NEP

Norwest Equity Partners

80 South 8th Street
Suite 3600
Minneapolis, Minnesota
55402

612.215.1600 PHONE
612.215.1601 FAX

www.nep.com

To: Members of the Federal Reserve Board

From: John P. Whaley, Managing Administrative Partner,
Norwest Equity Partners

Re: FR Y-12A

Date: October 27, 2006

The proposed reporting form FR Y-12A is intended to provide the Federal Reserve Board ("FRB") with data concerning the merchant banking investments that are approaching the end of the holding period permissible under Regulation Y. This proposed report highlights a significant issue facing all merchant banking operations that are subject to Regulation Y.

BACKGROUND ON MERCHANT BANKING HOLDING PERIODS

It is helpful to take a step back to understand the issues surrounding this situation. Merchant banking activities involve making illiquid investments in private companies. These investments are made with a long term orientation, generally 5 to 8 years, to allow the company to execute its strategy which usually involves the development and introduction of new products, expansion of the companies' served markets or acquisition of other companies. The execution of these strategies is expected to have a meaningful impact on the value of the business. Once value has been created in the business enterprise, the stockholders then need to be able to successfully exit their investment either through the public markets (IPO) or an outright sale of the business.

Successful exits are dependent on having favorable capital markets conditions. Furthermore, once a company has executed a successful IPO, federal securities laws and practical marketing issues limit how quickly a significant shareholder can sell his investment. It typically takes at least 2 years to prudently liquidate an investment after a successful IPO.

The typical merchant banking investment is structured so that an investor can successfully exit the investment within a 5 to 8 year period. However, given the risks and illiquid nature of these types of investments, experience indicates that a certain number of investments (15%-20%) will be held for a period longer than 10 years. Companies that are held longer than 5-8 years are typically identified as "the living dead" or "restarts." They are part of every merchant banking portfolio.

GRAHAM-LEACH-BLILEY ACT

During the debate that led to the passage of the Graham Leach Bliley Act ("GLB") lawmakers addressed the issue of merchant banking investment holding periods. The statute states in Section 103 (H)(iii) that a FHC be permitted to hold merchant banking investments for a sufficient period of time to "enable the disposition thereof on a reasonable basis consistent with the financial viability of investing for appreciation and ultimate resale of disposition." In addition Congressional Committee Reports accompanying GLB reaffirmed Congressional intent that specific time limits not be imposed through regulation on merchant banking investments. Despite clear

Congressional intent, the FRB chose an arbitrary period of time, 10 years, as the maximum time that an investment could be held. This holding period limitation impairs the competitive position of GLB regulated participants in the merchant banking industry.

Attached to this memorandum are three examples of investments in the Wells Fargo merchant banking portfolio that were held, or are likely to be held, longer than 10 years that help illustrate the consequences of the holding period regulation. It seems logical that the FRB should revisit this issue. The FRB's concern over mixing "banking and commerce" can be addressed in other ways.

ALTERNATIVE RECOMMENDED CHANGES TO REGULATION Y

- Maximum holding period for direct investments be extended to 15 years; the same as with fund investments; or
- Allow the greater of 15% of the fund size or 15% of investments on the books at fair market value to be held for longer than 10 years without penalty.

These recommended changes to the holding period rules would provide a safe harbor for the investments that pursue a longer path to liquidity and would not place GMB regulated entities at a competitive disadvantage in the market. It protects the

FRB's banking and commerce concern by requiring the vast majority of assets (85%) be liquidated within a 10 year period.

John P. Whaley

Managing Administrative Partner

Norwest Equity Partners

EXAMPLES

1. Lifetime Fitness is a company that owns and operates fitness clubs. Norwest Equity Partners ("NEP") made its initial investment in Lifetime on May 8, 1996. At the time Lifetime had 5 fitness centers in the Minneapolis/St. Paul area. Since then NEP led three more rounds of private financing for Lifetime as it refined its operating model and expanded into new markets. The logical exit option for this investment was a public offering since the company was growing quickly and often required additional capital to meet its expansion goals.

The public offering opportunity didn't present itself until 2004 when Lifetime completed its IPO. NEP sold a portion of its stake at the time of the IPO and has since periodically liquidated a portion of its holdings at an increasing market price. In May, 2006 NEP still held approximately 20% of its investment 10 years after its initial investment.

Lifetime has performed very well as an investment and has resulted in one of the most profitable investments in the firm's history. It is important to point out that most of the gain has been realized since the company's public offering in 2004. Had the 10 year holding rule been in effect, the company could have delayed a public offering and forced NEP to sell at a discounted price to avoid the regulatory violation. If this had occurred, it would have wiped out over a hundred million dollars of gain subsequently realized by NEP. As it was, Lifetime was fortunate to be able to have a public offering in 2004, a year that had very difficult market characteristics. Exits that are forced are problematic in that value is never maximized. In the Lifetime example, NEP was able to maximize value, but only because the 10 year holding rule was not applicable.

2. EMC Corporation is the classic example of a portfolio company that is referred to as "the living dead". NEP's initial investment dates back to 1961, when NEP's predecessor company acquired a 9% stake in the company. EMC was a publisher of educational materials founded by three individuals. The company struggled along making money one year and losing money the next. They did well enough so that they could stay in business, but not well enough to create value to the business. It went on like this for many years. Efforts to sell our stock from time to time revealed that we would get our initial investment back, but not much more. We decided that we would maximize value when the management team decided it was time to sell the business.

It turns out that the management team was not about to sell until it had achieved some success and that was not until 2003. In 2004, it put the company up for sale and on April 28, 2005 the original management sold the business allowing for their shareholders to cash out some 44 years later.

This is an extreme example, but it does reinforce the point that some investments are not easily dealt with in a 10 year period of time. In this case, most of the appreciation that was realized upon sale came from the last couple years of performance. Forcing an arbitrary sale of an immature company like EMC would not have served anyone well; not EMC management or its employees; not Wells Fargo, and not the economy in general. Furthermore, as a minority shareholder, NEP could not force a sale transaction.

3. Yipes Communications, Inc. is a classic early stage emerging growth company based in San Francisco. Norwest Venture Partners ("NVP") first funded Yipes on July 12, 1999 to help it commercialize its managed optical networking service. NVP invested alongside New Enterprise Associates, another nationally recognized venture capital firm. By the end of 2000, Yipes had raised a total of $272.3 million of capital to develop and grow its business. During 2001, the capital markets changed dramatically as the internet bubble burst. Yipes was still operating at a loss and was unable to continue to finance its business. It filed for bankruptcy in 2002. NVP joined with other investors to buy assets out of bankruptcy later in 2002 with a restructured balance sheet, new management, and a revised business model. Since then, Yipes has required several different rounds of financing. Today, Yipes is approaching cash flow breakeven and it is considered one of the few survivals of the telecom bust.

The last chapter of Yipes is yet to be written, but if all goes well, they could get to an initial public offering in the 2009 time frame. This would allow NVP the ability to get liquidity in their investment by 2011 and 2012. Again, this is well past the 10 year limitation, but it is not surprising given the turmoil in the capital markets for telecom companies beginning in 2001. Yipes is an example of a "restart" in that the strategy and business model and management teams have had to be reconfigured several times given the dramatic changes in the marketplace. Now, after seven years of rebuilding and restarting, Yipes appears to be positioned to capitalize finally on its position in the market. To be forced to sell this investment by year 10 due to Regulation Y would not allow NVP the time needed to maximize the potential of Yipes.