Appendix C

January 2001

TO: Board of Governors

FROM: Mr. Alvarez and
Ms. Caesar

SUBJECT: Summary of Comments Received on Interim Merchant Banking Rule and Proposed Capital Rule

Introduction

The Board received more than 140 comments in response to its interim rule governing merchant banking activities of financial holding companies and proposed rule on capital treatment of equity investments of bank holding companies.[1] The interim rule defined the scope of permissible merchant banking activities, defined limits set forth in the GLB Act on maximum holding periods and involvement in routine management of portfolio companies, provided guidance on risk management policies, introduced minimal reporting requirements, and established overall investment thresholds. The capital proposal requested comment on a plan to amend the Board's consolidated capital guidelines for bank holding companies to apply a 50 percent capital charge to all investments made, directly or indirectly, by a bank holding company in nonfinancial companies under the merchant banking authority of section 4(k)(4)(H) of the Bank Holding Company Act (the "BHC Act") and other, preexisting authority.[2]

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[1]The interim rule implemented provisions of the recently enacted Gramm-Leach-Bliley Act (the "GLB 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 Treasury Department jointly adopted the interim rule, which became effective on March 17, 2000.

[2]Equity investments held under non-merchant banking authority include those made under the Board's Regulation K, under section 24 of the Federal Deposit Insurance Act, through small business

(continued...)

The comment period for both the interim rule and the capital proposal ended on May 22, 2000. This memorandum provides a review of the comments received.[3] Part I contains a summary; Part II provides an account of issues raised in comments on the proposed and interim rules.

I. Summary

More than 140 individuals and organizations submitted comments about the interim rule and capital proposal.[4] The Board received comments from 44 state banking organizations, 18 LCBOs, 2 foreign banking organizations, 9 other banking organizations, 24 trade associations, 11 state and local government agencies, 5 congressional offices and committees, 4 non-banking organizations and investors, 3 law firms, and 1 association of state government officials.[5] About half of the LCBOs stated in their individual comments either that they had participated in the development of industry trade association submissions to the Board and to the Department of the Treasury or that they otherwise

[2](...continued)
investment companies ("SBICs") (whether controlled by the bank holding company or by a subsidiary depository institution), or under sections 4(c)(6) or (7) of the BHC Act in fewer than 5 percent of the shares of a nonfinancial company.

[3]An annotated list of the comments, describing the contents of each submission, is available in the Secretary's office.

[4] Several trade association representatives met with Board Members and Board staff during the comment period. Summaries of these meetings are in the public file containing comments received on the interim and proposed rule. Pennsylvania Bankers Association (comments presented at meeting with Governor Gramlich and Board staff) (March 23, 2000); Michigan Bankers Association (comments presented at meeting with Governor Gramlich and Board staff) (March 31, 2000); New York Bankers Association (May 17, 2000); Memorandum of Meeting of Governors Meyer and Gramlich and Board staff with the Financial Services Roundtable (submitted by Legal Division) (May 26, 2000).

[5]See "Comments by Type" (histograms) and chart of "Percentage of Comments by Type" in Appendix (chart).

supported the positions taken in these comments.[6] Almost all of the financial institutions that provided comments were engaged in or anticipated engaging in merchant banking activity; a few banking organizations submitted comments stating that they had no such plans.[7]

The vast majority of comments focused on the capital proposal. In particular, a significant number of commenters argued that the proposed 50 percent capital charge is too high, disproportionate given the capital charge on other assets, and inappropriate for certain specific types of investments. Comments also discussed the likely effect of the capital proposal upon bank holding company earnings, credit ratings, and competitiveness. Many commenters objected to applying the proposed increased capital charge against investments held through small business investment companies, and fully one-third of the comments consisted of objections from state banks regarding the application of the 50 percent proposed capital charge to equity investments held under authority specifically grandfathered under section 24 of the Federal Deposit Insurance Act. A few responses also stated that no evidence exists that the superior returns associated with merchant banking investments can be attributed to the increased risk of these assets.[8] Comments were also received on a wide range of other issues associated with the interim rule. These comments objected to, or requested modification of, among other matters,

1) the aggregate limits on merchant banking investments,

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[6] E.g., Corporate and Institutional Client Group, Merrill Lynch (May 26, 2000); U.S. Bancorp (May 23, 2000) (supporting, in particular, ABA Securities Association proposal of 200 percent risk weighting for merchant banking assets to extent that their value exceeds 20 percent of holding company Tier 1 capital); First Union Corporation (May 22, 2000); Mellon Financial Corporation (May 22, 2000); The PNC Financial Services Group, Inc., (May 22, 2000); The Chase Manhattan Bank (May 19, 2000); Wells Fargo (May 18, 2000).

[7] E.g., Summit Bancorp (May 18, 2000).

[8] E.g., Credit Suisse First Boston Private Equity, Credit Suisse First Boston Corporation (May 22, 2000).

2) the restrictions on the routine management of a portfolio company,

3) the holding period limits for merchant banking investments,

4) the definition of a "private equity fund,"

5) the application of sections 23A and 23B of the Federal Reserve Act to merchant banking transactions,

6) the recordkeeping and reporting requirements,

7) the restrictions on cross-marketing,

8) the definition of a "securities affiliate," and

9) the treatment of real estate investments.

A plurality of the submissions stated that the regulations undermined the intent of Congress in enacting the financial modernization legislation by placing excessive restrictions upon merchant banking activity. The majority of the comments from large institutions and their trade associations claimed that the proposed and interim rules jeopardize the "two-way street" intended by Congress to ensure opportunities for firms from each of the banking and securities industries to participate in both sectors.[9]

By contrast, only one industry comment stated its unequivocal support for the capital and other limits in the interim rule and capital proposal, underscoring that these limits reflect the congressional intent to maintain the separation of banking and commerce. This submission by the Independent Community Bankers of America ("ICBA") further expressed its agreement with the interim rule's risk management and internal controls requirements for financial holding companies engaged in merchant banking activities as well as with the aggregate limits upon merchant banking investments. The ICBA also praised the Board's capital proposal and cited a Standard & Poor's news release of March 27, 2000 as evidence of independent support for the 50 percent capital charge on equity investments.[10]

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[9] E.g., ABA Securities Association (May 15, 2000).

[10] Independent Community Bankers of America (March 30, 2000).

II. Issues Raised in the Comments

Each of the significant issues raised in the comments, including the amount of the proposed capital charge, the temporal and aggregate limits upon merchant banking activity, the prohibition upon routine management of portfolio companies, and the recordkeeping and reporting requirements for merchant banking investments, among others, is reviewed in this Part II.

A. General Comments

1. Intent of Congress in Enacting the GLB Act

Numerous responses from large banking organizations and trade associations contended that the Board's interim and proposed rules imposed restrictions on merchant banking activity that exceeded the authority that Congress delegated to the Board under the GLB Act.[11] Virtually all of these comments featured the criticism that restrictions in the rules contravened the congressional intent of the financial modernization legislation by undermining the "two-way street" -- the regulatory reform principle of enabling securities firms to enter the banking industry by acquiring banks as well as permitting the expansion of banking organizations into a broad range of nonbanking activities.

Several of the commenters argued that Congress carefully defined in the GLB Act all of the limits that Congress intended to impose on merchant banking activities, and contended that the banking industry and Congress would not have supported the GLB Act if they had been aware then that the Board would impose a high capital charge on these activities. Several comments argued that the statutory provisions governing merchant banking activity are self-executing and that, in fact, no need exists for detailed agency regulations explaining or expanding these limits.[12] Another comment asserted that, given that the authority of section 4(k)(4)(H) extends beyond investments made for appreciation and ultimate resale, the rule should include language confirming that dealing, market

[11] See, e.g., Securities Industry Association (April 24, 2000).

[12] See, e.g., Bank of America Corporation (May 19, 2000);Wells Fargo (May 18, 2000); New York Clearing House (April 24, 2000).

making, and underwriting are merchant banking activities.[13] One comment requested explicitly that the Board and the Treasury withdraw both the interim rule and capital proposal.[14]

In addition, comments submitted by members of the House Banking Committee expressed concern that the aggregate thresholds and cross marketing restrictions of the interim rule reportedly have had a negative impact upon merchant banking operations of banking organizations. These comments also stated that the GLB Act does not require or authorize new capital standards for merchant banking activities.

B. Issues with Respect to the Capital Proposal

1. Criticism of Capital Proposal

The vast majority of submissions criticized the capital proposal as an onerous regulatory burden and an inappropriate use of the Board's authority.[15] Among the arguments presented were that:

- the capital charge constitutes "cherry picking,"on the part of regulators, of isolated instances of internal capital assessments by firms and is inconsistent with industry practice because, for example, firms apply different capital charges to various portfolio investments based upon their risk, the firm's experience with the portfolio company, and the firm's understanding of the industry or market in which the portfolio company operates.[16]

- the capital charge may force institutions either to raise additional capital for regulatory purposes or to risk a downgrade from credit rating agencies.[17] One comment stated, for example, that the capital proposal would require bank and other financial holding companies to raise additional capital because they maintain a Tier 1 risk-based

[13]Shearman & Sterling (May 15, 2000).

[14]Wells Fargo (May 18, 2000).

[15]E.g., The Chase Manhattan Bank (May 19, 2000).

[16]Securities Industry Association (May 22, 2000).

[17]See, e.g., The PNC Financial Services Group, Inc. (May 22, 2000); Securities Industry Association (May 22, 2000).

capital ratio that is well above the regulatory standard given that capital markets would "negatively view financial institutions that did not maintain such a cushion."[18]

- the capital charge will inadvertently encourage risk-taking by banking organizations and, thereby, reduce the safety and soundness of the banking system because holding companies will seek to neutralize the balance sheet effects of the capital charge by selecting riskier investments.[19]

- the capital proposal penalizes successful merchant banking operations by applying the capital charge to the carrying value of investments rather than the cost basis.

- the capital proposal is based upon insufficient empirical support.

- the capital proposal specifically undermines the "two-way street" by making venture capital investing too costly for securities firms that might consider electing financial holding company status and may interfere with the Basle capital initiatives.[20]

- the unrealized gains that a banking organization may have from equity investment activities provide a sufficient financial cushion in times of stress without the need for an additional regulatory capital charge.[21]

- the positive historical performance of equity investments indicates that the capital charge is unnecessary.[22]

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[18] The PNC Financial Services Group, Inc. (May 22, 2000).

[19] See, e.g., New York Clearing House (April 24, 2000).

[20] The Hon. Richard H. Baker, Chairman, and the Hon. Spencer Bachu, the Hon. Judy Biggert, the Hon. Lee Terry, the Hon. Ron Paul, the Hon. Sue W. Kelly, the Hon. Patrick J. Toomey, the Hon. Bob Riley, the Hon. James H. Maloney, and the Hon. Ken Bentsen, members, of the House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises (September 18, 2000). This comment argued specifically that the fifty percent capital charge would discourage merchant banking participation by financial holding companies.

[21] Wells Fargo (May 18, 2000). This comment also states that other limitations upon merchant banking investments should be subject to the two-year sunset provision.

[22] See, e.g., The Financial Services Roundtable (May 22, 2000); The Chase Manhattan Bank (May 19, 2000); Danvers Savings Bank (May 19, 2000).

One trade association expressed the view of many LCBOs in stating that the 50 percent capital charge is "simply too great and, with a 'one-size-fits-all' approach, fails to take account of the differing risk characteristics of various instruments,"[23] including debt and hybrid securities. Another comment stated that internal capital models vary too greatly among institutions to be used as a "proxy" for regulatory capital.[24] Numerous comments stated that the 50 percent charge does not accurately reflect industry practice in internal capital modeling and risk management and that the internal charge applied by banking organizations to merchant banking-type investments varies widely.[25] Some comments stated that the internal capital models on which the capital proposal is based are tools used to evaluate management performance and, therefore, do not serve the same purpose as regulatory capital standards.[26]

Several respondents suggested that the capital proposal is based upon a misunderstanding of internal capital allocation practices within financial institutions. According to the comments, the capital charge reflects "cherry-picking" of capital components without a comparable adjustment for the very small capital allocations that financial institutions make to relatively low risk assets, such as high-quality commercial loans. Some of these commenters argued that, if the Board believes it appropriate to use the merchant banking charges derived from internal models, the Board should allow banking organizations to meet all regulatory capital requirements by applying internal models designed by the organization.

2. Alternative Capital Proposals

Trade associations and LCBOs presented a variety of recommendations for revising the capital rule. Among these proposals are:

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[23]ABA Securities Association (March 30, 2000).

[24]TCF National Bank (May 22, 2000).

[25]E.g., New York Clearing House (April 24, 2000); see also First Union Corporation (May 22, 2000) (stating that bank holds capital equal to considerably less than 50 percent against merchant banking investments, reserving differing amounts for private equities, public equities, and subordinated debt).

[26]Bank of America Corporation (May 19, 2000).

- permitting institutions with strong valuation models and policies to have their capital levels monitored through the supervisory process without a special regulatory capital charge for merchant banking investments.[27] Under this proposal, a capital charge in excess of 8 percent would be applied through the supervisory process when a holding company's internal models fail to permit the sufficient allocation of capital to merchant banking activities;[28]

- adopting capital standards similar to those that states have established for insurance companies in their regulatory schemes: allocation of capital equal to 30 percent of the value of equity investments and 9 percent of the value of subordinated debt holdings;[29]

- establishing a two-part standard, excluding unrealized gains on merchant banking investments from Tier 1 capital and imposing a 200 percent risk weighting on the amount of merchant banking investments that, based on book value, exceeds 40 percent of a financial holding company's Tier 1 capital;[30]

- adopting a 200 percent risk weighting for merchant banking investments, a measure that would increase the total minimum capital-to-assets ratio to 16 percent for merchant banking assets,[31] or, in the alternative, adopting a 250 percent risk-weighting for merchant banking assets;[32]

- applying higher capital standards to merchant banking investments and other equity investments on a case-by-case basis through the supervisory process;

- requiring use of accounting rules that would minimize or eliminate the potential for unrealized increases in the value of merchant banking assets (unrealized gains) to inflate regulatory capital;

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[27]J.P. Morgan & Co., Incorporated (May 22, 2000).

[28]See, e.g. ABA Securities Association (March 30, 2000).

[29]National City Corporation (May 19, 2000).

[30]The PNC Financial Services Group, Inc. (May 22, 2000).

[31]Citigroup (May 22, 2000).

[32]New York State Banking Dept. (May 23, 2000).

- requiring prompt recognition of permanent impairments in the value of merchant banking investments;[33]

- excluding from Tier 1 capital 100 percent of the after-tax amount of net unrealized gains attributable to merchant banking investments;[34]

- retaining the current 100 percent risk-weighting for all equity investments;[35]

- providing for grandfathered treatment of equity investments made under preexisting regulatory authority and applying the 50 percent capital charge only to merchant banking investments;[36]

- applying the 50 percent capital charge to Tier 2 rather than Tier 1 capital;[37]

- reducing the Tier 1 capital charge from 50 percent to 25 percent.[38]

Of those comments that advanced the increased risk-weighting approach to revising the capital standard, almost all proposed that the final rule exempt from any new standard all equity investment activity conducted under preexisting statutory or regulatory authority.[39]

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[33]Bank of America Corporation (May 19, 2000).

[34]Citigroup (May 22, 2000).

[35]Chase Capital Partners (May 7, 2000) (additional materials submitted to Board staff).

[36]Chase Capital Partners (May 7, 2000).

[37]Chase Capital Partners (May 7, 2000).

[38]Chase Capital Partners (May 7, 2000).

[39]E.g., New York Clearing House (April 24, 2000).

One comment suggested a two-year sunset period for the capital rule and other “investment limitations.”[40]

The Conference of State Bank Supervisors recommended that the Board adopt a multifactor risk-weighted capital charge that considers the experience of principals, the diversification of the merchant banking portfolio, and the value-weighting of portfolio assets. The comment from this group asked that the Board consult directly with state bank supervisors in promulgating the final capital rule. [41]

A submission from a major securities firm stated that the Board should exempt from the capital charge passive investments of less than five percent of the voting securities of publicly traded commercial firms. This comment also argued that the five-percent threshold should actually be increased to ten percent of voting securities, noting that this threshold is consistent with equity interest affiliation presumption and reporting standards under section 16 of the Securities Exchange Act.

3. Application of Capital Charge to Debt Investments

A number of comments from LCBOs and their trade associations objected to application of the capital proposal to debt investments.[42] One respondent criticized the capital proposal for not distinguishing between subordinated debt and equity merchant banking investments. The submission argued that subordinated debt, although riskier than a senior loan, is far less risky than equity because it “has a faster cash return feature than equity” and is not in a “first loss” position in the event of insolvency.[43] One trade association suggested that the analysis for making equity investments differs greatly from

[40]Wells Fargo (May 18, 2000).

[41]Conference of State Bank Supervisors (May 22, 2000).

[42]ABA Securities Association (May 15, 2000).

[43]Key Principal Partners (May 19, 2000).

that employed in making loans and that the risk profile of portfolio company credits is not necessarily different from that of other loans.[44]

A few submissions also expressed opposition to the application of the capital charge to warrants that a portfolio company may issue to a financial holding company with the sale of debt. One comment noted that if the capital charge applies to the carrying value of the entire investment, then the charge would require inclusion of unrecognized gain in the value of the warrants even though "the warrants typically represent [only] nominal capital at risk."[45]

4. Application of Capital Charge to Equity Investments Made Pursuant to Preexisting Statutory and Regulatory Authority

Virtually all of the comments voiced opposition to application of the capital rule to equity investments held under existing statutory and regulatory authority, including investments made, directly or indirectly, by a bank holding company in nonfinancial companies under the Board's Regulation K, under section 24 of the Federal Deposit Insurance Act, through SBICs (whether controlled by the bank holding company or by a subsidiary depository institution), or under sections 4(c)(6) or (7) of the BHC Act in fewer than 5 percent of the shares of a nonfinancial company.[46]

If the capital charge must apply to activities conducted under preexisting authority, several respondents argued, regulators should provide a five-year transition period.[47] Some of the comments also generally urged that the capital charge not apply to joint ventures and "strategic partnerships" of financial holding companies.

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[44]New York Clearing House (April 24, 2000).

[45]Wachovia Corporation (May 22, 2000).

[46] E.g., Hibernia Corporation (May 19, 2000); Wells Fargo (May 18, 2000).

[47]E.g., The Financial Services Roundtable (May 22, 2000).

a. Small Business Investment Companies

Numerous respondents said that the proposed 50 percent capital charge should not be applied to investments in SBICs.[48] These submissions often argued that the limits on SBIC investments imposed by statute and by Small Business Administration regulations make this activity one of limited risk for bank holding companies.[49] Many comments described SBICs that banking organizations own or control ("bank-owned SBICs") as profitable, conservative investment vehicles that have been operated in a manner more conservative than that of independent venture capital funds.[50]

The majority of comments contended that SBICs have played a key role in the national economy by providing financing to small businesses. According to these submissions, the 50 percent capital charge will encourage banks to abandon SBICs. A few comments, moreover, argued that the capital proposal would preclude SBIC investments by independent community banks and otherwise require reductions in their asset base because

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[48] E.g., The Hon. William J. Jefferson, Member of Congress, The Hon. Gregory W. Meeks, Member of Congress (May 24, 2000); Office of Advocacy, U.S. Small Business Administration (May 22, 2000).

[49] E.g., CRA Funding LLC (May 22, 2000) (opposing application of capital proposal to SBICs and stating that risk profile and regulation of SBICs do not warrant this regulatory approach); Support Group for Modern National Banking (May 22, 2000) (stating that Small Business Administration regulations require licensing of SBICs, which are also subject to capital-based investment limits, capital minimums, debt limits, examination requirements, conflict-of-interest rules, and reporting requirements); The Hon. Christopher S. Bond, Chairman, The Hon. John F. Kerry, Ranking Member, Senate Committee on Small Business; The Hon. James M. Talent, Chairman, The Hon. Nydia Velazquez, Ranking Member, House Committee on Small Business (May 16, 2000).

[50] Shorebank (May 16, 2000); Bradley Steeter, bradleystreeter@netscape.net (no mailing address) (April 17, 2000). This comment also makes the point that SBICs hold minority stakes in a portfolio of venture-stage companies and characterizes merchant banking investments made outside of SBICs as significantly higher in risk, arguing that venture capital investments frequently take the form of majority equity interests.

of the constraints upon asset growth associated with the capital charge.[51] Several respondents also stated that the capital charge will raise banks' costs of meeting Community Reinvestment Act requirements through SBIC investments[52] and Minority Enterprise SBICs ("MESBICs"), and reduce regional bank funding of these investment vehicles.[53]

In addition, a trade association for SBICs argued that regulators should conduct and analyze surveys of internal accounting models used by bank-owned SBICs, operating results of bank-owned SBICs under various macroeconomic conditions, and likely effects of the proposed regulation upon bank-owned SBICs of different sizes. This respondent recommended that regulators analyze the current laws and regulations that are designed to limit the risk of SBIC operations and to ensure the safety and soundness of banking organizations that own SBICs, including, respectively, the Small Business Administration regulations and the Bank Holding Company Act.

Citigroup, Inc., in its submission, argued that the capital charge is unnecessary to protect the safety and soundness of the banking system and should not apply to SBICs (or to other previously authorized investment activities of financial holding companies, loans to merchant banking clients, or joint ventures and strategic partnerships of financial holding companies).[54]

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[51]Independent Bankers Capital Fund, L.P. (May 17, 2000).

[52]The Independent BankersBank (May 19, 2000).

[53]First Tennessee National Corporation (May 22, 2000); see also National Black Chamber of Commerce (May 25, 2000) (positing that capital proposal should not apply to SBICs or to SSBICs (Special Small Business Investment Companies, which focus upon investing in female- and minority-owned businesses)).

[54]Citigroup Inc. (May 22, 2000).

b. Equity Investments Held under the Federal Deposit Insurance Act

Forty state banks and several trade associations submitted comments objecting to the manner in which the capital proposal would apply to equity investments made by state banks under authority grandfathered in section 24 of the Federal Deposit Insurance Act. Section 24 of the Federal Deposit Insurance Act allows certain grandfathered state banks to retain equity investments in publicly traded companies under certain circumstances. It also allows state banks to own subsidiaries that engage in activities that are not permissible for national banks so long as the FDIC has found that the activity does not pose a material risk to the deposit insurance fund.

All of these state banks argued that grandfathered equity investment activities conducted pursuant to section 24 have a positive effect on the diversification of risk in bank portfolios -- with most also noting that both Congress and the FDIC have reviewed and permitted these investments. Many comments from state banks in Massachusetts noted that their institutions are subject to both FDIC and state examination, which includes a review of the risk of the bank's equity portfolio. One state regulator expressed a similar view that the proposed rule's extension to state institutions represents overreaching by federal regulators.[55]

The comments from state banks also invariably asserted that the capital charge would adversely affect the profitability of banks conducting these equity investment activities.[56] Many comments provided data regarding the extent to which the capital

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[55]State of Washington, Department of Financial Institutions (May 22, 2000).

[56]See., e.g., The Savings Bank (April 24, 2000); see also Office of the Commissioner of Banks, Commonwealth of Massachusetts (May 22, 2000); Eastern Bank (May 18, 2000); Peoples Bank (May 17, 2000) (noting bank has had up to 24 percent of its capital devoted to equity investments, which have contributed greatly to earnings and tax position).

proposal would cause a decrease in the capital-to-assets ratios of specific institutions.[57] These comments added that many banks use available-for-sale accounting for their equity portfolios, carrying these investments at fair market value without including unrealized gains in regulatory capital.[58]

Several comments stated that the success of section 24 investments enabled Massachusetts banks to weather the banking liquidity crisis of the 1980s. One respondent added that the capital charge will discourage banks from taking advantage of special state income tax treatment for certain activities conducted through a bank corporate affiliate.[59]

The Connecticut Bankers Association argued that association members are using the section 24 power in order to diversify portfolios and enhance returns through conservative equity investing in publicly traded securities and not to engage in venture capital or other merchant banking activities, which largely involve privately held companies. The submission added that the Board should seek capital adjustments on a case-by-case basis.[60]

One comment contained the observation that, to the extent that the rapid expansion of equity investments made under preexisting authority provided the rationale for extending the capital proposal to cover these investments, state banks are not rapidly

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[57]E.g., Massbank 01867 (May 18, 2000) (citing prospective capital ratio decrease by 62 basis points to 9.98 percent); Granite Savings Bank (May 16, 2000) (claiming capital ratio would decrease from 13.89 percent to 12.2 percent).

[58]Hyde Park Savings Bank (May 16, 2000); Granite Savings Bank (May 16, 2000) (adding that bank accounts for its equity investments according to FAS 115 and marks these investments to market monthly).

[59]Massachusetts Bankers Association (May 22, 2000).

[60]Connecticut Bankers Association (May 19, 2000).

expanding their equity activities.[61] This submission emphasized that FDIC regulations require 100 percent capital deduction from Tier 1 capital only for assets held within banks' securities underwriting and real estate investment subsidiaries. In other cases, the comment stated, the extent to which the value of an investment must be deducted from Tier 1 capital is left to the FDIC's discretion.[62]

Another respondent complained that, if state banks with section 24 equity investment authority are subjected to the capital proposal, the capital charge should also apply to insurance underwriting subsidiaries of financial holding companies because both insurance subsidiaries and state banks are subject to functional regulation. Only one submission from a state bank argued that a lower capital standard should apply to investments made pursuant to section 24 than to merchant banking investments, rather than calling for outright elimination of the proposed capital charge with respect to these assets.[63]

In its comment, the FDIC expressed concern that the capital proposal could affect approximately 50 banking organizations to which the FDIC has issued section 24 approvals for limited real estate investments held through a subsidiary, as well as approximately 150 banking organizations in which state nonmember banks hold listed equity securities and registered mutual fund shares pursuant to the statute. The FDIC stressed its belief that "the concerns which the FRB has articulated in support of the rule are already fully addressed by existing [FDIC] procedures" and recommended that section 24 investments and activities be exempted from the capital proposal. The agency also emphasized that Congress has authorized the FDIC to determine whether nonfinancial activities of a state bank and its subsidiaries present a significant risk to the deposit

[61] People's Bank (May 19, 2000).

[62] People's Bank (May 19, 2000).

[63] People's Bank (May 19, 2000).

insurance fund; the FDIC noted that it had exercised its power as it considered appropriate to impose capital requirements on state banks.

C. Issues with Respect to the Interim Rule

A number of comments related to individual aspects of the interim rule governing the definition and conduct of merchant banking activities. These include comments regarding: 1) the aggregate threshold for review of merchant banking investments, 2) the restrictions on the routine management of a portfolio company, 3) the limits on holding periods for merchant banking investments, 4) the definition of a "private equity fund," 5) the application of sections 23A and 23B of the Federal Reserve Act to merchant banking transactions, 6) the recordkeeping and reporting requirements, 7) the restrictions on cross-marketing, 8) the definition of a "securities affiliate," and 9) the treatment of real estate investments.

1. Aggregate Thresholds for Review of Merchant Banking Investments

A trade association representing LCBOs argued that the aggregate thresholds that the interim rule establishes for merchant banking investments are "unduly restrictive" and not supported by the legislative history of the GLB Act.[64]
A large banking organization also argued that these thresholds could potentially curtail a banking organization's private equity activity and place banking organizations at a competitive disadvantage with respect to investment banks and foreign banks.[65]

One trade association argued that the current aggregate caps create "a particularly unreasonable and unfair limitation" upon the largest U.S. banks. As an alternative, the association proposed that the aggregate limits be increased to 50 percent of capital or that regulators adopt an aggregate limit equal to 5 percent of total assets and that

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[64] ABA Securities Association (March 30, 2000).

[65] J.P. Morgan & Co., Incorporated (May 22, 2000).

any cap be based on the cost, rather than carrying value, of the investments. This comment argued that basing the aggregate limits on the carrying value of investments will penalize financial holding companies with successful merchant banking operations.[66] Citigroup, Inc. urged that the interim rule contain a single aggregate limit of no greater than 30 percent of total capital.[67]

Several bank holding companies characterized the dollar-based limit on aggregate merchant banking investments as arbitrary and argued that the Board should not be concerned about the dollar amount of a bank holding company's investment if the amount invested in this activity is not significant in relation to the size of the bank holding company and the bank holding company has sufficient capital to support the investment.[68] Another banking organization took the position that, whereas a *dollar-based* cap on aggregate investments is inappropriate, a *capital-based* cap is acceptable.[69]

2. <u>Restrictions on the Routine Management of a Portfolio Company</u>

Several respondents criticized the provision of the rule prohibiting employee and officer interlocks between financial holding companies and portfolio companies.[70] These commenters argued that financial holding companies often employ persons with special expertise who can assist management of a portfolio company either temporarily or

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[66] New York Clearing House (April 24, 2000).

[67] Citigroup Inc. (May 22, 2000).

[68] <u>E.g.</u>, Wachovia Corporation (May 22, 2000).

[69] National City Corporation (May 19, 2000).

[70] These commenters included Senator Bennett, Chairman of the Senate Financial Institutions Subcommittee, who argued that the interim rule should provide for interlocks among both junior and senior officers and employees but should perhaps limit the number of interlocks to "two or three . . . at a single portfolio company." One comment objected to the prohibition upon employee and officer interlocks between financial holding companies and their portfolio companies but stated that prohibitions on *director* interlocks would be appropriate. Summit Bancorp (May 18, 2000).

as a junior officer or employee of the portfolio company. These commenters argued that these types of interlocks do not represent "routine management" of the type restricted by the GLB Act.[71] Instead, these commenters argued that the GLB Act restriction on routine management limits only day-to-day management of a portfolio company, and should not be viewed as limiting participation in management that is strategic or not day-to-day decisionmaking.

Most comments on the subject of routine management requested additional guidance from the Board regarding legal concepts referenced in the rule, such as the scope of portfolio company management decisions made in the ordinary course of business (in which a financial holding company cannot participate) as opposed to those decisions in which a portfolio company director "customarily participates." For example, one respondent requested that the Board develop a list of customary director decisions.[72]

A few comments stated that the prohibition on routine management will retard investment activities in the e-commerce sector and prevent financial holding companies from remaining competitive with other financial institutions and with independent private equity funds in acquiring investments in technology companies.[73] In addition, numerous comments contended that the interim rule's exception to the bar on routine management of a portfolio company, which allows routine management by financial holding companies of portfolio companies only under special circumstances and only when risk of impairment of an investment exists, is inconsistent with the statute and too restrictive. Many respondents argued that the standard for routine management under

[71]One comment argued that it is important that interlocks involving senior officers, as well as junior officers and employees, be permitted as long as the officers devote only limited time and effort to their involvement with the portfolio companies. (The Hon. Robert F. Bennett, Senate Committee on Banking, Housing, and Urban Affairs (October 11, 2000).

[72]American Bankers Association (May 22, 2000).

[73]New York Clearing House (April 24, 2000).

special circumstances should reflect that of the statute, which permits routine management when "necessary or required to obtain a reasonable return on investment upon resale or disposition."[74]

These submissions argued that the requirement in the rule that a financial holding company receive Board approval to routinely manage a portfolio company for a period of more than six months provides portfolio companies with an unfair source of leverage over financial holding company investors.[75] One comment stated that the exception for routine management of a portfolio company under special circumstances should cover the financial holding company's preparation of an exit strategy. Other comments recommended that routine management of a portfolio company by a financial holding company be addressed through the supervisory process.[76]

Some commenters also requested that the Board expand the list of permissible covenants to allow financial holding companies to include a greater variety of contractual conditions on their investments in portfolio companies without triggering the restrictions on routine management.[77] Some submissions from LCBOs asked that agents be

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[74] Bank One Corporation (May 22, 2000).

[75] The interim rule provides that a financial holding company may engage in routine management of a portfolio company for a period of no more than six months when intervention is necessary to address a material risk to the value or operation of the portfolio company, such as a significant operating loss or loss of senior management. Under the interim rule such routine management by the financial holding company may continue only for the period of time as may be necessary to address the cause of involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return upon the resale or disposition of the investment.

[76] The PNC Financial Services Group, Inc. (May 22, 2000).

[77] See, e.g., ABA Securities Association (May 15, 2000).

eliminated from the category of impermissible interlocks among financial holding companies and portfolio companies.[78]

3. Holding Period Limits for Merchant Banking Investments

Several commenters claimed that the holding period restrictions are inconsistent with the statute.[79] One commenter argued that the holding periods should be 15 years for both direct investments and those made through private equity funds.[80] Another commenter asked that, in the case of direct investments, financial holding companies receive a 60-day grace period to divest up to 10 percent of such investments following the expiration of the 10-year holding period.[81]

Merrill Lynch claimed that holding period restrictions would adversely impact the financial operations of financial holding companies engaged in the merchant banking business and, in some cases, cause financial holding companies to compromise fiduciary duties that they may owe to direct or indirect investors in a portfolio company. The comment offered the explanation that:

> sizeable, complex or problem investments require an investor to be as flexible as possible in order to develop a solution that maximizes the benefit, or minimizes the harm, to the relevant investor. It is not uncommon for merchant banking investments to become the subject of contentious discussions and negotiations, particularly where the views of other stakeholders in the portfolio company differ from the FHC. In this context, any investment restrictions on an FHC investor, whether real or perceived, will act to diminish the leverage of such investor in its negotiations with other stakeholders.

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[78]E.g., Citigroup Inc. (May 22, 2000).

[79]E.g., ABA Securities Association (May 15, 2000); New York Clearing House (April 24, 2000).

[80]Citigroup Inc. (May 22, 2000).

[81] The PNC Financial Services Group, Inc. (May 22, 2000).

In general, other commenters urged that holding periods be left unrestricted by the rule and be reviewed on a case-by-case basis through the supervisory process. Others argued for longer holding periods for all investments, including up to 15 years or 25 years.

Several commenters also requested that the submission of divestiture plans, required under the holding period extension provisions of the interim rule, become part of the supervisory process, and that a financial holding company be permitted to request an extension of time closer to the end of the holding period.[82] The interim rule provided that all requests for an extension of the holding period be submitted at least one year before then end of the holding period.

4. Definition of Private Equity Fund

The ABA Securities Association argued that the exception provided in the interim rule for private equity funds was very useful but should be broadened. In particular, commenters urged that the definition of private equity funds be expanded and that private equity funds not be subject to any of the restrictions imposed on direct merchant banking investments held by financial holding companies -- that is, private equity funds should not be subject to any limit on the time period for holding investments in portfolio companies, should not be prevented from routinely managing portfolio companies, and should not be required to establish risk management policies or file any reports.[83] Other respondents took the approach that direct investments should be permitted to be held for the same extended 15-year period that applies to investments held through private equity funds.[84]

[82]Bank of America Corporation (May 19, 2000).

[83]ABA Securities Association (May 15, 2000).

[84]E.g., Wells Fargo (May 18, 2000).

A number of comments from LCBOs argued that the definition of a private equity fund should be modified to eliminate the criterion of ten outside investors.[85] These comments added that the requirement that 75 percent of the equity of the fund be held by outside investors is sufficient to ensure that the fund will be operated in a fashion that is consistent with the holding periods and diversification and safety and soundness concerns that motivated the interim rule. Other commenters requested that the definition of private equity fund be expanded to include those investment companies in which a financial holding company acquires up to 50 percent of the total equity.[86]

The Financial Services Roundtable and several others argued that the definition of private equity fund is too restrictive and that most private equity funds have a tenure not limited to 12 years. These comments also contended that other aspects of the interim rule's private equity fund definition, such as the requirement that the fund have policies regarding diversification of assets, are inconsistent with market practice.[87]

Several commenters urged that the interim rule be modified to include an exception that would allow financial holding companies to make passive investments in funds controlled by independent third parties without the constraints on holding periods and routine management that apply to direct investments in portfolio companies by financial holding companies and without requiring that the third party fund meet the requirements of the rule's definition of private equity fund.

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[85]E.g., Bank of America Corporation (May 19, 2000) (proposing that regulations permit "look-through" count of outside investors when fund limited partners are limited partnerships or limited liability companies themselves).

[86]The PNC Financial Services Group, Inc. (May 22, 2000). A submission from Merrill Lynch also requested that the definition of private equity fund include a registered "employees securities company," as defined in section 2(a)(13) of the Investment Company Act of 1940 (or as granted an exemption from registration pursuant to S.E.C. order). Merrill Lynch (May 26, 2000).

[87]E.g., The Financial Services Roundtable (May 22, 2000).

In particular, these commenters argued that passive financial holding company investments in non-qualifying equity funds should not be subject to the 10-year holding period limit because the terms of limited partnership agreements may not permit divestiture on this timetable without the consent of the general partner.[88] Several respondents suggested amending the interim rule to provide for a 15-year holding period for all merchant banking investments.[89]

5. Application of Sections 23A and 23B of the Federal Reserve Act

Under the GLB Act, the restrictions on lending by an insured depository institution contained in sections 23A and 23B of the Federal Reserve Act are applied to transactions between an insured depository institution and any portfolio company in which the parent financial holding company of the insured depository institution holds a 15 percent equity interest. The GLB Act established this 15 percent threshold as a rebuttable presumption. Sections 23A and 23B would apply by their terms if the parent financial holding company owned or controlled 25 percent or more of the portfolio company. Several submissions from large banking organizations now engaged in limited investment activities suggested that a "control" principle provide the trigger for the rebuttable presumption added by the GLB Act to sections 23A and 23B of the Federal Reserve Act. These comments contended that the presumption of control for purposes of sections 23A and 23B of the Federal Reserve Act should be rebutted *per se* if a financial holding company's ownership level in a portfolio company or private equity fund is less than 25 percent *and* if the financial holding company has no more than one representative among the portfolio company's (or private equity fund's) directors.[90] Several respondents argued that the presumption should also be rebutted if two or more investors unaffiliated with the

[88] E.g., Key Principal Partners (May 19, 2000).

[89] E.g., Citigroup Inc. (May 22, 2000); The Financial Services Roundtable (May 22, 2000).

[90] E.g., Bank of America Corporation (May 19, 2000).

financial holding company assert greater control over a portfolio company than the financial holding company itself.[91]

A few respondents stated their objection to the interim rule's application of section 23A of the Federal Reserve Act to transactions between uninsured U.S. branches and agencies of foreign banks and certain of their merchant banking affiliates. These comments also contended that, because uninsured branches and agencies do not participate in the federal deposit insurance fund, their activities are not a threat to the federal deposit insurance regime. These submissions argued that the regulatory framework for ensuring the safety and soundness of a foreign bank is the law that its home country regulator enforces.[92]

6. Recordkeeping and Reporting Requirements

Several respondents opposed the interim rule's requirement that records be maintained at a centralized location.[93] Commenters found this requirement burdensome and unnecessary. Most argued that records could be retrieved by a financial holding company upon request without requiring that all records be maintained continuously at a central location.

Other comments claimed that quarterly reporting would be burdensome and that increased reporting for older investments should begin after seven years, rather than after five years, as the current interim rule provision directs.[94] Several respondents asked

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[91] See, e.g., ABA Securities Association (May 15, 2000); New York Clearing House (April 24, 2000).

[92] ABN AMRO North America, Inc. (May 22, 2000); Swiss Bankers Association (May 22, 2000) (stating that application of sections 23A and 23B of the Federal Reserve Act to transactions between U.S. branches and agencies of foreign-headquartered financial holding companies and merchant banking portfolio companies is unwarranted).

[93] E.g., Wells Fargo (May 18, 2000).

[94] E.g., Merrill Lynch (May 26, 2000); Key Principal Partners (May 19, 2000).

that the recordkeeping and reporting requirements for passive investments in private equity funds be clarified and reduced.[95]

7. Restrictions on Cross-Marketing

A few comments from LCBOs stated their opposition to any prohibition on sales of private equity fund interests to customers of an affiliate that is a depository institution.[96] Several comments requested a determination that the use of hyperlinks to portfolio company web pages or other portfolio company advertisements on subsidiary bank web pages is not prohibited cross-marketing.[97] The ABA Securities Association argued that the prohibition on cross-marketing should not extend to depository institution subsidiaries authorized under specific statutory authority, such as SBICs and Edge corporations.[98]

[95] E.g., Key Principal Partners (May 19, 2000).

[96] E.g., American Bar Association (May 22, 2000).

[97] E.g., Bank of America Corporation (May 19, 2000).

[98] ABA Securities Association (May 15, 2000)

8. Definition of "Securities Affiliate"

A few institutions, including one foreign bank, welcomed the interim rule's broad definition of a "securities affiliate."[99] One submission contended that regulators should expand the securities affiliate definition in the interim rule to include municipal securities dealers.[100] One trade association comment stated that establishment of a broker-dealer is expensive and burdensome and argued that the definition should be expanded in order to "permit both large and community based financial holding companies to establish merchant banking activities." The submissions did not, however, provide recommendations about how such an expansion should be effected in a final merchant banking rule.[101] A comment from a foreign bank suggested that ownership of an SBIC be allowed to satisfy the securities affiliate requirement. This comment contended that the risk assessment and internal controls systems required for operation of an SBIC are "precisely those required to manage a merchant banking investment activity."[102]

9. Treatment of Real Estate Investments

One trade association requested assurance that equity investments in real estate receive treatment under the merchant banking regulations that is equivalent to that accorded other equity investments.[103] Another respondent stated agreement with the interim rule's extension of merchant banking authority to include real estate investments, adding

[99]ABN AMRO North America, Inc. (May 22, 2000).

[100]American Bankers Association (May 22, 2000).

[101]American Association of Bank Directors (May 22, 2000).

[102]Saudi International Bank (May 18, 2000).

[103]The Real Estate Roundtable (February 16, 2000). It was also suggested that the Board clarify that investments or joint ventures that are financial in nature, and designed to obtain, provide, or enhance products, services, or information to the financial institution itself, its customers, or both, are strategic investments and not merchant banking investments and will be treated as such for regulatory purposes. The Hon. Jack Reed, United States Senate (June 30, 2000).

that financial holding companies should be able to hold real estate directly.[104] One comment that a group of banking lawyers submitted argued that the interim rule should not prohibit financial holding companies from investing in portfolios that consist entirely of real estate. This comment argued that the FDIC has liberalized its regime for regulating real estate investments.[105]

10. Miscellaneous Issues

- A few submissions reflected uncertainty about whether investments in financial companies are permitted under the merchant banking authority because the interim rule addresses investments in nonfinancial companies.[106]

- Another comment expressed a similar uncertainty with respect to "tax-credit lending."[107]

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[104] Wells Fargo (May 18, 2000).

[105] American Bar Association (May 22, 2000).

[106] ABA Securities Association (May 15, 2000); New York Clearing House (April 24, 2000). Financial holding company investments in financial companies are authorized generally under section 4(k) of the Bank Holding Company Act, as amended by the GLB Act.

[107] First Tennessee National Corporation (May 22, 2000).