APPENDIX B

FEDERAL RESERVE SYSTEM
12 CFR Part 225
Regulation Y; Docket No. R-1065

DEPARTMENT OF THE TREASURY
Office of the Under Secretary for Domestic Finance
12 CFR Part 1500
RIN 1505-AA78

Bank Holding Companies and Change in Bank Control

AGENCIES: Board of Governors of the Federal Reserve System and the Secretary of the Treasury.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System and the Secretary of the Treasury jointly adopt this final rule governing merchant banking investments made by financial holding companies. The rule implements provisions of the Gramm-Leach-Bliley Act that permit financial holding companies to make investments as part of a bona fide securities underwriting or merchant or investment banking activity. The Board and the Secretary have incorporated a number of amendments to the final rule to address issues raised by public commenters, to reduce potential regulatory burdens, and to clarify the application of the rule. These changes include expanding the definition of "securities affiliate" to include a department or division of a bank registered as a municipal securities dealer; modifying the provisions defining prohibited routine management and operation of portfolio companies; adopting a sunset provision for the investment thresholds under the interim rule and eliminating the dollar-based threshold for the review of a financial holding company's merchant banking activities; streamlining the rule's reporting and recordkeeping requirements; broadening the definition of "private equity" funds and clarifying the rule's application to such funds; and adopting several safe-harbors to the presumptions in the rule

governing the definition of affiliate for purposes of sections 23A and 23B of the Federal Reserve Act.

DATES: The final rule is effective February 15, 2001.

FOR FURTHER INFORMATION CONTACT:

Board of Governors: Scott G. Alvarez, Associate General Counsel (202/452-3583), Kieran J. Fallon, Senior Counsel (202/452-5270), or Camille M. Caesar, Counsel (202/452-3513), Legal Division; Jean Nellie Liang, Chief, Capital Markets (202/452-2918), Division of Research & Statistics; Michael G. Martinson, Deputy Associate Director (202/452-3640) or James A. Embersit, Manager, Capital Markets (202/452-5249), Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. Users of Telecommunications Device for the Deaf (TDD) only contact Janice Simms at (202) 872-4984.

Department of the Treasury: Roberta K. McInerney, Assistant General Counsel (Banking and Finance) (202/622-0480), Gary Sutton, Senior Banking Counsel (202/622-0480), or Gerry Hughes, Senior Financial Economist (202/622-2740), 1500 Pennsylvania Avenue, N.W., Washington, D.C. 20220.

SUPPLEMENTARY INFORMATION:

A. Background

The Gramm-Leach-Bliley Act (GLB Act)[1] amended the Bank Holding Company Act (BHC Act) to allow a bank holding company that has made an effective election to become a financial holding company to make investments in nonfinancial companies as part of a bona fide securities underwriting or merchant or investment banking activity. These investments may be made in any type of ownership interest in any type of nonfinancial entity (portfolio company), and may represent any amount of the equity of a portfolio company. Investments made under this new authority, which is codified in

[1] Pub. L. 106-102, 113 Stat. 1338 (1999).

section 4(k)(4)(H) of the BHC Act (12 U.S.C. 1843(k)(4)(H)), are referred to as "merchant banking investments." The GLB Act imposed conditions on the length of time that these investments may be held, the ability of the financial holding company to routinely manage or operate the portfolio company, and other aspects of the relationship between the financial holding company and its affiliates on the one hand and the portfolio company on the other hand. These restrictions further the fundamental purposes of the BHC Act--to help maintain the separation of banking and commerce and promote safety and soundness.

In March 2000, the Board of Governors of the Federal Reserve System (Board) and the Secretary of the Treasury (Secretary) jointly adopted, on an interim basis, and requested public comment on a rule governing the merchant banking investments of financial holding companies.[2] The interim rule provided guidance concerning the types of investments that are permissible under section 4(k)(4)(H) and defined the term "securities affiliate" for purposes of determining those financial holding companies eligible to make merchant banking investments. In addition, the interim rule implemented the provisions of the GLB Act that limit the holding period of merchant banking investments and the ability of financial holding companies to routinely manage or operate a portfolio company.

The interim rule also contained provisions designed to ensure that the merchant banking investment activities of financial holding companies are conducted in compliance with the GLB Act and in a safe and sound manner that does not endanger depository institutions or the federal deposit insurance funds. In this regard, the interim rule established aggregate investment thresholds for the review by the Board of the merchant banking investment activities of a financial holding company. The Board and the Secretary adopted these investment thresholds to allow the agencies to monitor the implementation of the merchant banking investments under the new authority and address situations that could pose a material risk to the safety and soundness of depository institutions. The interim rule also required financial holding companies to establish

[2]65 FR 16460 (March 28, 2000).

policies and procedures reasonably designed to monitor and manage the risks associated with merchant banking investments, and to maintain records and file reports necessary for the financial holding company and the Board to monitor the company's merchant banking investments and the company's compliance with the GLB Act and the interim rule. Furthermore, the interim rule implemented the cross-marketing and affiliate transaction restrictions applied by the GLB Act to merchant banking investments.

At the time the Board and the Secretary adopted the interim rule, the Board also issued for public comment proposed amendments to the Board's capital guidelines for bank holding companies to address the appropriate capital treatment for merchant banking and similar investments made by bank holding companies and their subsidiaries. This capital proposal, which was not adopted on an interim basis, generally would have required financial holding companies to deduct 50 percent of the carrying value of their merchant banking investments from Tier 1 capital.

Prior to issuing the interim rule and capital proposal, staff of the Federal Reserve and the Department of the Treasury conducted interviews with a number of securities firms that make merchant banking investments to collect information concerning how these firms conduct their merchant banking activities. Staff also conducted interviews with several bank holding companies that were engaged in equity investment activities prior to the GLB Act under the more limited statutory authorities then in existence. The information collected in these interviews, which is described in greater detail in the Supplementary Information accompanying the interim rule and capital proposal,[3] was used in developing the interim rule and this final rule.

B. <u>Overview of Comments</u>

The Board and the Secretary together received more than 140 comments on the interim rule and the related capital proposal. Commenters included members of Congress, other federal agencies, state banking departments, banking organizations,

---

[3] See 65 FR 16460, 16461-62 (March 28, 2000).

securities firms, trade associations for the banking and securities industries, law firms and individuals. Most comments focused on the capital charge proposed in conjunction with the interim rule.

Many commenters also addressed one or more specific parts of the interim rule. Some commenters suggested that the Board and the Secretary should eliminate or significantly modify the interim rule's aggregate investment thresholds, holding period limitations or routine management and operation restrictions and instead rely on the examination and supervisory process to address potential safety and soundness concerns and administer and enforce the GLB Act's provisions that are designed to help maintain the separation of banking and commerce. A number of commenters contended that these provisions would frustrate Congress' desire to permit a "two-way" street between securities firms and banking organizations or place financial holding companies at a disadvantage in competing with nonbank organizations in making merchant banking investments.

Some commenters also contended that the Board and the Secretary lacked the authority to establish aggregate investment thresholds and maximum holding periods for merchant banking investments or to limit the period of time that a financial holding company may routinely manage or operate a portfolio company without Board approval. Several commenters argued that the Board and the Secretary lacked the legal authority to determine that, in every case without exception, certain types of officer and employee interlocks and investor covenants represent routine management of the portfolio company.

Many commenters suggested specific amendments to the interim rule to clarify its application, reduce potential burden or provide financial holding companies additional flexibility in making merchant banking investments. For example, some commenters requested that the Board and the Secretary extend the permissible holding periods for merchant banking investments or streamline the process for seeking approval to hold a merchant banking investment beyond the periods specified in the rule. Some commenters suggested that the agencies expand the types of relationships that a financial holding company may have with a portfolio company without becoming involved in the routine management or operations of the company or expand the circumstances under which a financial holding company may routinely manage or operate a portfolio company. In addition, some commenters requested that the agencies streamline the rule's recordkeeping and reporting requirements, or clarify or streamline application of the rule to private equity funds.

C. <u>Explanation of Final Rule</u>

The Board and the Secretary have carefully reviewed the comments received on the interim rule in light of the language and purposes of the GLB Act and the BHC Act. After this review, the Board and the Secretary have modified the interim rule in a number of respects. In particular, the Board and the Secretary have–

- Expanded the definition of "securities affiliate" to include a registered municipal securities dealer, including a division or department of a bank that is registered as a municipal securities dealer under the Securities Exchange Act of 1934, thereby broadening the eligibility of financial holding companies to make merchant banking investments under the rule;
- Modified the provisions defining actions that represent routine management or operation, clarified the circumstances under which a financial holding company may routinely manage and operate a portfolio company, and extended the period of time that a financial holding company may routinely manage or operate a portfolio company without providing notice to the Board;
- Broadened the definition of private equity funds and created a new section of the rule (section 225.173) that explains how the holding period and management and operations restrictions of the rule apply to private equity funds;

• Adopted an automatic sunset provision for the investment thresholds contained in the interim rule and eliminated the dollar-based threshold for Board review of the merchant banking investment activities of a financial holding company during the period before the sunset;

• Streamlined the recordkeeping and reporting provisions of the rule to reduce burden;

• Clarified the circumstances in which the cross-marketing provisions apply; and

• Adopted three safe harbors to the rebuttable presumptions established under sections 23A and B of the Federal Reserve Act.

These changes as well as the agencies' responses to the comments received are discussed in greater detail below.

As an initial matter, the Board and the Secretary believe that the rule is both within the statutory authority of the agencies and consistent with the language and purposes of the GLB Act and BHC Act. The GLB Act specifically authorizes the Board and the Secretary to issue such regulations implementing section 4(k)(4)(H) as the Board and the Secretary jointly deem appropriate to assure compliance with the purposes and prevent evasions of the BHC Act and the GLB Act and to protect depository institutions.[4] This authority supplements the authority granted the Board by the BHC Act and other federal law

[4] 12 U.S.C. 1843(k)(7)(A); see also 145 Cong. Record at H11529 (daily ed. Nov. 4, 1999) (statement by Chairman Leach) ("Importantly, the Act gives the Federal Reserve and the Treasury the authority to jointly develop implementing regulations on merchant banking activities that they deem appropriate to further the purposes and prevent evasions of the [GLB] Act and the Bank Holding Company Act. Under the authority, the Federal Reserve and Treasury may define relevant terms and impose such limitations as they deem appropriate to ensure that this new authority does not foster conflicts of interest or undermine the safety and soundness of depository institutions or the Act's general prohibitions on the mixing of banking and commerce."); 145 Cong. Record S13788 (daily ed. Nov. 3, 1999) (statement of Sen. Sarbanes).

to supervise bank holding companies and issue regulations and orders, including reporting and record keeping requirements, to administer and carry out the purposes of the BHC Act and prevent evasions thereof.[5]

As discussed in detail below, the rule defines the scope of activities permitted by section 4(k)(4)(H) and implements the provisions of section 4(k)(4)(H) that are designed to limit the potential mixing of banking and commerce. The rule also contains provisions that are designed to protect the safety and soundness of depository institutions, as well as recordkeeping and reporting provisions that the agencies believe are appropriate to monitor compliance with, and prevent evasions of, the BHC Act and the GLB Act.

The Board and the Secretary believe that the rule permits a "two-way" street between securities firms and banking organizations while, at the same time, giving effect to the statutory limitations and framework adopted by Congress to help maintain the separation of banking and commerce and ensure the safety and soundness of depository institutions. Moreover, the Board and the Secretary believe that adoption of a rule, rather than reliance primarily on the supervisory process, is the most appropriate method for ensuring the fair and effective administration of the GLB Act's merchant banking provisions and preventing evasions of those provisions. The rule provides financial holding companies and members of the public with notice of the limitations generally applicable to merchant banking investment activities. The rule also allows the Board to grant exceptions to the general investment thresholds, holding period, and affiliate transaction limits included in the rule if the facts of a particular case demonstrate that the exemption is consistent with the purposes of the GLB and BHC Acts. The Board intends also to continue to rely on the supervisory process to monitor compliance by financial holding companies with the rule and to address any safety and soundness issues that may arise with respect to the merchant banking investments of individual financial holding companies.

[5] See, e.g., 12 U.S.C. 1844; 12 U.S.C. 1818(b)(3).

<u>SECTION 225.170 - What Type of Investments are Permitted by this Subpart, and Under What Conditions may They be made?</u>

Section 4(k)(4)(H) and the rule permit a financial holding company to acquire or control any amount of shares, assets, or ownership interests of any company or other entity that is engaged in an activity not otherwise authorized for the financial holding company under section 4 of the BHC Act. Thus, section 4(k)(4)(H) and the rule permit a financial holding company directly or indirectly to acquire or control the shares, assets, or ownership interests of a company or other entity that is engaged in any activity that is not financial in nature, incidental to a financial activity or otherwise permissible for the financial holding company under section 4 of the BHC Act. Shares, assets and ownership interests acquired or controlled pursuant to section 4(k)(4)(H) and the rule are referred to as "merchant banking investments." A financial holding company may acquire or control merchant banking investments only in accordance with the requirements of the rule.

Section 4(k)(4)(H) and the rule allow a financial holding company to acquire the full range of ownership interests in a company, including securities, warrants, partnership interests, trust certificates, and other instruments representing an ownership interest in a company, whether the interest is voting or nonvoting. A financial holding company also may acquire any instrument convertible into a security or other ownership interest under the rule. In addition, a financial holding company may acquire *any amount* of ownership interests in a company or other entity under the rule, whether or not that amount results in control for purposes of the BHC Act. Thus, this merchant banking authority gives a financial holding company the flexibility to acquire or control a nominal amount, a majority, or all of the shares or other ownership interests of a portfolio company.

<u>Securities Affiliate</u>

The GLB Act grants authority to make merchant banking investments only to a bank holding company that becomes a financial holding company,[6] and either (1) controls or is a "securities affiliate" or (2) controls both an insurance underwriter affiliate and an investment adviser affiliate registered under the Investment Advisers Act of 1940 that provides investment advice to an insurance company. In addition, the financial holding company must provide notice to the Board within 30 days after commencing merchant banking investment activities or acquiring any company that makes merchant banking investments.[7]

The interim rule defined a "securities affiliate" to include any broker or dealer registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). Commenters generally supported the rule's broad definition of "securities affiliate." Some commenters also requested that the definition be expanded to include a separately identifiable division or department of a bank that is registered as a municipal securities dealer under section 15B of the Exchange Act, a small business investment company, or any affiliate predominantly engaged in the purchase, sale or underwriting of securities.

After considering the comments, the Board and the Secretary have amended the definition of securities affiliate to include a registered municipal securities dealer, including a separately identifiable division or department of a bank that is registered as a municipal securities dealer under the Exchange Act. A division or department that is registered with the SEC as a municipal securities dealer performs many of the same functions as a separately incorporated registered securities broker or dealer and would be considered to be a type of securities broker or dealer if the division or department were

---

[6] Subpart I of the Board's Regulation Y sets forth the procedures and qualification criteria applicable to bank holding companies that seek to elect to become a financial holding company. See 12 CFR 225.81 et seq.; 66 FR 400 (Jan. 3, 2001).

[7] See 12 U.S.C. 1843(k)(6)(A); 12 CFR 225.87(a).

incorporated outside the bank. The Board and Secretary also have amended the rule to clarify that a financial holding company may make merchant banking investments if the holding company is itself a registered securities broker or dealer.

The agencies do not believe at this time that an SBIC or a company that purchases securities for investment or other purposes without becoming a registered securities broker or dealer are securities affiliates for purposes of section 4(k)(4)(H). Commenters making these suggestions provided no evidence that Congress intended the term "securities affiliate" to cover companies that do not engage in significant levels of securities activities.

Authority Limited to Making Investments in Companies Engaged in Nonfinancial Activities

As discussed above, the rule authorizes a financial holding company to acquire or control investments in a company or other entity that is engaged in any activity that is not otherwise authorized for the financial holding company under section 4 of the BHC Act. Some commenters asserted that section 4(k)(4)(H) should be construed to permit financial holding companies to make investments in *financial* companies under their merchant banking authority. These commenters suggested that any investment made by a financial holding company for investment purposes, rather than for strategic or operating purposes, should be considered a merchant banking investment regardless of the activities conducted by the acquired company. Other commenters requested that the Board and Secretary clarify that the rule does not apply to investments made by financial holding companies or other banking organizations under legal authorities other than section 4(k)(4)(H).

The language of section 4(k)(4)(H) authorizes a financial holding company to acquire or control a company or entity "engaged in any activity not authorized pursuant to [section 4 of the BHC Act]." Financial holding companies have separate authority under other provisions of the BHC Act to make investments in companies engaged in financial activities. Section 4(k)(4)(H) does not restrict the authority of financial holding companies to acquire or control ownership interests in companies engaged in financial activities. Rather, it authorizes financial holding companies to make investments in companies that would otherwise be prohibited. Together, these sets of authorities allow financial holding companies, without prior approval in most cases, to acquire ownership interests in any type of company other than a depository institution.[8]

The rule does not prohibit a financial holding company from using a combination of authorities to invest through the same subsidiary or fund in ownership interests of both nonfinancial companies and financial companies. In addition, a company held as a merchant banking investment may be engaged in both nonfinancial and financial activities, so long as the investment otherwise complies with the requirements of the rule. Similarly, a financial holding company may retain a merchant banking investment in a nonfinancial company even if the company subsequently commences a financial activity.

Because section 4(k)(4)(H) does not authorize investments in financial companies, the restrictions contained in the rule, such as the restrictions on holding periods and cross-marketing, do not apply to investments by financial holding companies in financial companies that are made under other provisions of the BHC Act and the Board's Regulation Y–whether such investments are made for strategic reasons or for purposes of reselling the investment. A financial holding company may not, however, use the merchant banking authority as a means of evading restrictions, such as consent or approval requirements or restrictions that address conflicts of interest, that govern the acquisition of financial companies under the BHC Act or the Board's Regulation Y.[9]

---

[8]Nothing in section 4(k)(4)(H) or the rule overrides the prior approval requirements of section 3 of the BHC Act that govern the acquisition of shares of a bank or bank holding company or the provisions of section 4(k)(6) and 4(j) of the BHC Act that govern the acquisition of shares of a savings association or a company that controls a savings association.

[9]See, e.g., 12 U.S.C. 1843(*l*)(2); 12 CFR 225.84.

The authority granted by section 4(k)(4)(H) of the BHC Act to financial holding companies to make merchant banking investments also is an alternative to any other authority that a financial holding company may have to make investments in nonfinancial companies under other provisions of the BHC Act. For example, the rule does not address or apply to investments acquired as part of securities underwriting, dealing or market making activities conducted under section 4(k)(4)(E) of the BHC Act, investments made by insurance underwriting subsidiaries of a financial holding company in accordance with section 4(k)(4)(I) of the BHC Act, investments made under section 4(c)(6) or 4(c)(7) of the BHC Act, or investments made overseas under the Board's Regulation K.[10]

Merchant Banking Investments Must be Made as Part of a Bona Fide Underwriting or Merchant or Investment Banking Activity

The GLB Act and the rule provide that a financial holding company may make merchant banking investments only as part of a bona fide underwriting or merchant banking or investment banking activity.[11] When issuing the interim rule, the Board and the Secretary noted that this requirement was intended to distinguish between merchant banking investments that, by their very nature, are made for purposes of resale or other disposition, and investments that are made for purposes of allowing the financial holding company to engage in the nonfinancial activities conducted by the portfolio company. The GLB Act and the rule do not authorize a financial holding company to make an investment in a nonfinancial company for the purpose of engaging in the activities of the nonfinancial company and, in this way, the "bona fide" requirement preserves the financial nature of

[10] Although the rule does not apply to investments held under section 4(c)(6) or 4(c)(7) or the Board's Regulation K, those authorities are only available if the financial holding company's *aggregate* investment in the relevant company under a combination of authorities–including any investment made under the merchant banking authority--is within the applicable investment limitations and restrictions set forth in section 4(c)(6), 4(c)(7) or Regulation K.

[11] 12 U.S.C. § 1843(k)(4)(H).

merchant banking investment activities and helps further the GLB Act's purpose of maintaining the separation of banking and commerce.

As the agencies stated in the Supplementary Information accompanying the interim rule, the Board intends to monitor the merchant banking investment activities of financial holding companies through the supervisory process to ensure that all merchant banking investments are made in compliance with the Act's "bona fide" requirement and that financial holding companies do not use the merchant banking authority as a means of becoming impermissibly involved in nonfinancial activities, such as real estate investment or development. Some commenters expressed concern that the Board and the Secretary intended to discourage or prohibit financial holding companies from making merchant banking investments in companies engaged in real estate investment or development activities.

In considering whether an investment meets the rule's "bona fide" requirement, the Board will consider all the relevant facts and circumstances surrounding the investment, including the financial holding company's documented purpose for making the investment and overall relationship with the portfolio company. The "bona fide" requirement does not prohibit a financial holding company from specializing in making merchant banking investments in particular industries or from making its first merchant banking investment in a company engaged in real estate investment or development, provided such investments are made for investment purposes as part of an ongoing underwriting or investment or merchant banking activity and are otherwise held in accordance with the requirements of the rule.[12]

[12] Concentration in particular industries or in individual investments may present supervisory concerns. The Board expects all financial holding companies that engage in merchant banking investment activities to establish policies governing portfolio diversification and to maintain capital that is adequate in light of the company's investment portfolio. See Federal Reserve SR Letter No. 00-9 (SPE) (June 22, 2000).

Investments may be made directly or through funds

A financial holding company may acquire or control merchant banking investments directly or through any subsidiary other than a depository institution or subsidiary of a depository institution.[13] A financial holding company also may not acquire or control merchant banking investments on behalf of a depository institution or subsidiary of a depository institution. In order to assure competitive equality between U.S. and foreign banking organizations conducting merchant banking activities, the rule provides that a U.S. branch or agency of a foreign bank is considered a "depository institution" for purpose of the rule. Accordingly, a U.S. branch or agency of a foreign bank may not acquire or control merchant banking investments under the rule, and merchant banking investments may not be acquired or controlled on behalf of a U.S. branch or agency of a foreign bank.

As discussed more fully below, the rule allows a financial holding company to make merchant banking investments through a private equity fund or other investment fund that itself makes investments in nonfinancial companies. Where a financial holding company makes an investment in a private equity fund or other fund that in turn makes merchant banking investments, the investment by the holding company in the fund is considered a "merchant banking investment" and must comply with the requirements of the rule. As described further below, the rule provides certain benefits for investments in or held through a qualifying private equity fund, including an extended holding period and certain relief from the rule's cross-marketing restrictions. Investments in funds that do not qualify as private equity funds are treated as any other type of merchant banking investment held under the rule.

Definition of Portfolio Company and Financial Holding Company

[13]A financial subsidiary may make merchant banking investments only if, after five years of the date of enactment of the GLB Act, the Board and the Secretary jointly adopt rules in accordance with section 122 of the GLB Act that permit financial subsidiaries to make merchant banking investments.

Certain of the rule's requirements--such as the restrictions on routine management and operation--apply only with respect to "portfolio companies." The rule defines a "portfolio company" to mean any company or entity that is directly or indirectly held, owned or controlled by a financial holding company using the merchant banking authority and that is engaged in an activity that is not authorized for the financial holding company under section 4 of the BHC Act. (See section 225.177).

As a general matter, a "financial holding company" is defined for purposes of the rule to mean the financial holding company and any direct or indirect subsidiary of the holding company. The term does not include (i) a portfolio company that is controlled by the financial holding company, or (ii) a depository institution controlled by the financial holding company or any subsidiary of such a depository institution. As discussed below, the definition of financial holding company is modified to include depository institutions and certain types of affiliates of the financial holding company for purposes of certain provisions governing routine management.

<u>Requirement that Assets be Acquired by or Transferred to a Portfolio Company</u>

As noted above, the rule permits a financial holding company to acquire any type of ownership interest in a portfolio company. The interim rule also permits a financial holding company to acquire and control "assets" other than debt or equity securities or other ownership interests of a company. These assets may, for example, be real estate or the assets of a division of an operating company. To be permissible under the interim rule, the assets must be acquired through, or promptly transferred to, a portfolio company that has and maintains separate corporate existence, management, and operations to the extent otherwise required by the rule. (<u>See</u> § 225.170(e)(3).) Some commenters asserted that the rule should allow a financial holding company directly to acquire and hold all types of nonfinancial assets.

The final rule retains the requirement of the interim rule that a financial holding company hold any nonfinancial assets acquired as a merchant banking investment through a portfolio company that is separate from the financial holding company. The agencies believe that this requirement is consistent with the language of section 4(k)(4)(H), which allows a financial holding company to acquire only assets "of a company." In addition, this requirement facilitates compliance with the routine management and operation restrictions of the Act by interposing separate management between the financial holding company and any nonfinancial assets acquired, and enhances safety and soundness by providing the benefits of corporate separation.

SECTION 225.171 - What are the Limitations on Managing or Operating a Portfolio Company held as a Merchant Banking Investment?

The GLB Act prohibits a financial holding company from routinely managing or operating a portfolio company except as may be necessary or required to obtain a reasonable return on the resale or disposition of the investment. The interim rule addressed a number of arrangements that would not be considered to represent routinely managing or operating a company and that would, therefore, be permissible at any time as well as arrangements that represent routinely managing or operating a company. In particular, the interim rule provided that a financial holding company would generally not be considered to routinely manage or operate a portfolio company by having one or more representatives on the board of directors of the portfolio company, or by requiring a portfolio company (through written covenants or otherwise) to obtain the financial holding company's approval to take actions outside the ordinary course of business, such as the acquisition of another company; the sale, recapitalization or liquidation of the portfolio company; the issuance of additional capital stock; or making significant changes to the portfolio company's business plan. On the other hand, the interim rule also provided that a financial holding company would be considered to be routinely managing or operating a portfolio company if a director, officer, employee or agent of the financial holding company served as an officer or employee of the portfolio company, or if the financial holding company (through written covenants or otherwise) restricted the ability of the portfolio company to make routine business decisions.

The interim rule permitted a financial holding company to routinely manage or operate a portfolio company when such action was necessary to address a material risk to the value or operation of the portfolio company. In these special situations, a financial holding company was required to obtain the Board's approval if the company routinely managed or operated a portfolio company for more than 6 months.

Commenters supported the agencies' decision to allow financial holding companies to have director interlocks with portfolio companies. Commenters also supported allowing an investing company to participate in decisions by the portfolio company that are outside the ordinary course of business. These commenters viewed these actions as necessary protections for investors that did not involve the investor in the day-to-day management or operations of the portfolio company.

Many commenters, however, also requested that the Board and Secretary expand the types of relationships that a financial holding company may have with a portfolio company without being deemed to be routinely managing or operating the portfolio company. For example, commenters argued that the agencies should permit a financial holding company to have some officer or employee interlocks with a portfolio company on either a permanent or temporary basis. Commenters contended that an interlocking employee or junior officer would not necessarily involve the financial holding company in routinely managing or operating the company or in many cases confer authority on the financial holding company to make management decisions at the portfolio company.

Commenters also requested that the agencies strike the rule's prohibition on "agents" of a financial holding company serving as officers or employees of a portfolio company in light of the potential breadth and ambiguity of the term. In addition, commenters requested that the rule allow a financial holding company to have any type of "negative" covenant or other type of covenant as part of an investment in a portfolio company, and to participate in decisions regarding the hiring or firing of the portfolio company's independent accountant and lower-level officers and employees.

Commenters also asserted that the interim rule improperly limited the circumstances when a financial holding company is permitted to routinely manage or operate a portfolio company and the length of time such involvement may exist. In particular, commenters argued that section 4(k)(4)(H) allows a financial holding company to routinely manage or operate a portfolio company when "necessary or required to obtain a reasonable return on [the] investment upon resale or disposition." Some commenters asserted that this standard would be met if the portfolio company experienced a decline in profitability or the loss of key customers or personnel. Some commenters also asserted that the rule should not place any time limit on a financial holding company's involvement in the routine management or operations of a portfolio company or, alternatively, should allow a financial holding company to routinely manage or operate a portfolio company for a period longer than 6 months without Board approval.

As discussed below, the final rule contains modifications that address these points.

<u>Relationships that Involve Routine Management or Operation</u>

Section 225.171(a) of the rule implements the GLB Act's general prohibition on a financial holding company routinely managing or operating any portfolio company. As explained below, the final rule retains the definition of certain types of relationships as representing routinely managing or operating a portfolio company contained in the interim rule. The rule has been modified in several cases to construct presumptions that certain types of relationships represent routine management or operation, and to allow financial holding companies to have these relationships where they do not result in routine management or operation.

The agencies continue to believe that in all circumstances an executive officer of a company is involved in the day-to-day management or operations of the company and participates in management and operational decisions that occur in the ordinary course of the company's business and, thus, is involved in routinely managing or operating the company. For this reason, the final rule continues to provide that a financial holding company routinely manages or operates a portfolio company if any director, officer or employee of the financial holding company serves as, or has the responsibilities of, an executive officer of the portfolio company. The final rule defines the term "executive officer" in the same manner as the Board's Regulation O. As a general matter, this definition includes any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of the portfolio company, whether or not the officer has an official title, the title designates the officer as an assistant, or the officer serves without salary or other compensation. (See section 225.177(d); 12 CFR 215.2(e)(1).)[14] The agencies believe using this definition, which is familiar to banking organizations, will facilitate compliance with the rule.

The final rule also provides that a financial holding company routinely manages or operates a portfolio company if an executive officer of the parent financial holding company or of certain of its major subsidiaries becomes an officer or employee of the portfolio company. These executive officers are the highest officers of the financial holding company and its major subsidiaries and, by definition, exercise management and operational control over the financial holding company and its subsidiaries. In the context of a situation in which the financial holding company is a direct or indirect investor in a

[14]An "executive officer" does not include a person who may exercise a certain measure of discretion in the performance of their duties, including the discretion to make decisions in the ordinary course of business, but who does not participate in the determination of major policies of the company and whose decisions are limited by policy standards fixed by senior management. In addition, the term does not include any person who is excluded from participating (other than in the capacity of a director) in major policymaking functions of the company by resolution of the board of directors of by the bylaws of the company provided the person does not in fact participate in such policymaking functions.

portfolio company, allowing these executive officers to serve as an officer or employee of the portfolio company would permit the financial holding company to routinely manage or operate the portfolio company.

Finally, the final rule provides that covenants or agreements that restrict the portfolio company's ability to make routine business decisions represent routinely managing or operating the portfolio company. Covenants or agreements affected by this provision include restrictions on the portfolio company entering into transactions in the ordinary course of business or hiring non-executive officers or employees. As explained below, the rule permits covenants and agreements that restrict actions that are outside the ordinary course of business. In response to several comments, the final rule also permits covenants or other arrangements that govern the employment of any or all of the "executive officers" of a portfolio company (rather than just the 5 highest ranking officials of the portfolio company, as in the interim rule).

As noted above, the final rule modifies several other restrictions contained in the interim rule from absolute prohibitions to rebuttable presumptions. In particular, the agencies believe that, in most circumstances, a financial holding company would become involved in the day-to-day management or operations of a portfolio company if a director, officer or employee of the financial holding company serves as a non-executive officer or employee of the portfolio company or if an officer or employee of the portfolio company is supervised by or reports to an officer or employee of the financial holding company. The agencies also recognize, however, that there may be cases where the specific facts demonstrate that such a relationship with the portfolio company would not involve the investing financial holding company in routinely managing or operating the company. Accordingly, the agencies have modified the rule to establish a rebuttable presumption that these relationships represent routine management or operation of a portfolio company. In addition, in response to commenters, the reference in these presumptions to "agents" of the financial holding company has been deleted because the term is ambiguous.

The rule allows a financial holding company to request a determination from the Board that a presumption of routine management or operations is rebutted. (See section 225.171(c).) Any request to rebut a presumption should fully describe all the facts and circumstances related to the financial holding company's investment in, and relationships with, the portfolio company.

Relationships that Do Not Constitute Routine Management or Operation

Section 225.171(d) of the final rule identifies relationships with a portfolio company that would not involve a financial holding company in routinely managing or operating the portfolio company. The list of relationships included in section 225.171(d) is not intended to be a complete list of the types of contacts or relationships that a financial holding company may have with a portfolio company without being deemed to routinely manage or operate the portfolio company. Instead, the list is intended to identify types of relationships that commonly occur with a portfolio company and that would not involve the financial holding company in routinely managing or operating the portfolio company.

1. Director interlocks

The final rule continues to permit a financial holding company to have one or more representatives on the board of directors of a portfolio company. Consistent with the Board's existing interpretations, the selection of the partners (including the general partner) of a partnership is considered to be the equivalent of selecting the directors of a company. A representative of a financial holding company that serves as a director of a portfolio company may participate fully in those matters that are typically presented to directors of a company, whether the director participates in these matters at a meeting of the board, at meetings of committees of the board, through written votes, through meetings with officers or employees of the portfolio company or otherwise.

The financial holding company's director representatives, however, may not participate in the day-to-day operations of the portfolio company or in management decisions that are made in the ordinary course of business and not customarily presented to the directors of a company. In this manner, the rule prevents a financial holding company from using a person that is nominally designated as a director to routinely manage or operate a portfolio company. In order for a financial holding company to have a director interlock and not be deemed to be routinely managing or operating the portfolio company, the portfolio company also must have officers and employees that routinely manage and operate the company, and the financial holding company must not have other arrangements or relationships with the portfolio company that would involve the financial holding company in the routine management or operation of the portfolio company.

2. Covenants Concerning Actions Outside the Ordinary Course of Business

The final rule permits a financial holding company to restrict, by covenant or otherwise, the ability of a portfolio company to take actions outside the ordinary course of business. In response to comments, the final rule contains an expanded list of examples of actions that are outside the ordinary course of business and that may be subject to these types of covenants or agreements. These examples are–

- the acquisition of significant assets or control of another company by the portfolio company or any of its subsidiaries;
- the removal or selection of the portfolio company's independent accountant or investment banker;
- significant changes to the portfolio company's business plan or accounting methods or policies;
- the removal or replacement of any or all of the executive officers of the portfolio company;
- the redemption, authorization or issuance of any equity or debt securities of the portfolio company;
- any borrowing by the portfolio company that is outside the ordinary course of business;

• the amendment of the portfolio company's articles of incorporation or by-laws or similar governing documents; and

• the sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution or sale of substantially all of the assets of the portfolio company or any of its significant subsidiaries.

The examples included in the rule are not exclusive and are intended only to illustrate the types of actions that a financial holding company may restrict, by covenant or otherwise, without becoming involved in the routine management or operations of the portfolio company.

3. Providing advisory and underwriting services to, and consulting with, a portfolio company

The final rule also clarifies that a financial holding company does not routinely manage or operate a portfolio company by providing financial, investment or management consulting advisory services to the portfolio company as otherwise permitted by the Board's Regulation Y.[15] Any management consulting services provided to a portfolio company must remain solely advisory in nature, and the financial holding company may not assume responsibility for decision-making or for the day-to-day management or operations of the portfolio company.[16]

In addition, the final rule clarifies that a financial holding company may underwrite or act as placement agent for the securities of a portfolio company and provide assistance to the portfolio company in connection with the underwriting or placement of its securities without being considered to be involved in routinely managing or operating the company. The rule also clarifies that a financial holding company may have regular or periodic meetings with the officers or employees of a portfolio company to monitor and provide advice regarding the portfolio company's performance or activities so long as the

---

[15] See 12 CFR 225.28(b)(6) and 225.86(b)(1).

[16] See 12 CFR 225.28(b)(9) and 225.86(b)(1).

financial holding company, through such meeting or otherwise, does not routinely manage or operate the portfolio company.

These provisions were added to the final rule to address questions raised by commenters. They are not intended to identify all of the contacts that may be permissible between a financial holding company and a portfolio company.

When May a Financial Holding Company Routinely Manage or Operate a Portfolio Company?

Section 4(k)(4)(H) permits a financial holding company to routinely manage or operate a portfolio company when such action is "necessary or required to obtain a reasonable return on [the] investment upon resale or disposition."[17] The Board and the Secretary have amended the rule to incorporate this statutory standard. The final rule also provides examples of situations where intervention by a financial holding company might be necessary or required to obtain a reasonable return, such as when the portfolio company experiences a significant operating loss or the loss of senior management. The situations listed in the rule as examples are not intended to represent an exclusive list of situations when a financial holding company may permissibly intervene in the routine management or operation of a portfolio company.

The agencies note, however, that once the financial holding company has taken appropriate actions to obtain a reasonable return on the resale or disposition of the investment, the GLB Act requires the financial holding company to cease routinely managing or operating the portfolio company. Accordingly, the rule provides that a financial holding company may routinely manage or operate a portfolio company only for the period of time as may be necessary to address the cause of the holding company's involvement in the routine management or operations of the portfolio company, to obtain suitable management arrangements, to dispose of the investment or to otherwise obtain a reasonable return upon the resale or disposition of the investment.

[17] 12 U.S.C. 1843(k)(4)(H)(iv).

The Board and the Secretary recognize that the determination whether and how long intervention by the financial holding company is necessary or required will depend on the facts and circumstances associated with the particular investment. The final rule includes two requirements to assist the Board in monitoring interventions by financial holding companies in the routine management or operations of portfolio companies to ensure that such actions are consistent with the GLB Act's limitations.

First, the rule requires financial holding companies to maintain and make available to the Board upon request a written record describing the company's involvement in routinely managing or operating a portfolio company (see section 225.171(e)(4)). Second, the rule requires that a financial holding company provide the Board written notice if the company routinely manages or operates a portfolio company for more than 9 months (see section 225.171(e)(3)). This notice procedure substitutes for the prior approval process included in the interim rule. The notice may be in letter form and should identify the portfolio company, the date on which the financial holding company first became involved in the routine management or operations of the portfolio company, the reasons for the involvement, the actions that the financial holding company has taken to address the circumstances giving rise to the intervention, and an estimate of when the financial holding company anticipates ceasing routinely managing or operating the portfolio company. These records and notice will permit the Board to monitor the company's involvement in routinely managing or operating a portfolio company to assure that such actions remain consistent with the GLB Act and the rule.

Depository Institutions Prohibited from Managing or Operating Portfolio Companies

The final rule provides that a depository institution and a subsidiary of a depository institution may not routinely manage or operate a portfolio company held by a financial holding company under the rule. Depository institutions and their subsidiaries are not authorized to make merchant banking investments or to routinely manage or operate portfolio companies acquired by an affiliated financial holding company. The rule is not intended to prevent a depository institution from having covenants or from taking actions pursuant to covenants that are typically found in credit agreements to ensure repayment of extensions of credit in the ordinary course of business where the covenant or action is not an attempt to evade the restrictions of this subpart. To ensure competitive equality, this limitation would also apply to U.S. branches and agencies of foreign banks.

The rule does not prohibit a director, officer or employee of a depository institution (or subsidiary of a depository institution) or U.S. branch or agency from serving as a director of a portfolio company to the same extent as would be permitted for a director, officer or employee of a financial holding company or to take other actions that the rule does not define to be routine management or operation. In order to clarify these points, the rule includes a depository institution and its subsidiaries in the definition of financial holding company for purposes of the provisions defining routine management and operation. In addition, the rule does not apply the prohibition on routinely managing or operating a portfolio company to a financial subsidiary held in accordance with section 5136A of the Revised Statutes or section 46 of the Federal Deposit Insurance Act, or to a subsidiary that is a small business investment company held in accordance with the Small Business Investment Act of 1958, so long as the subsidiary exercises routine management or operation in accordance with the limitations that apply to financial holding companies under this subpart. As noted above, an affiliated depository institution may not, however, routinely manage or operate a portfolio company under section 225.171(e).

<u>SECTION 225.172 - What are the Holding Periods permitted for Merchant Banking Investments?</u>

The GLB Act requires that shares, assets, and ownership interests be held only for a period of time that enables the sale or disposition of the interest on a reasonable basis consistent with the financial viability of the financial holding company’s merchant banking activities. The interim rule included this statutory limitation and implemented it by establishing holding periods governing the retention of merchant banking investments by financial holding companies. Financial holding companies could hold merchant banking investments beyond the periods established by the rule only with the approval of the Board.

Permissible holding periods for merchant banking investments

The interim rule generally permitted financial holding companies to hold any merchant banking investment for a period of up to 10 years. In addition, the rule allowed financial holding companies to hold an interest in a private equity fund for the life of the fund, up to 15 years. Financial holding companies could hold any merchant banking investment for a longer period with the Board's approval.

The holding periods included in the rule reflect information collected by Federal Reserve and Treasury staff from a number of securities firms that currently make merchant banking investments and from several bank holding companies that have relatively large portfolios of similar equity investments that were made under legal authorities that pre-date the GLB Act. In developing these holding periods, the Board and the Secretary also considered the System's experience in supervising the equity investment activities of bank holding companies under these pre-existing authorities.

These data indicate that merchant banking and similar investments typically are held only for relatively short periods of time. Although the holding period for individual investments vary, these data indicate that the average holding period for investments under current market conditions is approximately 5 years, with a shorter average holding period for investments held through private equity funds and other pooled investment vehicles. These data also indicate that investments are only rarely held for a period in excess of 10 years.

Several commenters, including banking organizations active in equity investment activities and a securities trade association, concurred that the holding periods established by the interim rule generally are consistent with industry practice and that merchant banking investments are only occasionally held beyond the periods permitted by the rule. Another banking trade association also fully supported the holding periods included in the interim rule, noting that the periods were consistent with Congress' intent to maintain the separation between banking and commerce.

A number of commenters, on the other hand, asserted that Congress intended to leave the decision of when to sell a merchant banking investment to the discretion of the financial holding company. These commenters argued that establishing a regulatory holding period for merchant banking investments would place financial holding companies at a competitive disadvantage or require financial holding companies to dispose of investments prematurely. Some commenters recommended that the agencies eliminate or delay adoption of any fixed holding periods and rely on the supervisory process to enforce the limitations in the GLB Act restricting the period of time that merchant banking investments may be held. In addition, several commenters suggested that the agencies allow all merchant banking investments to be held for up to 15 years without approval, or establish a regulatory holding period that is based on the average holding period of the merchant banking investment portfolio of the financial holding company.

After carefully considering the comments in light of the language and purposes of the GLB Act and BHC Act, the agencies have retained the holding period provisions of the interim rule with several modifications discussed below. Under the final rule, a financial holding company, without any prior approval, may own or control a merchant banking investment for up to 10 years, and may own or control an investment in or held through a private equity fund for the duration of the fund, up to 15 years. The agencies have not amended the rule to use the average duration of a financial holding company's merchant banking portfolio as the criteria for measuring compliance with the rule's holding periods. Because merchant banking investments typically are held for only short periods of time, adopting an average duration approach could allow a financial holding company to retain individual merchant banking investments for an extended and virtually indefinite period of time in conflict with the purposes of the GLB and BHC Acts.

The agencies believe that the holding periods in the rule are appropriate to implement the limitation in section 4(k)(4)(H) that allows financial holding companies to own or control a merchant banking investment only for "a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability" of the financial holding company's merchant banking investment activities, and are consistent with the purpose of the GLB Act and BHC Act to maintain the separation between banking and commerce.

Nevertheless, the Board and the Secretary recognize that there may be circumstances where retention of a merchant banking investment beyond the periods established by the rule would be appropriate and consistent with the limitations in, and purposes of, the GLB and BHC Acts. Accordingly, the rule continues to allow a financial holding company to retain any merchant banking investment beyond the periods set forth in the rule with the Board's approval. This process provides financial holding companies with the flexibility to retain merchant banking investments beyond the holding periods in the rule where the financial holding company can demonstrate that such retention is necessary to enable the sale or other disposition of the investment on a reasonable basis and is otherwise consistent with the GLB and BHC Acts.

The rule lists the factors that the Board will consider in reviewing a request for an extension of the applicable holding period. These factors include the cost to the financial holding company of disposing of the investment within the applicable time period; the total exposure of the financial holding company to the portfolio company and the risks that disposing of the investment without an extension may pose to the financial holding company; market conditions; the nature of the portfolio company's business; the extent and history of the financial holding company's involvement in the management and operations of the portfolio company; and the average holding period of the financial holding company's merchant banking investments. The Board may also consider any other relevant information related to the investment.

In response to comments, the agencies also have streamlined the process for obtaining the Board's approval to retain a merchant banking investment beyond the applicable holding period. The final rule provides that an extension request must be filed at least 90 days (rather than 1 year, as in the interim rule) prior to the expiration of the holding period. Any request for an extension must provide the reasons for the request (including information that addresses the factors discussed above) and explain the financial holding company's plan for divesting the investment. A financial holding company may request confidential treatment of any information included in a request in accordance with the Freedom of Information Act (5 U.S.C. 552 et seq.) and the Board's Rules Regarding the Availability of Information (12 CFR Part 261).

The final rule provides that, in connection with granting any extension, the Board may impose restrictions that the Board determines to be appropriate in the circumstances. The agencies have eliminated all but one of the restrictions that will be applied by rule in all cases to investments held beyond the applicable holding period. In particular, the final rule retains an automatic capital charge for investments that are held for an extended period. The capital charge must be set by the Board at a rate that is above the highest marginal capital charge that would apply to investments made by that financial holding company under the final capital rules governing merchant banking investments, and may not be below 25 percent of the adjusted carrying value of the investment as reflected on the balance sheet of the financial holding company.

The final rule does not include the provisions from the interim rule prohibiting a financial holding company from entering into any additional transactions with any company held beyond the applicable holding period, including making additional extensions of credit to the company or acquiring additional shares of the company. Removal of these restrictions from the rule recognizes that, in individual circumstances, the acquisition of additional shares of a portfolio company or the addition of certain relationships or transactions (such as participation in underwriting the company's initial public offering) may facilitate the prompt sale of the portfolio company. The Board, in connection with granting a request to hold an investment beyond the applicable holding period, may determine to impose these or other restrictions if such restrictions are appropriate in the individual case.

Tacking rules

A few commenters recommended that the agencies eliminate the special holding period "tacking" provisions included in section 225.172(b)(2) and (3) of the interim rule. These commenters asserted that the tacking provisions, which are designed to prevent evasions of the rule's holding periods, might prevent a financial holding company from receiving securities as part of the liquidation of an investment fund. Commenters also argued that the agencies should rely on the supervisory process to uncover evasions of the holding periods.

The final rule retains the tacking provisions included in the interim rule. The Board and the Secretary believe these provisions are appropriate to prevent a financial holding company from evading the holding periods applicable to merchant banking and certain other types of investments under the banking laws.[18] In particular, these provisions prevent a financial holding company from attempting to circumvent the holding periods on merchant banking investments by transferring a merchant banking investment from one company or fund to another. The rule also provides that, for purposes of calculating compliance with the merchant banking holding periods, an investment acquired by the financial holding company under another authority that imposes a restriction on the amount of time that the financial holding company may hold the investment is considered to have been acquired on the original acquisition date.

[18]See, e.g., 12 U.S.C. 1843(c)(2) (maximum 10-year holding period for shares or assets acquired in satisfaction of a debt previously contracted).

SECTION 225.173–How are Investments in Private Equity Funds Treated Under this Subpart?

Securities firms typically make a significant percentage of their merchant banking investments through funds that are limited partnerships or other investment vehicles that pool the firm's capital with capital provided by third-party investors. These investors typically are institutional investors, such as other investment companies, pension funds, endowments, financial institutions or corporations, and sophisticated individual investors with high net worth. In most instances, the securities firm is the sponsor or adviser to the fund and has a general partnership or similar interest in the fund. Securities firms also make non-controlling investments in funds that are sponsored and advised by unaffiliated companies.

These pooled investment vehicles frequently have characteristics, such as limited terms, manager compensation arrangements, and the presence of third-party investors that monitor investments, that encourage the fund to dispose of its investments in a relatively short period of time. In light of these factors, the interim rule contained a number of features designed to accommodate merchant banking investment activities conducted through a qualifying "private equity fund." These features included a longer holding period designed to reflect the industry practice with private equity funds, a higher aggregate investment threshold for review of an organization that makes investments in or through private equity funds, and streamlined reporting and recordkeeping provisions for investments in, or held through, private equity funds.

Commenters generally supported the decision to provide regulatory benefits to merchant banking investments that are made in or through private equity funds. A number of commenters argued that private equity funds should be completely exempted from all or some of the rule's requirements, including the rule's provisions related to holding periods, routinely managing or operating portfolio companies, cross-marketing activities and recordkeeping and reporting requirements. Other commenters urged the agencies to clarify or reduce the requirements applicable to private equity funds that are not controlled by a financial holding company.

Commenters also requested modification of the interim rule's definition of a "private equity fund" in several respects. For example, a number of commenters asserted that a private equity fund should be permitted to have a term of more than 15 years or have fewer than 10 investors that are not affiliated with the financial holding company. A few commenters stated that the agencies should permit a financial holding company to own or control more than 25 percent of the total equity of a fund without losing the benefits that accrue to a private equity fund. Some commenters urged elimination of the requirement that a private equity fund maintain policies on diversification.

In light of the comments, the agencies have retained the special treatment for investments made in or through private equity funds. The final rule contains a number of modifications to the definition of "private equity fund" to address matters raised by commenters. In addition, the final rule has been reorganized to add a new section 225.173 that includes the definition of a "private equity fund" and describes how the rule's holding periods and routine management and operation restrictions apply to private equity funds. The agencies believe these changes make it easier for users to understand how the rule applies to private equity funds.

Definition of Private Equity Fund

The agencies have modified and expanded the definition of a "private equity fund" in the final rule in response to public comments. The agencies believe the definition included in the final rule is consistent with prevalent industry practice and ensures that a private equity fund retains the characteristics that encourage it to be operated in a manner consistent with the requirements of the GLB Act.

Under the final rule, a private equity fund qualifies for the special provisions of the rule if the fund has a fixed duration of not more than 15 years including all potential extensions, and the financial holding company (including its officers, directors, employees and principal shareholders) does not own more than 25 percent of the total equity of the fund. The rule does not impose any limits on advisory fees or on the various types of incentive compensation that the financial holding company may receive for services rendered to the fund provided that such fees do not increase the financial holding company's equity stake in the fund above the rule's 25 percent threshold.

The final rule eliminates the requirement that the fund have a specific number of outside investors, the requirement that the fund establish a plan for the resale of each of its investments and the requirement that the fund maintain diversification policies. The agencies believe that the purposes of these restrictions are served by the limitations noted above on the amount of the fund that may be owned or controlled by the financial holding company and by the remaining provisions. These provisions require that the fund not be an operating company, engage exclusively in the business of investing in financial and nonfinancial companies for resale or other disposition, and not be established or operated for the purpose of making investments that are inconsistent with section 4(k)(4)(H) of the BHC Act or evading the limitations on merchant banking activities contained in the GLB Act or the rule. As described below, the fund must have policies and systems for monitoring and addressing the various risks associated with merchant banking activities.

The final rule retains the provisions of the interim rule that allow a private equity fund to be organized in any form, including as a partnership, corporation or limited liability company. In addition, the fund may, but need not be, registered as an investment company under the Federal securities laws.

<u>Permissible Holding Period for Private Equity Fund Investments</u>

The final rule permits a financial holding company, without Board approval, to own or control an investment in a private equity fund that makes merchant banking investments for the duration of the fund, which may be up to 15 years. The rule contemplates that a qualifying private equity fund may hold investments in portfolio companies for the duration of the fund. Accordingly, a private equity fund that conducts merchant banking investment activities in accordance with the rule is not required to dispose of its investments within the 10 year period applicable to other types of merchant banking investments.

A financial holding company may seek the Board's approval to retain an investment in a qualifying private equity fund or to extend the duration of a private equity fund for a period longer than 15 years in special circumstances.[19] Any request must be filed at least 90 days prior to the expiration of the holding period and include the information described in section 225.172(b)(4) of the rule. If the Board grants the extension request, the financial holding company must apply the capital charge described in section 225.172(b)(6) of the rule to the financial holding company's investment in the fund and must comply with any other restrictions imposed by the Board.

Application of Routine Management and Operation Restrictions to Private Equity Funds

The GLB Act and the rule prohibit a financial holding company in most circumstances from routinely managing or operating any portfolio company--that is, any company engaged in nonfinancial activities. (See sections 225.177(c) and 225.171(a)). The final rule also provides that a financial holding company may not routinely manage or operate a portfolio company that is owned or controlled by a private equity fund in which the financial holding company owns or controls any ownership interest, except in the limited circumstances permitted by section 225.171(e) of the rule. The rule does not prohibit a financial holding company from routinely managing or operating a private equity fund.

Some commenters urged the agencies not to limit the ability of a private equity fund to routinely manage or operate a portfolio company under any circumstances. The final rule has been modified in two respects in response to the comments on this

---

[19] The holding period tacking rules set forth in section 225.172(b)(2) and (3) and described above must be applied in determining whether a private equity fund investment has been held longer than the period permitted by the rule.

matter. First, the final rule applies the restriction on routine management or operation of portfolio companies only to private equity funds that are controlled by a financial holding company and to the financial holding company. Second, the final rule permits a financial holding company to invest in a private equity fund that routinely manages a portfolio company so long as the financial holding company does not control the private equity fund and the financial holding company does not routinely manage or operate the portfolio company, except as permitted in the special circumstances explained above in section 225.171(e).

These changes are based on the view that a financial holding company is considered to be acting through any fund that it controls. On the other hand, in cases in which the financial holding company does not control the private equity fund, the actions of the private equity fund should not be attributed to the financial holding company. These changes are also consistent with other provisions of the BHC Act, which provide that a financial holding company would generally not be considered indirectly to control a company that is owned by an intermediate company unless the financial holding company controls the intermediate company.[20]

In the case of a private equity fund that is controlled by a financial holding company, the agencies do not believe that it is consistent with the terms or purposes of section 4(k)(4)(H) or the BHC Act to allow the private equity fund to routinely manage or operate portfolio companies. Section 4(k)(4)(H) prohibits a financial holding company from routinely managing or operating a portfolio company. This prohibition applies whether the financial holding company acts directly or acts indirectly, including through a company, such as a private equity fund, that is controlled by the financial holding company. The agencies also believe that allowing a fund that is controlled by a financial holding company to routinely manage a portfolio company would remove the separation between

---

[20] See 12 U.S.C. 1841(g)(1).

banking and commerce that the restriction on routine management was intended to preserve.

Accordingly, the rule continues to apply the routine management restrictions to any private equity fund controlled by a financial holding company. The final rule defines situations in which a financial holding company is considered to control a private equity fund. This definition is based on the provisions of the BHC Act and takes account of the special relationship that advisers have to investment funds.

Under the final rule, a financial holding company is considered to control a private equity fund if the financial holding company, including any director, officer, employee or principal shareholder of the company, (1) serves as a general partner, managing member or trustee of the private equity fund; (2) owns or controls in the aggregate 25 percent or more of any class of voting shares or similar interests in the fund; or (3) selects, controls or constitutes a majority of the directors, trustees or management of the fund. Interviews with securities firms and banking organizations that advise and operate private equity funds, as well as the Board's experience in supervising the pooled investment vehicles advised and operated by banking organizations under pre-existing authorities, indicate that the adviser of a fund typically establishes the policies that govern the fund's investments and operations, makes investment and disposition decisions on behalf of the fund, and otherwise controls the fund and its operations. In light of this information and experience, the rule also provides that a financial holding company is deemed to control a private equity fund for purposes of the rule if the company owns more than 5 percent of any class of voting shares or similar ownership interests in the fund and serves as the fund's investment adviser.

<u>Other Matters Related to Private Equity Funds</u>

Commenters requested guidance regarding how the other provisions of the rule would apply to investments in private equity funds that are not controlled by a financial holding company. As explained above, in circumstances where a financial holding company has a passive (i.e., noncontrolling) investment in a private equity fund that is advised and controlled by an unaffiliated entity, any shares owned by the fund generally are not considered to be owned or controlled by the passive financial holding company investor.[21] Accordingly, the final rule clarifies that the restrictions on cross-marketing the products or services of a portfolio company, the limitations of sections 23A and 23B of the Federal Reserve Act, and the reporting and recordkeeping requirements of the rule, do not apply with respect to investments in portfolio companies that are held by a private equity fund in which the financial holding company holds a noncontrolling interest. These restrictions and requirements (other than the cross-marketing restrictions) would, however, apply to the financial holding company's investment in the private equity fund and govern the relationship of the financial holding company with the private equity fund.

Funds that are not Qualifying Private Equity Funds

Although the rule permits certain advantages to funds that meet the rule's definition of a private equity fund, the rule also permits financial holding companies to invest in and control a fund that does not meet the rule's definition of a private equity fund. If the financial holding company controls the non-qualifying fund, then the provisions of the rule, including the provisions governing the holding periods for portfolio companies, the routine management restrictions, the risk-management and recordkeeping requirements, the cross-marketing provisions, and the section 23A provisions, apply to investments made by the non-qualifying fund in the same manner as those provisions would apply if the investment in the portfolio company were held directly by the financial holding company. If the financial holding company owns a noncontrolling interest in the fund, then the fund is itself considered to be a portfolio company and provisions of the rule apply to that investment in the same way as they apply to any other investment in a portfolio company.

[21] See 12 U.S.C. 1841(g)(1); 12 CFR 225.2(e)(2)(i).

Thus, under the rule, a financial holding company may own more than 25 percent of the equity of a fund that has an unlimited life (and, consequently is not a qualifying private equity fund), so long as the fund does not hold investments in portfolio companies for more than the 10-year holding period that would apply if the financial holding company held the investment in the portfolio company directly and the fund complies with the routine management and other restrictions in the rule. Similarly, a financial holding company may invest in a fund that, in addition to making merchant banking investments, engages in other businesses(and, consequently is not a qualifying private equity fund), so long as the financial holding company does not control the fund, divests its interest in the fund within the 10-year holding period, and complies with the other provisions of the rule that apply to other investments in a portfolio company.

This approach allows financial holding companies flexibility to conduct merchant banking investment activities in a variety of ways that are consistent with the restrictions and purposes of the BHC Act and the GLB Act. At the same time, the preferences in the rule for qualifying private equity funds recognize that funds meeting those definitions more regularly include structural incentives and features that reinforce the requirements and purposes of those Acts, and present fewer opportunities to evade those requirements.

<u>SECTION 225.174 - What Aggregate Thresholds Apply to Merchant Banking Investments?</u>

The interim rule required that a financial holding company receive the Board’s prior approval to make additional merchant banking investments if the carrying value of the company’s existing merchant banking investments exceeded either of two supervisory thresholds. These thresholds were designed to allow the Board to monitor the policies and risk management practices of a financial holding company that devotes significant resources to merchant banking activities. The Board and the Secretary also indicated that the supervisory limits included in the interim rule were transitional in nature, and would be reviewed once rules governing the regulatory capital treatment of merchant banking investments were in place and the agencies and industry gained experience with managing and supervising investments under the new merchant banking authority.

Under the interim rule, a financial holding company met the first threshold if the aggregate carrying value of all of its merchant banking investments exceeded the lesser of 30 percent of the company's Tier 1 capital or $6 billion. A financial holding company met the second threshold if the aggregate carrying value of its merchant banking investments–excluding interests in private equity funds–exceeded the lesser of 20 percent of the company's Tier 1 capital or $4 billion. These thresholds apply only to merchant banking investments made under section 4(k)(4)(H) and the rule, and do not apply to investments that are held under other authorities, such as investments made through SBICs under the Small Business Investment Act, in less than 5 percent of the voting shares of a company under section 4(c)(6) or 4(c)(7) of the BHC Act, or in companies overseas under Regulation K.

Numerous commenters argued that these supervisory thresholds were unnecessary. Some commenters contended that the Board and the Secretary lacked the legal authority to impose the thresholds, or that the thresholds adopted were arbitrary and not supported by sufficient evidence. Commenters also asserted that the thresholds–and particularly the dollar-based thresholds–would have an unfair impact on larger organizations that have significant investment portfolios and organizations whose investment portfolios have experienced significant increases in value. Some commenters also contended that the thresholds would place financial holding companies at a competitive disadvantage to other firms making merchant banking investments or would discourage securities firms from seeking to become a financial holding company.

Commenters also offered a number of suggested revisions to the thresholds if they were retained. For example, commenters suggested that the agencies should remove the dollar-based thresholds from the rule; exempt organizations with significant investment experience from the review provisions; provide higher thresholds for organizations with diversified portfolios; base the thresholds on the historical cost (rather than the carrying value) of merchant banking investments; or establish a definitive sunset date for the review process.

The Board and the Secretary believe that the risk to a financial holding company and its depository institution subsidiaries from merchant banking investments increases as the level of equity investments increases as a percentage of the financial holding company's capital. This is particularly true if the financial holding company has not established appropriate risk management policies, procedures, and controls (including capital reserves) to manage and control the significant potential risks that arise from having a substantial portion of the company's capital exposed to fluctuations in equity prices.

The Board and the Secretary also believe that the financial risks from merchant banking activities are best addressed by appropriate capital levels and by strong risk management policies and practices. The agencies note that the Federal banking agencies are working towards a new minimum regulatory capital proposal for equity investment activities.

While the appropriate regulatory capital standards are being developed and companies and the agencies are gaining experience in developing and implementing appropriate risk management practices and policies, the Board and the Secretary continue to believe that it is appropriate to monitor and review the practices of financial holding companies that commit a significant portion of their capital to new merchant banking investments. For these reasons, the agencies have retained the process for reviewing the policies and practices governing merchant banking activities of a financial holding company. However, the final rule specifically provides that this provision will remain in effect only until a final rule addressing the appropriate regulatory capital treatment of merchant banking and other equity investment activities is adopted and becomes effective.

The agencies have modified in two respects the review thresholds contained in the interim rule. First, the final rule eliminates the absolute dollar thresholds contained in the interim rule. Second, the final rule has been modified to clarify that the rule's review thresholds apply to the investment made by a financial holding company in a private equity fund, but do not apply to the fund itself or to investments in the fund made by unaffiliated third parties. The thresholds also do not restrict the ability of a financial holding company to make additional investments in a fiduciary capacity on behalf of its trust customers.

The Board and the Secretary believe that the agencies have the authority under the GLB Act, BHC Act and other federal banking laws to adopt supervisory thresholds governing merchant banking investments. The agencies also believe that the thresholds and review process included in the interim rule and the final rule are consistent with the purposes of the GLB Act, BHC Act and other Federal banking laws and are appropriate to protect depository institutions that are affiliated with financial holding companies engaged in merchant banking investment activities

SECTION 225.175 - What Risk Management, Record Keeping and Reporting Policies are Required to Make Merchant Banking Investments?

The interim rule required a financial holding company to adopt policies, procedures and systems reasonably designed to manage the risks associated with making merchant banking investments and to monitor compliance with the statutory and regulatory provisions governing such investments. These policies, procedures and systems must be reasonably designed to, among other things, allow the financial holding company to monitor and adequately assess the value of the company's merchant banking investments (both individually and in the aggregate) and the diversification of the company's merchant banking investment portfolio; identify and manage the market, liquidity, credit and other risks associated with merchant banking investments; and monitor the terms, amounts and types of transactions between the financial holding company and each company acquired under the rule. The interim rule also required a financial holding company to maintain at a central location certain types of records and supporting information related to its merchant banking investment activities, including records that detailed the cost, carrying value, market value, and performance of each merchant banking investment.

Several commenters acknowledged that companies engaged in making merchant banking investments should maintain strong internal controls and recordkeeping policies. A number of commenters also asked that the Board and Secretary streamline the risk management, recordkeeping or reporting requirements in the interim rule. For example, some commenters asserted that the agencies should eliminate the requirement that a financial holding company maintain its merchant banking records at a central location. Commenters also urged that a financial holding company be required to monitor its relationships with a portfolio company only where it has a substantial interest in the portfolio company. Several commenters requested that the rule clarify the way the recordkeeping requirements would apply to private equity funds that are not controlled by a financial holding company.

The Board recently issued supervisory guidance that describes in detail the internal controls and risk management policies, procedures and systems that the Federal Reserve expects bank holding companies engaged in equity investment activities to have and maintain to conduct equity investment activities in a safe and sound manner.[22] The SR Letter provides, among other things, that a financial holding company engaged in merchant banking activities should establish appropriate policies, procedures and systems to manage all elements of the investment decision-making and risk management process. These policies, procedures and systems include limits on the types and amounts of merchant banking investments that may be made; parameters governing portfolio diversification;

---

[22] See Federal Reserve SR Letter No. 00-9 (SPE) (June 22, 2000) ("SR Letter"). The SR Letter applies to financial holding companies engaged in making merchant banking investments under section 4(k)(4)(H) and the rule, as well as all bank holding companies that make equity investments in nonfinancial companies through SBICs or under section 4(c)(6) or 4(c)(7) of the BHC Act.

sound policies governing the valuation and accounting of investments; periodic audits of compliance with established limits and policies; and policies designed to ensure that all investments in, and relationships with, portfolio companies comply with applicable law.

The SR Letter also requires a financial holding company to monitor its lending and other business relationships with a company held under the merchant banking authority to ensure that the financial holding company's aggregate exposure to the company is reasonably limited and that all transactions are on reasonable terms. In addition, the SR Letter requires a financial holding company to maintain records that appropriately document these policies, procedures and systems and make such records available to examiners.

For these reasons, the Board and the Secretary have streamlined section 225.175 of the rule to identify the major areas that must be addressed by the internal policies and controls of a financial holding company engaged in making merchant banking investments. In particular, the final rule requires a financial holding company that makes merchant banking investments to establish and maintain policies, procedures, records and systems reasonably designed to conduct, monitor and manage investment activities and the associated risks in a safe and sound manner. These policies, procedures, records and systems must be reasonably designed to–

- Monitor and assess the carrying value, market value and performance of each merchant banking investment and the company's aggregate merchant banking investment portfolio;
- Identify and manage the market, credit, concentration and other risks associated with merchant banking investments;
- Identify, monitor and assess the terms, amounts and risks arising from transactions and relationships (including contingent fees or contingent interests) with each company in which the financial holding company holds an interest under the rule;

• Ensure the maintenance of corporate separateness between the financial holding company and each company in which the financial holding company holds an interest under the rule and protect the financial holding company and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of any such company; and

• Ensure compliance with the rule, including the rule's holding period, routine management and operation, and cross-marketing restrictions, and any other applicable provisions of law governing transactions and relationships with companies in which the financial holding company holds an interest under the rule, such as fiduciary principles and sections 23A and 23B of the Federal Reserve Act.

The list of policies, procedures, records and systems included in the rule is intended to identify only some of the most important elements of a sound approach to monitoring merchant banking investment activities. The SR Letter covers these elements and identifies other elements that a financial holding company should have in place to conduct merchant banking investment activities in a safe and sound manner–such as adequate regulatory capital and appropriate policies governing the public disclosure of the company's merchant banking investments. Additional elements may be needed to address the particular approach that a financial holding company takes to making merchant banking investments.

If the financial holding company controls a private equity fund or other fund that makes merchant banking investments, the financial holding company must ensure that the fund has the types of policies, procedures and systems described in the rule for making and monitoring the fund's merchant banking investments. Alternatively, the financial holding company may ensure that the private equity fund or other fund is subject to the financial holding company's merchant banking policies, procedures and systems. These requirements do not apply if the financial holding company does not control the fund. Nevertheless, a financial holding company must apply its merchant banking policies, procedures and systems to any investment made by the company in any fund that is controlled by an unaffiliated entity.

The Board and the Secretary expect that financial holding companies will be able to satisfy the rule's recordkeeping requirements by using internal reports and records that are prepared in the ordinary course of making a merchant banking investment or controlling a private equity fund. Similarly, where a financial holding company makes a noncontrolling investment in a private equity fund, it is anticipated that the financial holding company would be able to use information provided by the fund's adviser or sponsor to satisfy the rule's recordkeeping requirements.

The final rule does not require a financial holding company to maintain the records described in the rule at a central location. Instead, a financial holding company must be able to identify and promptly make the records--wherever located--available to the Federal Reserve upon request.

In light of the potential risks associated with making merchant banking investments and the importance of having in place appropriate policies and systems to monitor and manage such investment activities, the Federal Reserve generally will conduct a review of the investment and risk management policies, procedures and systems of a financial holding company that makes merchant banking investments within a short period after the holding company commences the activity. This review may be conducted either off-site or on-site depending on the expected level and complexity of the financial holding company's merchant banking investments and the company's previous experience in making equity investments under other legal authorities. This review may be deferred until the next regularly scheduled inspection or examination if the financial holding company has significant experience in making equity investments under pre-existing authorities and the Federal Reserve has recently reviewed the company's policies, procedures and systems for managing and controlling the risks associated with equity investment activities.

Quarterly and annual reporting requirements

The interim rule established annual and quarterly reporting requirements for merchant banking investments. The interim rule required financial holding companies to annually provide information concerning any merchant banking investment held longer than five years (or eight years in the case of investments in or held through a private equity fund) and aggregate data on the cost, value, diversification and holding periods of the company's merchant banking investments. The interim rule also required financial holding companies to provide certain other aggregate data on merchant banking investments on a quarterly basis. The Board noted that it anticipated developing forms that could be used to comply with these annual and quarterly reporting requirements.

Some commenters asserted that requiring a financial holding company to provide aggregate merchant banking data on a quarterly basis would be too burdensome and, because of the short reporting period, might not reflect any meaningful changes or trends in the company's merchant banking portfolio. Other commenters argued that the annual report should not require a financial holding company to develop or disclose its plans for divesting any merchant banking investment held longer than 8 years.

The Board and the Secretary continue to believe that it is important to receive at least annually information (including anticipated exit strategies) concerning merchant banking investments that have been held for a significant period of time and to receive at least quarterly aggregate cost and valuation data on a financial holding company's merchant banking investments. This information is necessary and appropriate to allow the Board to monitor a financial holding company's compliance with the holding periods established by the GLB Act and the rule and to monitor the potential impact of merchant banking investments on depository institution subsidiaries of a financial holding company.

The Board anticipates publishing forms in the near future that may be used by financial holding companies to fulfill these annual and quarterly reporting requirements. Accordingly, the agencies have modified the rule to require a financial holding company to submit these reports to the appropriate Federal Reserve Bank on such forms, and at such times, as the may be determined by the Board. The Board will consider the public comments received on the annual and quarterly reporting requirements in connection with issuing these forms.

Notice of acquisitions

Section 4(k)(6) of the BHC Act requires a financial holding company to provide written notice to the Board within 30 days after acquiring any company under any authority granted in section 4(k), which is the section that authorizes merchant banking investments. The interim rule provided that a financial holding company is not required to provide the Board with notice under section 4(k)(6) of any merchant banking investment if the financial holding company has previously notified the Board under section 4(k)(6) that it has commenced merchant banking investment activities generally. The rule required, however, that a financial holding company file a post-transaction notice with the Board within 30 days of making a merchant banking investment if (1) the investment represents more than 5 percent of the voting shares, assets or ownership interests of the company and (2) the total cost of the investment to the financial holding company exceeds the lesser of 5 percent of the Tier 1 capital of the financial holding company or $200 million.

The final rule retains these post-transaction notice procedures. In these circumstances, the Board believes supervisory notice of the acquisition is appropriate to allow the Board to monitor the impact of the investment on the financial holding company and any future impact the large exposure to a single company may have on the financial resources of the financial holding company. The procedures included in the rule parallel those contained in section 225.87 of the Board's Regulation Y and are included here solely for the convenience of users. The Board separately has considered the comments submitted on these notice requirements in connection with its adoption of section 225.87.[23]

[23] See 66 FR 400 (Jan. 3, 2001).

The Board, in separate rulemakings, has adopted forms to be used by financial holding companies in providing the Board with notice of a merchant banking or other transaction under section 4(k)(6).[24] Accordingly, the agencies have amended the final rule to require that any notice of a large merchant banking investment be provided on the appropriate form.[25]

SECTION 225.176 - How do the Statutory Cross-Marketing and Sections 23A and B Limitations Apply to Merchant Banking Investments?

Cross-Marketing Restrictions

The GLB Act prohibits any depository institution controlled by a financial holding company from marketing or offering, directly or through any arrangement, any product or service of a company held under section 4(k)(4)(H) or allowing any product or service of the depository institution to be offered or marketed, directly or through any arrangement, by or through any company held under that section. Section 225.175(a) of the interim rule implemented these restrictions and applied them to any subsidiary (other than a financial subsidiary) of a depository institution controlled by a financial holding company.

Several commenters requested that the agencies clarify the scope of the rule's cross-marketing prohibitions, either by including a definition of what constitutes "cross-marketing" or by stating that certain types of activities are not prohibited. A few commenters also asserted that the rule's cross-marketing restrictions should not be applied to subsidiaries of depository institutions generally or to any subsidiary that a depository institution is specifically authorized by statute to control, such as SBICs or Edge Act

[24] See 65 FR 56,910 (Sept. 20, 2000); 65 FR 20,821 (April 18, 2000).

[25] For a domestic financial holding company, the appropriate form is the FR Y-6A, which will soon be replaced by the FR Y-10. For qualifying foreign banking organizations, the appropriate form is the FR Y-7A, which soon will be replaced by the FR Y-10F.

subsidiaries. Others stated that the rule should not prohibit a depository institution from marketing the shares or other ownership interests in a private equity fund to its customers.[26]

The Act's cross-marketing restrictions apply to any depository institution controlled by a financial holding company. As noted above, U.S. branches and agencies of a foreign bank are considered depository institutions for purposes of the rule. Accordingly, a U.S. branch or agency of a foreign bank may not cross-market the products or services of a company that is owned or controlled by the foreign bank or an affiliate of the foreign bank under section 4(k)(4)(H).

Depository institutions have long been permitted to own or control so-called "operating subsidiaries" that engage in activities permissible for the parent depository institution on the basis that the subsidiary is, in essence, a department or division of the institution. For this same reason, the rule considers a depository institution and a subsidiary of the depository institution to be one and the same for purposes of the cross-marketing restrictions.

In certain instances, however, Congress has specifically authorized depository institutions to own or control subsidiaries that may engage in activities different than those permissible for the parent institution. The rule, therefore, does not apply the cross-marketing restrictions to (1) a financial subsidiary of a depository institution held in accordance with section 5136A of the Revised Statutes or section 46 of the Federal Deposit Insurance Act, (2) any company held by an Edge or Agreement subsidiary controlled pursuant to section 25 or 25A of the Federal Reserve Act, or (3) any company held by a SBIC controlled in accordance with the Small Business Investment Act.

[26] One commenter asserted that the GLB Act authorizes the Board to grant exceptions to the cross-marketing restrictions for arrangements that meet the requirements of section 4(k)(5)(B) of the BHC Act. The exemption described in section 4(k)(5)(B) is available only with respect to investments that are held by insurance company subsidiaries of a financial holding company under section 4(k)(4)(I) and not to merchant banking investments. See 12 U.S.C. 1843(k)(5)(B).

The cross-marketing restrictions of the GLB Act and rule do not apply to nondepository affiliates of financial holding companies. In addition, the rule does not apply the cross-marketing restrictions to companies in which the financial holding company, directly or indirectly, owns less than 5 percent of the voting shares or ownership interests since the holding company could own such interests under section 4(c)(6) or 4(c)(7) of the BHC Act without being subject to the GLB Act's cross-marketing restrictions.

The agencies also have amended the rule to clarify the application of the cross-marketing restrictions to interests in or held through private equity funds. A purpose of the cross-marketing restrictions is to assist in maintaining the separation between banking and commerce.[27] Since private equity funds, by definition, may engage only in investment activities for resale or other disposition in accordance with the rule and may not be engaged in impermissible commercial activities, the Board and the Secretary believe that depository institutions (and their subsidiaries) may offer or market the shares or other ownership interests in a private equity fund in which the financial holding company has an interest under the rule. Accordingly, the agencies have amended the rule to provide that section 225.176(a) does not prohibit the sale, offer or marketing of any interest in a private equity fund, whether or not the fund is controlled by a financial holding company.

The final rule also provides that the cross-marketing restrictions do not prohibit a depository institution subsidiary of a financial holding company from engaging in cross-marketing activities with a portfolio company held by a private equity fund that is owned but not controlled by the financial holding company. Where the financial holding company does not control a private equity fund, shares held by the fund generally are not attributed to the financial holding company.

The Act and the rule also do not prohibit a depository institution or subsidiary of a depository institution from marketing its own products or services--such as

---

[27] See H.R. Rep. 106-74, 106th Cong., 1st Sess. at 122-23 (1999).

deposit, lending, and advisory products or services--*to* a portfolio company so long as the portfolio company does not then market those products or services to its customers or others. In addition, the Act and the rule do not prohibit a depository institution from purchasing the products or services of a portfolio company--such as data processing hardware, software or services--to support the depository institution's own operations provided that the institution does not, directly or indirectly or through any arrangement, market the portfolio company's products or services to the institution's customers or others.[28]

The agencies recognize that companies currently may use a wide variety of methods or arrangements to market or offer their products with those of other companies, and new methods or arrangements for cross-marketing may develop with advances in technology, changes in consumer shopping or purchasing habits, or other developments. In light of these facts, the agencies have not attempted in the rule or in this preamble to identify every type of arrangement that would, and would not, be subject to the cross-marketing restrictions of the rule. The agencies believe that questions concerning the application of the rule's cross-marketing restrictions to particular types of activities or arrangements are handled most appropriately on a case-by-case basis, which would allow full consideration of the particular circumstances at issue in the context of the purposes of the GLB Act.

Presumption of Control Under Sections 23A and 23B

Sections 23A and 23B of the Federal Reserve Act impose specific quantitative, qualitative and collateral requirements on certain types of transactions between an insured depository institution and companies that are under common control

[28]Likewise, the cross-marketing restrictions would not prohibit a depository institution controlled by a financial holding company from engaging in cross-marketing activities with a company that is a co-investor with the financial holding company in a portfolio company, so long as those activities do not involve products or services of the portfolio company.

with the insured depository institution. The GLB Act includes a presumption that a financial holding company or other person controls a company for purposes of sections 23A and 23B if the company or other person, directly or indirectly, or acting through one or more other persons, owns or controls 15 percent or more of the equity capital of the company under section 4(k)(4)(H).

The interim rule included this presumption and stated that a financial holding company could rebut the presumption by providing information acceptable to the Board demonstrating that the financial holding company did not control the company.[29] Several commenters requested that the agencies identify in the rule circumstances that would be sufficient to rebut this presumption of control. For example, some commenters suggested that the presumption should be rebutted if the financial holding company had no more than one director interlock with the portfolio company, or if an unaffiliated investor (or two or more unaffiliated investors acting in concert) owned or controlled a larger equity interest in the portfolio company than the financial holding company.

In light of these comments, the agencies have amended the rule to identify three situations in which the GLB Act's presumption of control will be considered rebutted. In each situation the financial holding company is assumed to own more than 15 percent of the total equity of the portfolio company (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the portfolio company (thereby not meeting the statutory definition of control). In particular, the rule provides that, absent evidence to the contrary, a financial holding company will <u>not</u> be presumed to control a portfolio company in any of the following situations–

---

[29] The final rule clarifies that the presumption applies only where a financial holding company owns or controls 15 percent or more of the total equity of a portfolio company under section 4(k)(4)(H) and the rule. The Board notes, however, that, under existing Board precedents, a financial holding company may not own any shares of a company in reliance on sections 4(c)(6) or 4(c)(7) of the BHC Act where the company owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.

• no officer, director or employee of the financial holding company serves as a director, trustee or general partner (or individual exercising similar functions) of the portfolio company;

• a person that is not affiliated or associated with the financial holding company owns or controls a greater percentage of the equity capital of the portfolio company than the financial holding company and no more than one officer or employee of the holding company serves as a director or trustee (or individuals exercising similar functions) of the portfolio company; or

• a person that is not affiliated or associated with the financial holding company owns or controls more than 50 percent of the voting shares of the portfolio company and officers and employees of the financial holding company do not constitute a majority of the directors or trustees (or individuals exercising similar functions) of the portfolio company.

These safe harbors do not require Board review or approval under the provisions allowing rebuttal of the presumptions. Moreover, the situations identified in the rule are not intended to be a complete list of circumstances in which the presumption may be rebutted, and the rule permits a financial holding company to submit evidence that would support rebuttal of the presumption in other circumstances.

The agencies note that the presumption of control in section 225.176(b) is independent from the general definition of control in section 23A of the Federal Reserve Act.[30] Accordingly, under the statute, a portfolio company is *per se* an affiliate of any insured depository institution subsidiary of a financial holding company if the financial holding company owns more than 25 percent of a class of voting securities of the portfolio company, even if the financial holding company owns or controls less than 15 percent of

[30] See 12 U.S.C. 371c(3)(A).

the portfolio company's *total equity* or is within one of the safe harbors contained in the final rule.[31]

A financial holding company generally is considered indirectly to own or control only those shares or other ownership interests that are owned or controlled by a subsidiary of the financial holding company. Accordingly, the rule clarifies that, for purposes of applying the presumption of control described above, a financial holding company that has an investment in a private equity fund will not be considered indirectly to own the equity capital of a portfolio company held by the fund unless the financial holding company controls the private equity fund. For example, if a financial holding company has a noncontrolling investment in a private equity fund that, in turn, owns 20 percent of the total equity of a portfolio company, the portfolio company is not presumed to be an affiliate of the insured depository institution subsidiaries of the financial holding company under section 225.176(b)(1). On the other hand, if a financial holding company acts as general partner of a private equity fund and, thus, controls the fund, and the private equity fund owns or controls more than 15 percent of the total equity of any portfolio company, the portfolio company is presumed to be an affiliate of the insured depository institution subsidiaries of the financial holding company under section 225.176(b)(1).

The rule also applies sections 23A and 23B to covered transactions between a U.S. branch or agency of a foreign bank and (1) any portfolio company controlled by the foreign bank or an affiliate of the foreign bank, and (2) any company controlled by the foreign bank or an affiliate where the company is engaged in making merchant banking investments if the proceeds of the covered transaction are used for the purpose of funding the company's merchant banking activities under this subpart. The presumption of control and exceptions to this presumption described above also apply to a foreign bank or affiliate that makes merchant banking investments in the same manner the presumption and exceptions apply to domestic financial holding companies.

---

[31] See 12 U.S.C. 371c(b)(3)(A)(i).

A few commenters contended that the Board should not apply sections 23A and 23B to covered transactions involving a U.S. branch or agency of a foreign bank. These commenters noted that U.S. branches and agencies do not hold federally insured deposits and contended that application of sections 23A and 23B is not necessary to ensure competitive equality and that any potential safety and soundness concerns may be addressed by the appropriate home country supervisor of the foreign bank.

The Board and the Secretary believe application of sections 23A and 23B to covered transactions between a U.S. branch or agency of a foreign bank and portfolio companies held by the foreign bank or an affiliate under the merchant banking authority, and companies engaged in making merchant banking investments, is appropriate to ensure competitive equity and safe and sound banking. Furthermore, the rule only restricts transactions by a foreign bank's branches and agencies with portfolio companies and with affiliated companies that are actually engaged in making merchant banking investments.[32] It does not restrict otherwise permissible lending to affiliated companies where the proceeds of such lending would not be used by these companies to make, or fund the making of, merchant banking investments under this subpart. Moreover, it does not restrict transactions between the U.S. branch or agency and its parent foreign bank.

D. Regulatory Flexibility Act Analysis

In accordance with section 4(a) of the Regulatory Flexibility Act (5 U.S.C. 604(a)), the Board must publish a final regulatory flexibility analysis with this rulemaking. The rule implements provisions of section 103 of the GLB Act that allow entities that have become financial holding companies to make merchant banking investments. Because the rule establishes guidelines for a newly authorized activity, the rule will affect only merchant banking activities that are newly authorized under the GLB Act.

---

[32]For purposes of applying the restrictions of sections 23A and 23B to U.S. branches and agencies of foreign banks, the "capital stock and surplus" of the U.S. branch or agency is determined by reference to the capital of the foreign bank as calculated under its home country capital standards.

The statute's limits apply to all financial holding companies, regardless of size, that are engaged in merchant banking activities. Similarly, the final rule directs each financial holding company, regardless of size, that is engaged in merchant banking activity to establish necessary internal controls, including recordkeeping procedures, and provide reports to the appropriate Reserve Bank as the Board may require. The internal controls, reporting and recordkeeping requirements that the rule establishes are necessary to ensure that the new activities are conducted in a safe and sound manner that does not adversely affect affiliated depository institutions, to enable the Board to execute properly its supervisory function and to ensure compliance by financial holding companies with the limitations that the GLB Act imposes on merchant banking activities. The Board believes that the information that financial holding companies are required to submit, pursuant to the final rule, will be similar to that appearing in routine reports to senior management, third-party investors, or other regulatory agencies (including the Securities and Exchange Commission), or that will be part of materials that an organization prepares and retains in the normal conduct of its investment activities.

The ability of financial holding companies to participate in the merchant banking business will likely enhance the overall efficiency and competitiveness of these institutions in the market for corporate financial services. In promulgating the interim rule, the Board specifically sought comment on the likely burden that the rule would impose on financial holding companies that engage in merchant banking activities. A few comments argued that the recordkeeping and reporting requirements of the rule were burdensome and unnecessary given other forms of regulatory supervision to which financial holding companies would remain subject. As explained above, the final rule has been streamlined in an attempt to reduce unnecessary burden. Other comments argued that financial holding companies will require a transition period in order to comply with the reporting and recordkeeping requirements of the rule. In this regard, the annual reports proposed under the rule relate only to investments held for a period of approximately five years, which, because the authority to make these investments is new, has the effect of phasing in the annual reporting requirement. Moreover, none of the comments addressed how the interim rule's requirements would substantially increase the regulatory burden for financial holding companies given that most of the data that the interim rule required is found in reports that financial holding companies make to their investors or to other regulatory agencies, or maintain for their own internal use.

[**E. Executive Order 12866 Determination**

The Department of the Treasury has determined that this final rule does not constitute a "significant regulatory action" for purposes of Executive Order 12866.]

F. Administrative Procedure Act

The provisions of the rule are effective on February 15, 2001 on a final basis. In accordance with requirements of 5 U.S.C. 553, the interim rule set forth procedures to implement statutory changes that had become effective on March 11, 2000. The interim rule itself became effective on March 17, 2000. The Board and the Secretary sought public comment on all aspects of the interim rule and have amended the rule as appropriate after reviewing the comments.

Subject to certain exceptions, 12 U.S.C. 4802(b)(1) provides that new regulations and amendments to regulations prescribed by a federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. The final rule imposes no additional reporting, disclosure, or other new requirements on an insured depository institution because the new activities that the rule governs cannot be conducted by an insured depository institution. For this reason, section 4802(b)(1) does not apply to this rulemaking.

G. Paperwork Reduction Act

In accordance with section 3506 of the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35; 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.

Most of the collection of information requirements in the final rule are found in 12 CFR 225.171, 225.172, 225.173, and 225.175. This information is required to evidence compliance with the requirements of Title I of the GLB Act (Pub. L. No. 106-102, 113 Stat. 1338 (1999)), which amends section 4 of the Bank Holding Company Act (12 U.S.C. 1843), and to allow the Board to exercise properly its supervisory responsibility for financial holding companies. The respondents are financial holding companies that choose to engage in merchant banking activities.

The final rule requires that financial holding companies submit reports to the Reserve Bank that the Board may prescribe (12 CFR 225.175(b)). The Board expects to publish a separate notice to issue reporting forms that may be used to comply with the these reporting requirements. The burden associated with these information collections will be addressed at that time.

In addition, the final rule requires that a financial holding company file a notice with the Reserve Bank within 30 days of making a large merchant banking investment (see 12 CFR 225.175(c)(2)). This requirement is imposed by statute, and the agencies have minimized the information that must be filed to fulfill this statutory requirement. This notice requirement is also codified in section 225.87(b)(4) of the Board's Regulation Y and is included in this rule solely for convenience. The regulatory burden associated with this notice was addressed in the final rule implementing provisions of the Gramm-Leach-Bliley Act that establish certain eligibility requirements for financial holding companies (see 66 FR 400).

In addition, the rule allows a financial holding company to seek relief from the holding period limits imposed by the rule by filing a request and supporting documentation with the Board (12 CFR 225.172(b) and 225.173(c)). The agency form number for these requests will be FR 4019. Information may also be submitted in letter form. The Board expects to receive very few of these notices and requests. The Board estimates that approximately 450 financial holding companies will be engaged in merchant banking activities within the first year of promulgation of the final rule. Of these financial holding companies, the Board believes that a high estimate of the potential number of notices and requests that would be filed under these various requirements during a single year is 100. The Board estimates that these companies will spend approximately 1 hour to prepare these filings, resulting in an estimated annual burden of 100 hours. Based on a rate of $50 per hour, the annual cost to the public will have been $5,000.

The rule also requires a financial holding company to provide notice to the Board prior to routinely managing or operating a portfolio company for more than 9 months (12 CFR 225.171(e)(3)). These notices, which may be in letter form, should contain the information described above under section 225.171. The agency form number for these notices also will be FR 4019. The Board estimates receiving 25 notices during a single year and that financial holding companies will spend approximately 1 hour to prepare these notices, resulting in an estimated annual burden of 25 hours. Based on a rate of $50 per hour, the annual cost to the public would be $1,250.

The final rule also requires that a financial holding company engaged in merchant banking activities establish and maintain certain policies, procedures, and systems to appropriately monitor and manage its merchant banking activities and maintain certain records relating to the company's merchant banking activities (12 CFR 225.175(a), 225.171(a)(4)). The Federal Reserve believes that most of these internal control and recordkeeping requirements are consistent with those established and maintained by organizations in the normal course of conducting a merchant banking business. The Board estimates that the 450 financial holding companies will spend approximately 50 hours in complying with these internal control and recordkeeping requirements, resulting in an estimated annual burden of 22,500 hours. Based on a rate of $50 per hour, the annual cost to the public would be $1.13 million.

In issuing the interim rule, the Federal Reserve specifically requested comment on the accuracy of its original burden estimates. No comments challenged the accuracy of those estimates beyond asserting that the recordkeeping requirements of the interim rule would prove burdensome to financial holding companies. The Board has streamlined many of the recordkeeping and reporting provisions of the interim rule and made them part of the Board's supervisory process.

The Federal Reserve may not conduct or sponsor, and an organization is not required to respond to, an information collection unless the Board has displayed a currently valid OMB control number. The OMB control number for these information collections is 7100-0292. A financial holding company may request confidentiality for the information contained in these information collections pursuant to sections 522(b)(4) and 522(b)(6) of the Freedom of Information Act (5 U.S.C. 552(b)(4) and (b)(6)).

The Federal Reserve has a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate, or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to: Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, DC 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0292), Washington, DC 20503.

H. Use of "Plain Language"

Section 722 of the GLB Act requires the Board to use "plain language" in all proposed and final rules published after January 1, 2000. The Board invited comments about how to make the rule easier to understand and, in doing so, posed the following questions:

1) Has the Board organized the material in an effective manner? If not, how could the material be better organized?

2) Are the terms of the rule clearly stated? If not, how could the terms be more clearly stated?

3) Does the rule contain technical language or jargon that is unclear? If so, which language requires clarification?

4) Would a different format (with respect to the grouping and order of sections and use of headings) make the rule easier to understand? If so, what changes to the format would make the rule easier to understand?

5) Would increasing the number of sections (and making each section shorter) clarify the rule? If so, which portions of the rule should be changed in this respect?

6) What additional changes would make the rule easier to understand?

The Board also solicited comment about whether including factual examples in the rule, in order to illustrate its terms, is appropriate. The Board noted that creating safe harbors in the rule may generate certain problems over time due to changes in technology or business practices and asked whether alternatives exist that the Board should consider to illustrate the terms in the rule.

One comment questioned the use of an interrogatory format for the headings accompanying each section of the rule but stated that the rule generally complied with the requirements and purpose of the statute.

The Board has streamlined and reorganized parts of the rule in an effort to make the rule more understandable and believes that the final rule is written plainly and clearly.