

FEDERAL RESERVE SYSTEM

12 CFR Part 217 Regulation Q

Docket No. R-1506

RIN 7100-AE 27

Regulatory Capital Rules: Regulatory Capital, Final Rule Demonstrating Application of Common Equity Tier 1 Capital Eligibility Criteria and Excluding Certain Holding Companies from Regulation Q

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is adopting amendments to the Board's regulatory capital framework (Regulation Q) to clarify how the definition of common equity tier 1 capital, a key capital component, applies to ownership interests issued by depository institution holding companies that are structured as partnerships or limited liability companies. In addition, the final rule amends Regulation Q to exclude temporarily from Regulation Q savings and loan holding companies that are trusts and depository institution holding companies that are employee stock ownership plans.

DATES: The final rule is effective January 1, 2016. Any company subject to the final rule may elect to adopt it before this date.

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SUPPLEMENTARY INFORMATION:

I. Background

In July 2013, the Board adopted Regulation Q, a revised capital framework that strengthened the capital requirements applicable to state member banks and bank holding companies (BHCs) and implemented capital requirements for certain savings and loan holding companies (SLHCs).¹ Among other changes, Regulation Q introduced a common equity tier 1 capital (CET1) requirement.

Following issuance of Regulation Q, several depository institution holding companies sought clarification as to how the CET1 requirement would apply in light of their capital structures. These holding companies included BHCs and SLHCs organized in non-stock form (non-stock holding companies) (such as partnerships or limited liability corporations (LLCs)), estate trusts that are SLHCs (estate trust SLHCs), and employee stock ownership plans that are BHCs or SLHCs (ESOP holding companies).

¹ See 12 CFR part 217. Savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities are exempt temporarily from the revised capital framework. See 12 CFR 217.2, “Covered savings and loan holding company.” In addition, earlier this year, the Board issued a final rule that raised the asset threshold for applicability of the Board’s Small Bank Holding Company Policy Statement (12 CFR part 225, Appendix C) from less than \$500 million to less than \$1 billion and made corresponding revisions to the applicability provisions of Regulation Q to exempt small SLHCs from Regulation Q to the same extent as small BHCs. See 12 CFR 217.1(c)(1)(ii)-(iii); 80 FR 20153 (April 15, 2015).

On December 12, 2014, the Board invited comment on a proposed rule that described how the CET1 requirement would apply to holding companies organized as partnerships or LLCs and that would have temporarily excluded estate trust SLHCs and ESOP holding companies from Regulation Q.²

The Board received two comments on the proposal—one from a financial services trade association and another from a savings and loan holding company—both of which expressed support for the proposal. After reviewing these comments, the Board is adopting the proposal largely as proposed, with certain clarifying edits and non-substantive changes to order and formatting.

II. Description of the Proposed and Final Rules

1. Application of the eligibility criteria for common equity tier 1 instruments to LLC and partnership interests

Regulation Q includes a CET1 requirement of 4.5 percent of risk-weighted assets. The purpose of the requirement is to ensure that banking organizations subject to Regulation Q hold sufficient high-quality regulatory capital that is available to absorb losses on a going concern basis.³ In particular, CET1 must be the most subordinated form of capital in an institution's capital structure and thus available to absorb losses first.⁴ CET1 is composed of common stock and instruments issued by mutual banking organizations that meet certain eligibility criteria.⁵

² 79 FR 75759 (December 19, 2014).

³ 12 CFR 217.20(b); 78 FR 62018, 62029.

⁴ 78 FR 62018, 62044.

⁵ The qualifying criteria under Regulation Q for a CET1 instrument include the following:

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- (i) The instrument is paid-in, issued directly by the Board-regulated institution, and represents the most subordinated claim in a receivership, insolvency, liquidation, or similar proceeding of the Board-regulated institution;
- (ii) The holder of the instrument is entitled to a claim on the residual assets of the Board-regulated institution that is proportional with the holder's share of the Board-regulated institution's issued capital after all senior claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding;
- (iii) The instrument has no maturity date, can only be redeemed via discretionary repurchases with the prior approval of the Board, and does not contain any term or feature that creates an incentive to redeem;
- (iv) The Board-regulated institution did not create at issuance of the instrument through any action or communication an expectation that it will buy back, cancel, or redeem the instrument, and the instrument does not include any term or feature that might give rise to such an expectation;
- (v) Any cash dividend payments on the instrument are paid out of the Board-regulated institution's net income, retained earnings, or surplus related to common stock, and are not subject to a limit imposed by the contractual terms governing the instrument. State member banks are subject to other legal restrictions on reductions in capital resulting from cash dividends, including out of the capital surplus account, under 12 U.S.C. 324 and 12 CFR 208.5.
- (vi) The Board-regulated institution has full discretion at all times to refrain from paying any dividends and making any other distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restrictions on the Board-regulated institution;
- (vii) Dividend payments and any other distributions on the instrument may be paid only after all legal and contractual obligations of the Board-regulated institution have been satisfied, including payments due on more senior claims;
- (viii) The holders of the instrument bear losses as they occur equally, proportionately, and simultaneously with the holders of all other common stock instruments before any losses are borne by holders of claims on the Board-regulated institution with greater priority in a receivership, insolvency, liquidation, or similar proceeding;
- (ix) The paid-in amount is classified as equity under GAAP;
- (x) The Board-regulated institution, or an entity that the Board-regulated institution controls, did not purchase or directly or indirectly fund the purchase of the instrument;
- (xi) The instrument is not secured, not covered by a guarantee of the Board-regulated institution or of an affiliate of the Board-regulated institution, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument;
- (xii) The instrument has been issued in accordance with applicable laws and regulations; and

In a stock company, common stock generally is the most subordinated element of its capital structure. While a non-stock holding company does not issue common stock, it generally should also have the ability to issue capital instruments that have loss absorbency features similar to those of common stock.

In addition, a stock company may issue capital instruments that are not the most subordinated elements of its capital structure, such as preferred stock with a liquidation preference and cumulative dividend rights. Similarly, non-stock holding companies may issue capital instruments that are not the most subordinated elements of their capital structure. Regardless of whether the issuer is a stock company or a non-stock company, a capital instrument that is not the most subordinated element of a company's capital structure would not qualify as CET1 under Regulation Q.⁶

Features that cast doubt on whether a particular class of capital instruments is the most subordinated and therefore available to absorb losses first include unlimited liability for the general partner in a partnership, allocation of losses among classes that is disproportionate to amounts invested, mandatory distributions, minimum rates of return, and/or reallocations of earlier distributions. If such features limit or could limit the ability of capital instruments to bear first losses or effectively absorb losses then such

(xiii) The instrument is reported on the Board-regulated institution's regulatory financial statements separately from other capital instruments.

12 CFR 217.20(b)(1).

⁶ See 12 CFR 217.20(b)(1)(i).

features are inconsistent with Regulation Q's eligibility criteria for CET1 instruments and therefore may not qualify as such under Regulation Q.⁷

The proposed rule would have clarified, through examples, how the definition of CET1 would apply to ownership interests issued by non-stock holding companies.⁸ In general, the examples showed that an LLC or partnership could issue capital that would qualify as CET1 provided that all ownership classes shared equally in losses, even if all ownership classes do not share equally in profits. The examples also showed that other features of capital instruments, such as a mandatory capital distribution upon the occurrence of an event or a date, different liquidation preferences among ownership classes, or unequal sharing of losses, could prevent a capital instrument from qualifying as CET1.

As noted, the Board received two comments on the proposal. One comment related to the application of the eligibility criteria for CET1 instruments to LLC and partnership interests. The commenter expressed concern that Regulation Q did not adequately address the special characteristics of non-stock holding companies and observed that the proposal facilitated the application of Regulation Q to such holding companies.

The final rule follows the same basic structure of the proposal, and adds some clarifications. The Board reordered the examples in the final rule to group together those examples discussing similar structures. In addition, the Board revised examples related

⁷ To the extent that the economic rights of one class of ownership interests differ from those of another class, each class should be evaluated separately to determine qualification as common equity tier 1 capital.

⁸ See 79 FR 75759, 75761-2.

to loss sharing to clarify that each distribution must be reviewed separately and to clarify that losses must be borne equally by all holders of CET1 instruments when investment proceeds are distributed.

In particular, Example (3) in the proposal related to an LLC with two classes of membership interests that share proportionately in losses, return of contributed capital, and profits up to a set rate of return. However, the classes of membership interests share disproportionately in profits above a particular level. This example provided that both classes of membership interest could qualify as CET1 so long as the classes always share any losses proportionately among the classes or among the instruments in each class, even if there is disproportionate allocation of profits. In the final rule, this example, renumbered as Example (4), clarifies that disproportionate sharing of profits does not prevent qualification as CET1, so long as the classes bear the losses pro rata. Despite the potential for disproportionate allocations of profits from a distribution, the classes of capital instruments would bear losses pro rata, placing them at the same level of seniority in bankruptcy or liquidation.

In the proposal, Example (7) related to an LLC with two classes of membership interests where one class could be required, under certain circumstances, to return previously received distributions that would then be allocated to the other class. The example provided that a class of capital instruments advantaged by an arrangement such that the advantaged class might not bear losses pro rata with the other class, would not qualify as CET1. The example also offered general suggestions for revising such arrangements so that such class of capital instrument could count as CET1. In the final rule, the Board revised Example (7) to emphasize the concern that a reallocation of

distributions may affect the analysis of whether a class of capital instruments is in a first-loss position. In addition, the Board revised Example (7) to state that reallocations that were limited to reversing prior disproportionate allocations of profits would not raise this concern. Finally, the Board removed general suggestions in Example (7) regarding potential alternative structures to avoid confusion for the reader.

Section 217.501 of the final rule does not differ fundamentally from the existing CET1 eligibility criteria in Regulation Q. Instead, it expands on and clarifies the application of these criteria in particular circumstances in substantially the same manner as the proposal.

In addition, the proposed rule would have allowed an LLC or partnership with outstanding capital instruments that would not have qualified under the proposed rule as CET1 to continue to treat these instruments as CET1 until January 1, 2016. The Board proposed this extension to provide time for depository institution holding companies organized as LLCs or partnership to assess whether their capital instruments comply with the Regulation Q eligibility criteria and to make any needed modifications. The final rule extends this compliance date to July 1, 2016.

The Board expects that all holding companies that are subject to Regulation Q and that have issued capital instruments that do not qualify as CET1 under sections 217.20 and 217.501 to be in full compliance with Regulation Q by July 1, 2016. A non-stock holding company subject to Regulation Q, such as a company organized as an LLC or partnership, that has capital instruments that do not meet the applicable eligibility criteria under Regulation Q may need to take steps to ensure compliance with Regulation Q,

including modifying its capital structure or the governing documents of specific capital instruments or issuing additional qualifying capital.

The Board may consider the appropriate treatment under Regulation Q for specific capital instruments on a case-by-case basis. Further, the Board reserves the authority to determine that a particular capital instrument may or may not qualify as any form of regulatory capital based on its ability to absorb losses or other considerations, or whether the capital instrument qualifies as an element of a particular regulatory capital component under Regulation Q.⁹

2. Estate Trust SLHCs

Estate trust SLHCs with total consolidated assets of more than \$1 billion became subject to Regulation Q on January 1, 2015.¹⁰ Many estate trusts, however, do not issue capital instruments that would qualify as regulatory capital under Regulation Q or prepare financial statements under U.S. Generally Applicable Accounting Principles (GAAP). Such estate trust SLHCs, therefore, may not be able to meet the minimum regulatory capital ratios under Regulation Q, and requiring these institutions to develop and implement the management information systems necessary to prepare financial statements to demonstrate compliance with Regulation Q could impose significant burden and expense. In addition, a temporary exemption from Regulation Q for estate trust

⁹ 12 CFR 217.1(d)(2).

¹⁰ While the Home Owners' Loan Act contains a narrow exemption for testamentary trusts from the definition of savings and loan holding company, there are approximately 107 family and personal trusts that do not qualify for this exemption and thus, are savings and loan holding companies. As of January 1, 2015, some of these entities became subject to Regulation Q. The Bank Holding Company Act exempts certain testamentary and inter vivos trusts from the definition of "company."

SLHCs does not appear to raise significant supervisory concerns because the estate planning purpose of these entities generally results in limited operations and leverage.¹¹ To address these issues, the proposed rule would have excluded estate trust SLHCs from Regulation Q, pending development by the Board of an alternative capital regime for these institutions.

The Board received one comment on this aspect of the proposal. This commenter noted that it was a closely held SLHC with an ownership structure that included estate trusts and a limited partnership. This commenter expressed concern over the application of Regulation Q and other prudential regulations to family estate planning vehicles and expressed support for the Board's proposed temporary exclusion of estate trust SLHCs from Regulation Q.

The final rule adopts the exclusion for SLHCs that are estate trusts without modification. For these entities, the Board intends to develop alternative capital adequacy standards.¹²

3. ESOPs

ESOPs are entities created as part of employee benefits arrangements that hold shares of the sponsoring entities' stock. An ESOP may be a holding company due to its

¹¹ A review of estate trust SLHCs found that these institutions generally hold high levels of capital, with an estimated median leverage ratio of approximately 99 percent and an estimated mean leverage ratio of approximately 94 percent. Leverage was measured as the ratio of assets minus liabilities over assets. However, estate trust SLHCs do not file regular financial reports with the Board, and estimated median and mean leverage ratios are based on data collected from a significant number of estate trust SLHCs in 2014.

¹² Any alternative capital standard must be consistent section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 171 of the Dodd-Frank Act generally requires that the Board impose minimum leverage and risk-based capital requirements on depository institution holding companies, including estate trust SLHCs.

ownership interest in the banking organization that sponsors the ESOP. Under U.S. GAAP, the assets and liabilities of ESOP holding companies are consolidated onto the balance sheet of the banking organization that sponsors the ESOP (either a depository institution or a holding company that may be subject to Regulation Q). Thus, an ESOP holding company may be considered the top-tier holding company in a banking organization for ownership purposes but not considered the top-tier holding company for accounting purposes. This distinction has created confusion regarding the application of Regulation Q to ESOP holding companies, which generally do not issue capital instruments.

The proposed rule would have excluded ESOPs from Regulation Q until the Board clarifies the regulatory capital treatment for these entities. The Board did not receive any comments on the aspects of the proposal related to ESOPs and is adopting the proposed temporary exclusion for ESOPs without modification.

For a banking organization that has an ESOP holding company within its structure, the Board will evaluate compliance with Regulation Q by assessing the regulatory capital of an ESOP holding company's sponsor banking organization.

4. Early Compliance

The final rule will be effective January 1, 2016. As noted above, the final rule includes an extended compliance date of July 1, 2016, to allow time for non-stock holding companies to assess whether their capital instruments comply with Regulation Q and to make any necessary modifications. However, any banking organization subject to Regulation Q may elect to treat the final rule as effective before the effective date.

Accordingly, the Board will not object if an institution wishes to apply the provisions of the final rule beginning with the date it is published in the Federal Register.

III. Regulatory Analysis

A. Paperwork Reduction Act (PRA)

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. § 3506; 5 CFR 1320, Appendix A.1), the Board reviewed the final rule under the authority delegated to the Board by the Office of Management and Budget. The final rule contains no requirements subject to the PRA.

B. Regulatory Flexibility Act Analysis

The Board is providing a final regulatory flexibility analysis with respect to this final rule. As discussed previously, the final rule provides examples of how the Board will apply the eligibility criteria for CET1 under Regulation Q to instruments issued by non-stock holding companies and provides certain exclusions from Regulation Q. The Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* (RFA), generally requires that an agency provide a final regulatory flexibility analysis in connection with a final rule. Under regulations issued by the Small Business Administration, a small entity includes a BHC, bank, or SLHC with assets of \$550 million or less (small banking organization).¹³ As of December 31, 2014, there were approximately 3,833 small BHCs and 271 small SLHCs.

The Board received no comments from the public or from the Chief Counsel for Advocacy of the Small Business Administration in response to the initial regulatory flexibility analysis. Thus, no issues were raised in public comments related to the

¹³ See 13 CFR 121.201. Effective July 14, 2014, the Small Business Administration revised the size standards for banking organizations to \$550 million in assets from \$500 million in assets. 79 FR 33647 (June 12, 2014).

Board's initial Regulatory Flexibility Act analysis and no changes are being made in response to such comments.

The final rule would apply to top-tier depository institution holding companies that are subject to Regulation Q. A substantial number of small depository institution holding companies are exempt from Regulation Q through the application of the Board's Small Bank Holding Company Policy Statement.¹⁴ In addition, the Board does not believe that the final rule would have a significant impact on small banking organizations because the Board considers the final rule as clarifying the CET1 eligibility criteria and providing specific guidance on the application of the eligibility criteria to entities subject to Regulation Q, rather than imposing significant new requirements. The temporary exemptions from Regulation Q provided for estate trust SLHCs and ESOP holding companies relieve burden on covered small banking organizations, rather than imposing burden.

The Board is not aware of any other Federal rules that duplicate, overlap, or conflict with the final rule. The Board believes that the final rule will not have a significant economic impact on small banking organizations supervised by the Board and therefore believes that there are no significant alternatives to the final rule that would reduce the economic impact on small banking organizations supervised by the Board.

C. Plain Language

Section 722 of the Gramm-Leach-Bliley Act requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The

¹⁴ See 12 CFR 217.1; 12 CFR part 225, Appendix C; 80 Federal Register 5666 (February 3, 2015).

Board has sought to present the final rule in a simple and straightforward manner. The Board did not receive any comments on its use of plain language in the proposed rule.

List of Subjects

12 CFR Part 217

Administrative practice and procedure, Banks, Banking, Capital, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

Board of Governors of the Federal Reserve System

12 CFR CHAPTER II

Authority and Issuance

For the reasons set forth in the preamble, part 217 of chapter II of title 12 of the Code of Federal Regulations is amended as follows:

PART 217 – CAPITAL ADEQUACY OF BANK HOLDING COMPANIES, SAVINGS AND LOAN HOLDING COMPANIES AND STATE MEMBER BANKS (REGULATION Q)

1. The authority citation for part 217 continues to read as follows:

Authority: 12 U.S.C. 248(a), 321–338a, 481-486, 1462a, 1467a, 1818, 1828, 1831n, 1831o, 1831p–l, 1831w, 1835, 1844(b), 1851, 3904, 3906-3909, 4808, 5365, 5368, 5371.

2. Add subpart I to read as follows:

Subpart I – Application of Capital Rules

Sec.

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| 217.501 | The Board’s Regulatory Capital Framework for Depository Institution Holding Companies Organized as Non-Stock Companies. |
| 217.502 | Application of the Board’s Regulatory Capital Framework to Employee Stock Ownership Plans that are Depository Institution Holding Companies and Certain Trusts that are Savings and Loan Holding Companies. |

§ 217.501 The Board’s Regulatory Capital Framework for Depository Institution Holding Companies Organized as Non-Stock Companies.

(a) *Applicability.* (1) This section applies to all depository institution holding companies that are organized as legal entities other than stock corporations and that are subject to this part (Regulation Q, 12 CFR part 217).¹⁵

(2) Notwithstanding §§ 217.2 and 217.10, a bank holding company or covered savings and loan holding company that is organized as a legal entity other than a stock corporation and has issued capital instruments that do not qualify as common equity tier 1 capital under § 217.20 by virtue of the requirements set forth in this section may treat those capital instruments as common equity tier 1 capital until July 1, 2016.

(b) *Common equity tier 1 capital criteria applied to capital instruments issued by non-stock companies.* (1) Subpart C of this part provides criteria for capital instruments to qualify as common equity tier 1 capital. This section describes how certain criteria apply to capital instruments issued by bank holding companies and covered savings and loan holding companies that are organized as legal entities other than stock corporations, such as limited liability companies (LLCs) and partnerships.

(2) Holding companies are organized using a variety of legal structures, including corporate forms, LLCs, partnerships, and similar structures.¹⁶ In the Board’s experience, some depository institution holding companies that are organized in non-stock form issue

¹⁵ See 12 CFR 217.1(c)(1)-(3).

¹⁶ A stock corporation’s common stock should satisfy the CET1 criteria so long as the common stock does not have unusual features, such as a limited duration.

multiple classes of capital instruments that allocate profit and loss from a distribution differently among classes, which may affect the ability of those classes to qualify as common equity tier 1 capital.¹⁷

(3) Common equity tier 1 capital is defined in § 217.20(b). To qualify as common equity tier 1 capital, capital instruments must satisfy a number of criteria. This section provides examples of the application of certain common equity tier 1 capital criteria that relate to the economic interests in the company represented by particular capital instruments.

(c) *Examples.* The following examples show how the criteria for common equity tier 1 capital apply to particular partnership or LLC structures.¹⁸

(1) *LLC with one class of membership interests.* (i) An LLC issues one class of membership interests that provides that all holders of the interests bear losses and receive dividends proportionate to their levels of ownership.

(ii) Provided that the other criteria in § 217.20(b) are met, the membership interests would qualify as common equity tier 1 capital.

(2) *Partnership with limited and general partners.* (i) A partnership has two classes of interests: general partnership interests and limited partnership interests. The general partners and the limited partners bear losses and receive distributions allocated

¹⁷ Notably, voting powers or other means of exercising control are not relevant for purposes of satisfying the CET1 eligibility criteria. Thus, the fact that a particular partner or member controls a holding company, for instance, due to serving as general partner or managing member, is not material to qualification of particular interests as CET1.

¹⁸ Although the examples refer to specific types of legal entities for purposes of illustration, the substance of the Regulation Q criteria reflected in the examples applies to all types of legal entities.

proportionately to their capital contributions. In addition, the general partner has unlimited liability for the debts of the partnership.

(ii) Provided that the other criteria in § 217.20(b) are met, the general and limited partnership interests would qualify as common equity tier 1 capital. The fact of unlimited liability of the general partner is not relevant in the context of the eligibility criteria of common equity tier 1 capital instruments, provided that the general partner and limited partners share losses equally to the extent of the assets of the partnership, and the general partner is liable after the assets of the partnership are exhausted. In this regard, the general partner's unlimited liability is similar to a guarantee provided by the general partner, rather than a feature of the general partnership interest.

(3) *Senior and junior classes of capital instruments.* (i) An LLC issues two types of membership interests, Class A and Class B. Holders of Class A and Class B interests participate equally in operating distributions and have equal voting rights. However, in liquidation, holders of Class B interests must receive the entire amount of their contributed capital in order for any distributions to be made to holders of Class A interests.

(ii) Class B interests have a preference over Class A interests in liquidation and, therefore, would not qualify as common equity tier 1 capital as the Class B interests are not the most subordinated claim (criterion (i) § 217.20(b)) and do not share losses proportionately (criterion (viii) § 217.20(b)).

(A) If all other criteria are satisfied, Class A interests would qualify as common equity tier 1 capital.

(B) Class B interests may qualify as additional tier 1 capital, or tier 2 capital, if the Class B interests meet the applicable criteria (§ 217.20(c)-(d)).

(4) *LLC with two classes of membership interests.* (i) An LLC issues two types of membership interests, Class A and Class B. To the extent that the LLC makes a distribution, holders of Class A and Class B interests share proportionately in any losses and receive proportionate shares of contributed capital. To the extent that a capital distribution includes an allocation of profits, holders of Class A and Class B interests share proportionately up to the point where all holders receive a specific annual rate of return on capital contributions, and, if the distribution exceeds that point, holders of Class B interests receive double their proportional share and holders of Class A interests receive the remainder of the distribution.

(ii) Class A and Class B interests would both qualify as common equity tier 1 capital, provided that under all circumstances they share losses proportionately, as measured with respect to each distribution, and that they satisfy the common equity tier 1 capital criteria. The holders of Class A and Class B interests may receive different allocations of profits with respect to a distribution, provided that the distribution is made simultaneously to all members of Class A and Class B interests. Despite the potential for disproportionate profits, Class A and Class B interests have the same level of seniority with regard to potential losses and therefore they both satisfy all the criteria in § 217.20(b), including criterion (ii).

(5) *Alternative LLC with two classes of membership interests.* (i) An LLC issues two types of membership interests, Class A and Class B. In the event that the LLC makes a distribution, holders of Class A interests bear a disproportionately low level of

any losses, such that the Class B interests bear a disproportionately high level of losses at the distribution. In contrast to the example in paragraph (c)(4) of this section, the different participation rights apply to distributions in situations where losses are allocated, including losses at liquidation.

(ii) Because holders of the Class A interests do not bear a proportional interest in the losses (criterion (ii) § 217.20(b)), the Class A interests would not qualify as common equity tier 1 capital.

(A) Companies with such structures may revise their capital structures in order to provide for a sufficiently large class of capital instruments that proportionally bear first losses in liquidation (that is, the Class B interests in this example).

(B) Alternatively, companies with such structures could revise their capital structure to ensure that all classes of capital instruments that are intended to qualify as common equity tier 1 capital share equally in losses in liquidation consistent with criteria (i), (ii), (vii), and (viii) in § 217.20(b), even if each class of capital instruments has different rights to allocations of profits, as in paragraph (c)(4) of this section.

(6) *Mandatory distributions.* (i) A partnership agreement contains provisions that require distributions to holders of one or more classes of capital instruments on the occurrence of particular events, such as upon specific dates or following a significant sale of assets, but not including any final distributions in liquidation.

(ii) Any class of capital instruments that provides holders with rights to mandatory distributions would not qualify as common equity tier 1 capital because a holding company must have full discretion at all times to refrain from paying any dividends and making any other distributions on the instrument without triggering an

event of default, a requirement to make a payment-in-kind, or an imposition of any other restriction on the holding company (criterion (vi) in § 217.20(b)). Companies must ensure that they have a sufficient amount of capital instruments that do not have such rights and that meet the other criteria of common equity tier 1 capital, in order to meet the requirements of Regulation Q.

(7) *Features that Reallocate Prior Distributions.* (i) An LLC issues two types of membership interests, Class A and Class B. The terms of the LLC's membership interests provide that, under certain circumstances, holders of Class A interests must return a portion of earlier distributions, which are then distributed to holders of Class B interests (sometimes called a "clawback").

(ii) If the reallocation of prior distributions described in paragraph (c)(7)(i) could result in holders of the Class B interests bearing fewer losses on an aggregate basis than Class A interests, the Class B interests would not qualify as common equity tier 1 capital. However, where the membership interests provide for disproportionate allocation of profits, such as described in the example in paragraph (c)(4) of this section, and the reallocation of prior distributions would be limited to reversing the disproportionate portions of prior distributions, both the Class A and Class B interests could qualify as common equity tier 1 capital provided that they met all the other criteria in § 217.20(b).

§ 217.502 Application of the Board's Regulatory Capital Framework to Employee Stock Ownership Plans that are Depository Institution Holding Companies and Certain Trusts that are Savings and Loan Holding Companies.

(a) *Employee Stock Ownership Plans.* Notwithstanding § 217.1(c), a bank holding company or covered savings and loan holding company that is an employee stock

ownership plan is exempt from this part until the Board adopts regulations that directly relate to the application of capital regulations to employee stock ownership plans.

(b) *Personal or Family Trusts.* Notwithstanding § 217.1(c), a covered savings and loan holding company is exempt from this part if it is a personal or family trust and not a business trust until the Board adopts regulations that apply capital regulations to such a covered savings and loan holding company.

By order of the Board of Governors of the Federal Reserve System, December 4, 2015.

Robert deV. Frierson
Secretary of the Board.