presumed to control that company as a result of the business relationship where the total annual revenues or expenses of either the investor or company is 2% or greater, even though there may be multiple investors in such company, each with a significantly greater revenue/expense percentage (*e.g.*, 10%) that clearly demonstrate the original investor's inability to exercise a controlling influence over the company. This might involve a joint venture in which the investor with the 15% voting interest is a late entrant into the company's business. This could further involve a situation in which the 2% level is triggered, even though there may be another, unaffiliated investor that holds a majority voting interest in the company, or is responsible for a majority of the company's total annual revenues or expenses. Such situations clearly should not implicate the controlling influence prong.

The Proposal, therefore, should be modified with respect to the 2%, 5%, and 10% revenue/expense thresholds as follows: (i) place *no* restrictions on the size or nature of the business relationship, where the investor controls less than 10% of the voting interest in the company; and (ii) create a presumption of non-control where (A) the investor controls between 10% and 14.99% of the voting interest in the company, and less than 20% of the company's

[27] *See* 84 *Fed. Reg.* at 21,641.
[28] *Id.*

revenues[29] are attributable to the business relationship with the investor; or (B) the investor controls between 15% and 24.99% of the voting interest in the company, and less than 10% of the company's revenues are attributable to the business relationship with the investor. These revised thresholds would more proportionately match an investor's equity investment with its corresponding commitment to doing business with the company.

Moreover, the Board further can adjust the percentages to address those situations that involve the presence of other investors that have a significant equity stake in, or business relationship with, the company. For example, (i) where an investor controls 10% to 14.99% voting interest in the company, the revenue/expense threshold can be raised from the revised 20% threshold to 30%; and (ii) where an investor controls 15% to 24.99% voting interest in the company, the revenue/expense threshold can be raised from the revised 10% threshold to 20%, in each case where there is an unaffiliated investor that either controls a majority voting interest in the company, or where a majority of the company's revenues or expenses is attributable to such unaffiliated investor. This recommendation would also be consistent with the Proposal's divestiture of control provisions, in which an investor would not be presumed to control a company if at least 50% of the company's voting interest is controlled by another investor that is not affiliated with the investor.[30]

C. Confirm that a Presumption of Non-Control Exists for Investments Described under Section 4(c)(6) of the BHCA.

The Proposal generally allows for a presumption of non-control for any investment that is less than a 5% voting interest in a company.[31] The Proposal, however, is unclear as to whether this presumption would extend to an investment made under section 4(c)(6) of the BHCA (*i.e.*, an investment in a nonbanking company).[32] The Board should confirm that the presumption of non-control applies also to any investment described under section 4(c)(6) of the BHCA.

D. Confirm that the Requirement that any Voting Interest Held in a Fiduciary Capacity Must Be Held, in order to Avoid Triggering a Presumption of Control, "Without Sole Discretionary Authority to Exercise Voting Rights," Applies Only to Banking Investments and Not to Nonbanking Investments.

The Proposal provides that the presumption of control would not apply if an investor controls the company's securities "in a fiduciary capacity without sole discretionary authority to exercise voting rights" (fiduciary exception).[33] The Proposal, however, does not distinguish between banking investments (*i.e.*, investments made under section 3 of the BHCA) and nonbanking investments (*i.e.*, investments made under section 4 of the BHCA). Although the BHCA and Regulation Y condition the inapplicability of the presumption of control to an investor holding securities in a *bank's* voting shares as a fiduciary, where the investor does not have sole

[29] The Board should evaluate a business relationship based solely on the revenues of the company, as the percentage of the *investor's* revenues attributable to the business relationship has little or no bearing on the significance of the relationship with the company.
[30] *See* 12 C.F.R. § 225.32(i), 84 *Fed. Reg.* at 21,659.
[31] *See* Federal Reserve, Presumption of Control Chart, *supra.*
[32] *See* 12 U.S.C. § 1843(c)(6).
[33] 84 *Fed. Reg.* at 21,659.

discretionary authority to exercise voting rights with respect to the bank's shares,[34] there is no such limitation with respect to holding securities in a *non*banking company.[35] The Board, therefore, should confirm that the condition to the fiduciary exception, "sole discretionary authority to exercise voting power," applies only to banking investments made under section 3 of the BHCA and not to nonbanking investments made under section 4 of the BHCA.

E. Eliminate the Accounting Consolidation Requirement, Beginning with the Exclusion of Investor Holdings of Special-Purpose Vehicles (such as Variable Interest Entities) from the Presumption of Control Test.

Under the Proposal, the Federal Reserve would presume that an investor that consolidates a company using the equity method of accounting under U.S. generally accepted accounting principles (GAAP) would be presumed to control the company for purposes of the BHCA, apparently without regard to the investor's voting interest in the company. The Board has explained that this presumption is "appropriate" because consolidation generally is called for under GAAP in circumstances in which the consolidating entity has a controlling financial interest over the consolidated entity.[36] The Board references GAAP consolidation (i) where an investor has the power to direct the activities of the company that most significantly impacts that company's economic performance and has the right to receive a considerable portion of the economic benefits of the company, or (ii) where an investor controls the company by contract.[37]

The Board provides no legal, regulatory, or policy reason why an investor's use of the equity method of accounting should trigger a presumption of control under the BHCA, particularly given that there is a valid distinction between the level of control required for full consolidation (a "controlling interest," generally involving majority ownership of voting securities) and the criteria used for equity accounting (a "significant influence," which is presumed when there is direct or indirect ownership of 20% of voting securities). By presuming control through the use of the equity accounting method, the Board essentially is creating a new (and stricter) presumption of control test that is set at a 20% voting interest threshold. Such a presumption not only creates a needless restriction but also may force investors to change or restructure their accounting method for investment in a company simply to avoid the presumption of control, possibly creating adverse capital effects.[38]

The Proposal further does not address situations in which GAAP consolidation may be required but where the relationships between the investor and a company would not necessarily implicate

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[34] *See* 12 U.S.C. § 1841(a)(5)(A); 12 C.F.R. § 225.12(a).

[35] *See* 12 C.F.R. § 225.22(d)(3) (Board approval not required for voting interest acquired by a bank or other company (other than a trust that is a company) in good faith and in a fiduciary capacity, if the voting interest (i) is held in the ordinary course of business, and (ii) is not acquired for the benefit of the company or its shareholders, employees, or subsidiaries). *See also* 48 *Fed. Reg.* 23,520, 23,529 (citing 12 U.S.C. § 1843(c)(4)).

[36] *See* 84 *Fed. Reg.* at 21,644.

[37] *See id*. *See, e.g.*, FASB, Accounting Standards Codification (ASC) 810-10.

[38] In particular, it has been pointed out that to avoid equity accounting simply in order to avoid implicating a presumption of control over a company "could result in unfavorable capital effects, because investments not accounted for under the equity method instead would be accounted for using the fair value method, which as a general matter may result in greater volatility in the value of the investment." Davis Polk, *Federal Reserve's Proposed Rule on Controlling Influence: A Step in the Right Direction* (May 2, 2019) at 24.

BHCA "control" concerns.[39] In particular, GAAP consolidation of a variable interest entity (VIE) may be required even in the absence of any equity investment in the company, if an investor "has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance" and "the obligation to absorb 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."[40] Thus, the new presumption would have an outsized adverse impact on securitizations and other special purpose vehicles that qualify as VIEs. Moreover, GAAP consolidation still may be required even when an investor (a bank or BHC) has no equity or voting interest in the VIE; or where an affiliated collateral manager receives fees, holds certain interests in orphan collateralized loan obligations (CLOs), or holds certain types of beneficial interests in trusts.[41] Given the scope and level of potential industry disruption, and in the absence of legal or regulatory justification, the Board should withdraw this presumption from the Proposal. The Board should begin by expressly excluding VIEs and similar special-purpose vehicles from the presumption.

F. Eliminate Retained Earnings and Start-up Companies from the Total Equity Calculation and Provide Relief on the Treatment of Debt Instruments as the Functional Equivalent of Equity.

Consistent with Federal Reserve precedent, the Proposal would provide a standard calculation for determining an investor's total equity percentage in a company that is a stock corporation and that prepares its financial statements in accordance with GAAP. The calculation involves three steps. The first step would be to determine the percentage of each class of voting and nonvoting common or preferred stock issued by the company and controlled by the investor. The second step would involve multiplying the percentage of each class of investor-controlled stock by the value of the shareholders' equity allocated to the class of stock under GAAP.[42] For this purpose, retained earnings would be allocated to common stock. For the third step, the investor's dollars of shareholders' equity that had been determined under the second step would be divided by the company's total shareholders' equity, as determined under GAAP, to arrive at the total equity percentage of the investor's investment in the company.[43]

While publicly disclosing this method of calculating total equity is helpful (prior Board precedents and practices generally did not make this methodology publicly known), we believe that the calculation, as formulated, artificially may inflate an investor's total equity percentage where the company has negative retained earnings. This is especially likely to occur for investments in fintech companies and other start-up companies, where such companies are likely to report losses in the first several years of operation. Such investments, therefore, may provide

[39] This is, for example, not uncommon in the mortgage securitization business, where the mortgage servicer or other special-purpose entity may be consolidated onto the investor's balance sheet even though the investor is not involved in any control relationship with the entity.
[40] ASC 810-10. *See* Cleary Gottlieb, *The Federal Reserve's "Control" Proposal: Implications and Areas for Comment* (May 9, 2019) (Cleary Memo).
[41] *See* Cleary Memo at 24.
[42] The Board notes here that the value of shareholders' equity allocated to common stock would be all shareholders' equity not allocated to preferred stock. *See* 84 *Fed. Reg.* at 21,650.
[43] *See id.* For companies that are not stock corporations, this standard calculation would be applied "to the maximum extent possible consistent with the principles underlying the general standard." 84 *Fed. Reg.* at 21,651.

a misleading portrayal of an investor's actual level of voting ownership interest in such company. In order to avoid this distorted result, the Board should (i) eliminate retained earnings from the total equity calculation, and (ii) exempt start-up companies entirely from the total equity calculation, or at a minimum for a period of five years.

The Proposal further provides that, for purposes of calculating total equity, a debt instrument or other interest may be treated as an equity instrument if the debt instrument or other interest has equity-like characteristics that make it functionally equivalent to equity.[44] The Board then provides the following non-exclusive list of factors that would be used to determine whether a debt instrument may be considered functionally equivalent to equity:

- extremely long-dated maturity;
- subordination to other debt instruments issued by the company;
- qualification as regulatory capital under any regulatory capital rules applicable to the company;
- qualification of equity under applicable tax law;
- qualification as equity under GAAP or other applicable accounting standards;
- inadequacy of the regulatory capital underlying the debt at the time of the issuance of the debt; and
- issuance not on market terms.[45]

Moreover, an interest that is *not* a debt instrument may still be considered functionally equivalent to equity, such as when the interest entitles the investor to a share of the company's profits.[46] The Board, however, has stated that none of these factors is intended to result automatically in debt being treated as equity and that it would be unusual for a debt instrument or other interest to be considered functionally equivalent to equity.[47]

Although providing a list of factors is helpful, it is still not clear what types of debt instruments, particularly those with traditional characteristics and containing slight resemblance to equity, would be excluded from being deemed equity. Instruments such as subordinated debt, long-term loans, and certain types of swaps that generally are considered straightforward debt issuances may inadvertently be captured under the Proposal. The Board, therefore, should consider issuing a safe harbor that the Board could use to conclude that such debt instrument or other interest would *not* be considered the functional equivalent to equity. This would provide greater clarity and compliance certainty, particularly in situations where holding a debt instrument or other interest may trigger a presumption of control if it were considered equity and therefore aggregated with an investor's total equity holdings in a company.

When calculating total equity under the Proposal, the Board requests views as to whether the total equity percentage calculation should be made continuously or instead only at the time of an investor's investment in the company.[48] We believe that the Board should (i) require the

[44] *See id.*
[45] *See* 12 C.F.R. § 225.34(c)(3) (proposed), 84 *Fed. Reg.* at 21,660.
[46] *See* 12 C.F.R. § 225.34(c)(4) (proposed), 84 *Fed. Reg.* at 21,660.
[47] *See* 84 *Fed. Reg.* at 21, 651.
[48] *See id.* (Question 48).

percentage calculation of total equity only at the time of an investor's acquisition or divestiture of control of the company's equity instruments, and (ii) exclude recalculation based on a divestiture in those cases where the investor has a non-controlling stake at the time of divestiture. This would avoid an investor having needlessly to expend significant resources to monitor continuously a non-controlled company's total equity.

G. Allow for a Seeding Period on Investment Funds Consistent with Federal Reserve Guidance under the Volcker Rule Regulation, and Industry Practice.

The Proposal provides for a presumption of control where an investor serves as investment adviser to the company that is an investment fund, and where the investor controls 5% or more voting interest in the company or a total equity interest of at least 25%. The presumption of control, however, would not apply if the investor organized and sponsored the investment fund within the preceding 12 months. This is intended to allow an investor to avoid triggering a presumption of control over the investment fund during the fund's initial seeding period.[49] The Board has asked whether a longer seeding period would be warranted.[50] We believe that the Board should extend the seeding period in a manner that is consistent with the Federal Reserve's guidance under the Volcker Rule regulation and with industry practice concerning registered investment companies and foreign public funds.[51] This would allow for sufficient time to attract outside investors, who before making an initial investment in a newly created fund will routinely want to see an investment performance track record and the established eligibility for a performance rating by a nationally recognized rating agency.

H. Apply the Same Revised Framework under Regulation Y for Controlling Influence Determinations to Regulation O, Regulation W, and the Volcker Rule Regulation.

In addition to the BHCA, the "control" definition is found in the Federal Reserve Act's provisions governing credit extensions and transactions with affiliates (both of which include a controlling influence prong) and in the Federal Reserve's respective implementing rules, Regulation O and Regulation W.[52] Moreover, the BHCA's definition of "control" is referenced in the Volcker Rule regulation, which determines whether a company is a "banking entity" under the regulation and therefore subject to the restrictions on proprietary trading and covered fund activities.[53] In order to promote consistency, clarity, and compliance certainty, the Board should apply the same "control" framework under Regulation Y, as revised by the Proposal, to Regulation O, Regulation W, and to the Volcker Rule regulation.

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[49] *See* 84 *Fed. Reg.* at 21,644.
[50] *See id.* (Question 19).
[51] *See* Federal Reserve, *Foreign Public Funds Sponsored by Banking Entities*, Volcker Rule Frequently Asked Questions, No. 14 (2015) and *Seeding Period Treatment for Registered Investment Companies and Foreign Public Funds*, Volcker Rule Frequently Asked Questions, No. 16 (2015). *See also* 12 C.F.R. § 248.12(b)(1)(ii) (Volcker Rule regulation).
[52] *See* 12 U.S.C. § 371c(b)(3)(iii) and 12 C.F.R. § 223.3(g)(1)(iii) (affiliate transactions); 12 U.S.C. § 375b(9)(B)(iii) and 12 C.F.R. § 215.2(c)(1)(iii) (extensions of credit to directors, executive officers, and principal shareholders).
[53] *See* 12 C.F.R. § 248.2(c).

I. Add a Grandfathering Provision that Preserves Existing/Board-Approved Investment Arrangements and that Further Allows Investors to Modify these Arrangements to Leverage the Relief Provided under the Proposal's Reforms.

As a result of the Federal Reserve's longstanding work in this area, there are a number of investors that have an existing arrangement that governs one or more non-controlling investments that the investor still may hold. The Board, however, does not mention how the Proposal, if finalized, would impact these existing arrangements. We assume that no Board action would be taken against an investor for any such arrangement or any portion thereof that may not conform to the arrangements permitted under a finalized Proposal. We assume further that investors could modify these arrangements in reliance on the requirements contained in a finalized Proposal, without being required to apply to the Federal Reserve for express approval or non-objection. For example, if an investor with a 9.99% voting interest in a company that has limited its business relationships with the company to 2% of the company's total annual revenues or expenses wants to benefit from the Proposal's higher revenue/expense threshold, it may do so without having formally to request relief from the Board.

The Federal Reserve, therefore, should add a grandfathering provision that protects existing investment arrangements notwithstanding any requirements from the Proposal. At the same time, the Board should allow investors remaining in these investment arrangements the option to modify automatically such arrangement to leverage the relief provided under the Proposal's reforms. This would comport with prior Board actions involving changes to Regulation Y.[54] This would also be consistent with the Board's statement that it would generally not expect to find an investor to control a company unless the investor triggers a presumption of control with respect to the company.[55]

J. Issue Guidance that Would Provide a Clear Roadmap for Commensurate Investments in Non-Corporate Entities.

Although the Proposal provides a detailed framework for determining an investor's equity investment in a company, the Board's guidance is less clear with regard to situations where the company is a partnership, limited liability company (LLC), or other entity whose ownership does not involve the issuance of voting securities. In order to provide clarity and promote compliance certainty, the Federal Reserve should provide guidance on how an investor may exercise a controlling influence over the management or policies of a non-corporate entity. For instance, how would an ownership interest in a partnership, LLC, or trust correspond to the Board's voting securities ownership thresholds of less than 5%, 5% to 9.99%, 10% to 14.99%, and 15% to 24.99%? Would, for example, a limited partner be placed in the less than 5% category (absent other indicia of control) while a general partner would be placed in a higher category? Would a trustee of a trust automatically be deemed to control a trust? What if there were multiple trustees, or one or more directed trustees whose decision-making authority is limited or

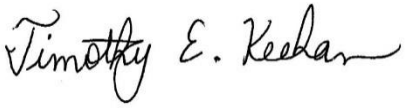
[54] *See, e.g.*, Federal Reserve, Bank Holding Companies and Change in Bank Control (Regulation Y), 62 *Fed. Reg.* 9290, 9302 (1997) (as part of adopting comprehensive amendments to Regulation Y, "the Board has determined to grant relief from [certain restrictions currently contained in Regulation Y] to all bank holding companies authorized to conduct each activity, without the need for a specific filing by an individual bank holding company").
[55] 84 *Fed. Reg.* at 21,637.

circumscribed? It is not clear how these situations involving non-corporate entities would be treated under the Proposal.

We would be glad to assist the Board as it considers crafting guidance that would provide a roadmap for investment in a non-corporate entity that generally would correspond with the various levels of investment in a company. This would further the Board's objective of providing clarity and transparency as it updates and refines a comprehensive regulatory framework for control determinations.

Thank you for your consideration of our views and recommendations. If you have any questions or require any additional information, please do not hesitate to contact the undersigned at 202-663-5479 (tkeehan@aba.com).

Sincerely,



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