January 8, 2001

To: Board of Governors

From: Staff[1]

Subject: Final rule governing merchant banking activities of financial holding companies.

<u>ACTION REQUESTED</u>: Approval of a final rule governing merchant banking activities permitted for financial holding companies ("FHCs") under the Gramm-Leach-Bliley Act ("GLB Act").

<u>SUMMARY</u>: The attached rule establishes a number of definitions and restrictions governing merchant banking activities and the manner in which these activities may be conducted. The rule is similar to and based on the interim rule that currently is in place, but incorporates a number of modifications and improvements in response to public comments. The major provisions of the final rule and the major differences from the interim rule are summarized below.

> * <u>Scope of activity</u>. As in the interim rule, the final rule allows a FHC to make investments in any amount of shares, assets or ownership interests of any type of nonfinancial company, directly or through any subsidiary of the FHC (other than a depository institution or subsidiary of a depository institution) or through a defined private equity fund.
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> * <u>Securities affiliate</u>. The final rule broadens the definition of "securities affiliate" for purposes of identifying FHCs that may engage in merchant banking activities. The final rule adds any separately identifiable department or division of a bank that is registered with the SEC as a municipal securities dealer to the definition in the interim rule, which currently includes any securities broker or dealer that is registered with the SEC.

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* Routine management or operation. The final rule retains the provision of the interim rule that permits a FHC to maintain director interlocks with a portfolio company under ordinary circumstances. The final rule also retains a list of situations that represent "routinely managing or operating" a portfolio company, such as establishing an officer or employee interlock, that would only be permissible on a temporary basis when needed to obtain a reasonable return on the resale of the investment. However, the rule has been restructured so that most employee and officer interlocks create only a rebuttable presumption that the investor is involved in routine management. The rule continues to prohibit interlocks at the executive officer level of the portfolio company, interlocks involving executive officers from the FHC and certain major affiliates, and covenants restricting decisions made in the ordinary course of business.

* Holding period. The final rule retains the holding periods in the interim rule, which allow investments in certain defined private equity funds to be held for a period of up to 15 years and allow all other types of merchant banking investments to be held for a period of up to 10 years, unless the Board allows a longer period. The final rule reduces the list of mandatory restrictions contained in the interim rule that would apply automatically in cases in which the Board permits a longer holding period, and allows the Board to impose restrictions on a case-by-case basis as appropriate.

* Aggregate activity thresholds. The final rule includes a sunset provision to the requirement of the interim rule that a FHC receive Board approval prior to using its merchant banking authority to make investments above certain levels. The sunset is tied to final adoption of a capital rule governing merchant banking investments. The final rule also eliminates immediately the absolute dollar thresholds for this review process. Until a final capital rule is adopted, the Board must review the merchant banking activities of a FHC if--

    * the FHC’s merchant banking investments in the aggregate exceed 30% of the FHC's Tier 1 capital, or

* the FHC’s merchant banking investments *other than* investments in private equity funds in the aggregate exceed 20% of the FHC's Tier 1 capital.

* Private equity funds. The final rule clarifies the manner in which the holding period, routine management, record-keeping and cross-marketing provisions apply to private equity funds that represent pools of resources from both FHCs and outside investors.

* Policies and recordkeeping requirements. The final rule retains the requirement that the FHC maintain adequate risk management and compliance policies and procedures and streamlines the record keeping requirements of the interim rule. The Board recently issued detailed supervisory guidance on these matters, and the Federal Register notice refers companies to this guidance.

* Cross-marketing and section 23A and B limitations. The final rule retains the restrictions contained in the GLB Act on cross-marketing activities between depository institutions and portfolio companies. The final rule also retains the new presumptions in the GLB Act defining portfolio companies that are subject to restrictions contained in sections 23A and B of the Federal Reserve Act on inter-affiliate transactions. The final rule also adopts three safe harbors from these presumptions in response to comments.

BACKGROUND: The GLB Act allows a FHC to make investments in nonfinancial companies as part of a bona fide underwriting, merchant or investment banking activity. The GLB Act describes merchant banking broadly to allow the acquisition of any type of ownership interest, without restriction on the amount of ownership interest acquired.

To qualify to conduct these activities, the FHC must control either a securities affiliate or certain types of insurance underwriters. The GLB Act requires that merchant banking investments be held only for a period of time to enable the sale or disposition of the investment on a reasonable basis consistent with the financial viability of the activity. The Act also prohibits the FHC from routinely managing or operating a company in which it has made a merchant banking investment ("portfolio company") except as necessary to obtain a reasonable return on the investment on resale or disposition.

The Act authorizes the Board and the Secretary of the Treasury jointly to establish rules governing these activities to assure compliance with the purposes and prevent evasions of the BHC Act and the GLB Act and to protect depository institutions. The interim rule and the attached final rule were developed in consultation with the Treasury Department. While the Treasury also supports the separate capital proposal and the portions of the final rule governing reporting, the capital proposal and reporting requirements are adopted under the Board's supervisory authority.

Brief summary of comments

The Board received more than 140 comments on the interim rule and related capital proposal. Commenters included members of Congress, other federal agencies, state banking departments, banking organizations, 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 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 suggested that the agencies expand the types of relationships that a financial holding company could 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. Some commenters also 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. 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.

As discussed below and in the attached draft Federal Register notice, the final rule has been modified in a number of ways to address these and other comments. A more detailed summary of the public comments is attached as Appendix C.

DISCUSSION:

A. Definition of merchant banking activities.

The final rule retains the broad definition of merchant banking activities contained in the GLB Act and the interim rule. It would allow investments in any type of ownership interest, including voting and nonvoting interests, of any type of nonfinancial company, including corporations, partnerships, limited liability companies and other entities.[2] Investments may be in any amount--from only a nominal amount of shares up to all of the ownership interests--of a company, and may be made by a FHC either directly or through any subsidiary (other than a depository institution or subsidiary of a depository institution).

Investments in assets, such as real estate, would also be permissible. However, the rule requires that assets be held through a company that maintains the formalities of corporate separation from the FHC, and requires that the FHC observe the same limits on routine management and operation

[2] The merchant banking authority granted in the GLB Act only authorizes FHCs to invest in companies engaged in activities that are *not* financial in nature, incidental to a financial activity or otherwise permissible for a FHC. FHCs may invest in financial companies using other authority. The preamble to the final rule explains that these authorities may be used in tandem. For example, a private equity fund controlled by a FHC may make investments in nonfinancial companies using its merchant banking authority and may make investments in financial companies using other authorities granted under the BHC Act.

of the company holding the asset as apply to other types of portfolio companies.

The GLB Act defines merchant banking so broadly as to overlap other authority that FHCs have to make investments, such as authority to make investments through small business investment corporations, to make investments abroad under Regulation K, and to make investments in up to 5% of the voting shares of any company. These other authorities continue to be available to FHCs as an alternative or supplement to merchant banking authority.

B. Definition of securities affiliate.

In order to engage in merchant banking activities, the GLB Act requires that the FHC control either a securities affiliate or both an insurance underwriter and a registered investment advisor that advises an insurance company.[3] The GLB Act does not define the term "securities affiliate," and the scope of that term will determine the number and type of FHCs that would be permitted to engage in merchant banking activities.

The interim rule defined a "securities affiliate" as any securities broker or dealer registered with the SEC under the federal securities laws. Nearly all commenters supported this definition because it would allow a broad range of large and small FHCs to take advantage of the new merchant banking authority. Some commenters requested that the definition be broadened to include any department or division of a bank that is registered

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[3] To qualify by virtue of ownership of an insurance underwriter, the GLB Act requires that the insurance company be predominantly engaged in underwriting life, accident and health or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities. This provision was intended to accommodate insurance underwriting companies that make merchant banking investments outside of the insurance company. A separate provision of the GLB Act allows an insurance underwriting company to make investments directly within the company as permitted under relevant state insurance laws, as long as the insurance company does not routinely manage or operate the portfolio company except as necessary to obtain a reasonable return on the investment.

with the SEC as a municipal securities dealer, and any small business investment company.

The final rule retains the definition of a “securities affiliate” as any registered securities broker or dealer. It also adds any registered municipal securities dealer, including a separately identifiable department or division of a bank that is registered with the SEC as a municipal securities dealer. These departments and divisions engage in a specialized type of securities activity, underwriting and dealing in municipal securities. They are treated by the SEC as separate entities for purposes of the securities laws and are allowed to be maintained in the bank for corporate convenience. Expanding the definition of “securities affiliate” in this way would eliminate the need for these companies to transfer their business to a separate affiliate in order to take advantage of the new merchant banking authority.

The final rule does not broaden the definition to include small business investment companies because these types of companies do not generally engage in securities activities.

C. Routine management or operation.

The GLB Act provides that the FHC may not "routinely manage or operate [a portfolio company] except as may be necessary or required to obtain a reasonable return on investments upon resale or disposition." This prohibition was intended to maintain a separation between banking and commerce by limiting the ability of a FHC to become involved in the day-to-day management or operation of portfolio companies.

The final rule allows a FHC to have representation on the boards of directors of portfolio companies without restricting the number of director interlocks, so long as the portfolio company maintains its own management and the interlocking directors do not routinely participate in management decisions made in the ordinary course of the business of the portfolio company. These provisions were also in the interim rule and were strongly supported by the commenters.

Commenters expressed strong reservations about other provisions of the interim rule that defined several specific types of relationships to represent routine management. In particular, the interim rule provided that a FHC would be considered to be involved in routinely managing or operating a portfolio company if any officer, director or employee of the FHC serves as an officer or employee of the portfolio company or if the FHC supervises any officer or employee of the portfolio company (other than through representation on the board of directors of the portfolio company). Similarly, the interim rule provided that a representative of the FHC that serves as a director of the portfolio company may not participate in management decisions made in the ordinary course of the portfolio company's business. In addition, the interim rule provided that covenants or restrictions on the management of a portfolio company that apply to the conduct of the ordinary course of business of the portfolio company represent routinely managing or operating the company.

Commenters argued that adoption of these provisions as part of a rule would eliminate the ability of FHCs to have relationships with portfolio companies even when the relationship did not allow the FHC to routinely manage or operate the company. For example, commenters argued that employee interlocks between an FHC and a portfolio company--especially interlocks at the junior officer or non-officer levels--often would not allow the FHC to exercise any decision-making authority at the portfolio company. Commenters also questioned the authority of the Board and the Secretary to adopt these provisions in cases where the relationship could be shown not to represent routine management of the portfolio company.

In response to these comments, the final rule has been restructured to establish a presumption that employee and officer interlocks represent routinely managing or operating a portfolio company. The final rule would allow a FHC to rebut this presumption if the facts of the specific case indicate that the relationship would not involve routinely managing or operating the portfolio company.

The final rule continues to provide that, in all cases, a FHC would be exercising routine management if an officer or employee of the FHC is an executive officer of the portfolio company.[4] The FHC is permitted, however, to participate in the selection or removal of executive officers of a portfolio company, either through representation on the board of directors of the portfolio company, through investor covenant or otherwise. The final rule also provides that, in all cases, a FHC would be exercising routine management if an executive officer of the FHC or certain of its major subsidiaries is a non-executive officer or employee of the portfolio company.

The final rule has also been modified to clarify that a FHC may, without being considered to be routinely managing a portfolio company, provide investment advisory services and management consulting services to the portfolio company so long as the FHC does not exercise management discretion of decision-making authority. The FHC may also meet with officers and employees of the portfolio company to monitor and provide advice regarding the activities and condition of the company. In addition,

[4] For purposes of the final rule, an "executive officer" is defined in the same as in Regulation O and includes any person, regardless of title, who participates or has authority to participate in major policymaking functions of the company.

the rule clarifies that the FHC may assist in underwriting or privately placing securities of the portfolio company.

The GLB Act allows a FHC to routinely manage or operate a portfolio company in circumstances when necessary or required to obtain a reasonable return on the resale or disposition of the investment. The final rule adopts the language in the GLB Act on this point, rather than the more limiting provision of the interim rule. The final rule also includes several examples of these types of circumstances, such as the loss of key management, a significant operating loss or a change in the strategic direction of the company.

As under the interim rule, the final rule contemplates that a FHC will intervene in the management of a portfolio company only for the period of time needed to address the material risk or otherwise facilitate disposal of the investment. The final rule requires a FHC to document each intervention for review in the examination process. The final rule eliminates the requirement in the interim rule that a FHC obtain Board *approval* to routinely manage a portfolio company for more than six months, and instead provides that a FHC must provide written *notice* to the Board in the event that the FHC routinely manages a portfolio company under this exception for a period that exceeds nine months. This notice will allow the Board to monitor the use of this exception in the supervisory process and take supervisory action in appropriate cases.

D. <u>Holding period</u>.

As noted above, the GLB Act allows a FHC to hold a merchant banking investment only for a period of time to enable the sale or disposition of the investment on a reasonable basis. The interim rule generally required the sale or disposition of each merchant banking investment (other than those made through private equity funds) within 10 years of its acquisition unless the Board allows a longer period of time after review of the FHC's divestiture plan. The interim rule allowed investments made through defined private equity funds to be held for up to 15 years. The interim rule allowed these holding periods based on a review of industry practice, and in recognition of the fact that holding periods are affected by general economic conditions as well as specific business requirements.

Several commenters acknowledged that the holding periods in the interim rule were consistent with industry practice and the final rule adopts the same time periods. Some commenters argued that the agencies should not adopt any holding periods and should supervise the sale of merchant banking investments in the supervisory process. This approach, while appearing to provide more flexibility, would result in more ad hoc limits and is likely to be both more burdensome and more uncertain for FHCs engaged in merchant banking activities.

In order to address situations where a FHC, despite its best efforts, is unable to dispose of an investment within the holding periods, the final rule allows the Board to grant extensions. Unlike the interim rule, which required a FHC to seek an extension from the Board at least 1 year in advance of expiration of the holding period, the final rule provides that an extension may be sought up to 90 days before the end of the holding period. This later review period, which was suggested by commenters, should allow adequate opportunity to review extension requests but will require FHCs to be prepared to complete a divestiture if an extension is not granted.

The interim rule contained a number incentives designed to discourage FHCs from seeking an extension of the holding periods. These incentives included a 100% capital charge on investments held longer than

10 years, a prohibition on the FHC making additional investments in the portfolio company, and a prohibition on the FHC having any other transactions or relationships with the portfolio company.

Commenters argued that the agencies should not adopt restrictions that would eliminate agency discretion to tailor restrictions to the facts of each individual extension request. Commenters were particularly concerned that a regulatory prohibition on additional investments and additional relationships at the end of a holding period would prevent a FHC from taking actions such as purchasing the interest of a partner or assisting in underwriting an initial public offering that would facilitate the FHC's disposition of its interest in the portfolio company. Consequently, commenters urged the agencies to eliminate the restrictions from the rule.

In response to the comments, the final rule eliminates all but one of the restrictions that automatically apply to investments held beyond the relevant holding period. The final rule retains the requirement that the FHC hold capital against the investment in an amount set by the Board that must be above the highest capital charge applicable to the requesting FHC under the agencies' capital rule (or proposal) for merchant banking investments, but in no event less than 25 percent of the adjusted carrying value of the investment. The final rule also retains the Board's authority, in connection with granting an extension of the holding period, to impose any restriction, including the types of restrictions identified in the interim rule, as appropriate.

E. Private equity funds.

As noted above, firms that engage in merchant banking activities often pool together capital from a number of investors into funds whose only business is making equity investments for resale. These funds typically have structural features, such as compensation arrangements, a defined and limited duration, and equity-holder review committees or mechanisms, that encourage the fund adviser to manage carefully the risks of each investment held by the fund and to dispose of investments within a reasonable period. Typically these funds have a life that is limited to between 10 and 15 years.

Because private equity funds have features that encourage the careful management of risk and the resale of equity investments after a reasonable holding period, the interim rule provided several accommodations designed to allow these types of funds to continue to be operated in much the same way as they are currently operated. These included a longer holding period that accommodates the typical life of private equity funds, a higher investment threshold prior to Board review of investments in private equity funds, and streamlined reporting and record-keeping requirements.

Nearly all commenters favored these provisions. Commenters suggested, however, that the agencies broaden the definition of a private equity fund that would qualify for these accommodations and clarify the manner in which several of the restrictions in the rule apply to both funds that qualify under this definition and funds that do not meet the definition.

The final rule addresses these comments in two ways. First, the final rule simplifies the definition of a qualifying private equity fund to eliminate the requirements that the fund have a minimum of 10 outside investors and establish an exit plan for each investment. Instead, the definition retains the requirement that outside investors own at least 75 percent of the fund and the general requirement that the fund be formed for the purpose of making investments in equity for the purpose of resale. Several commenters agreed that these requirements would be sufficient to assure third-party oversight of the investment advisor and the resale of fund investments within a reasonable period.

Second, the final rule reorganizes the provisions governing private equity funds into a new section that explains how the routine management and holding period provisions apply to qualifying private equity funds. In particular, the new section explains that the routine management restrictions apply only to private equity funds that are controlled by a FHC.[5] In addition, the preamble to the rule explains the manner in which these provisions apply to funds that do not meet the definition of a qualifying private equity fund under the rule.

F. Aggregate activity thresholds.

The interim rule required that a FHC obtain Board approval prior to the aggregate carrying value of a FHC's merchant banking investments exceeding certain aggregate investment thresholds. Under the interim rule, the threshold for all merchant banking investments (including both investments made directly in portfolio companies and investments made in private equity funds) was the lesser of 30% of the FHC's Tier 1 capital or $6 billion, unless the Board approved a higher amount for the FHC. A separate sublimit equal to the lesser of 20% of the FHC's Tier 1 capital or $4 billion was established for total investments other than investments in private equity funds.[6]

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[5] A FHC that makes a passive, noncontrolling investment in a private equity fund would itself be restricted from routinely managing or operating a portfolio company held by the private equity fund under other provisions of the rule.

[6] The limits provide more room for investments made in private equity funds than for other types of merchant banking investments because the discipline imposed by outside investors on the investments of private equity funds appears to reinforce the restrictions in the BHC Act. No limit is placed on the amount an FHC may raise from outside investors as part of a private equity fund. Moreover, these investment limits would not apply to investments held by the FHC through SBICs, under Regulation K, or in less than 5% of a company's shares.

Commenters strongly opposed these investment thresholds. They argued that these investment thresholds, and in particular the absolute dollar thresholds, would place FHCs at a competitive disadvantage in competing with other venture capital firms in making investments, and would punish FHCs for making successful investments that grew in value. Commenters also argued that the thresholds would impede or prevent securities firms from acquiring banks and were, consequently, contrary to the intent of the GLB Act to establish a two-way street. Several commenters contended that the agencies lacked the legal authority to establish a review process at any level.

The investment thresholds were designed to provide the Board with an opportunity to review the risk management policies, investment expertise, diversification policies and capital reserves of a FHC that seeks to commit significant amounts of its capital to merchant banking activities. The thresholds under the interim rule are not absolute limits, and contemplate that a FHC with a well managed and well capitalized merchant banking operation would be permitted to invest amounts above those thresholds. In establishing the interim rule, the Board and the Secretary stated that the agencies would revisit the need for the thresholds in connection with adoption of appropriate capital treatment for equity investment activities.

The final rule specifically includes a sunset provision that makes the thresholds ineffective upon the adoption of a capital rule governing equity investment activities. The final rule also modifies the thresholds during this interim period to remove the absolute dollar triggers. Consequently, the thresholds are based entirely on the size of an FHC's merchant banking portfolio as a percentage of the FHC's Tier 1 capital during the period until a final capital rule is adopted.

Since the thresholds apply only to investments made by FHCs under the new merchant banking authority conferred under the GLB Act and FHCs have only recently begun to exercise this authority, the investment thresholds are not likely to be binding on FHCs initially. These thresholds also do not appear to be an impediment to most large securities firms that conduct merchant banking activities affiliating with banks, though these thresholds may require some specialty firms that conduct primarily merchant banking activities to obtain Board approval to exceed these thresholds in the event that the firm decides to affiliate with a bank.

The Board and the Secretary have express authority under the GLB Act to adopt rules implementing the merchant banking provisions that the Board and the Secretary "jointly deem appropriate…to protect depository institutions."[7] In addition, the Board has supervisory authority under the BHC Act and the Federal Deposit Insurance Act to take actions necessary to prevent unsafe and unsound practices at bank holding companies.

G. Policies and recordkeeping requirements.

Since the adoption of the interim rule in March, 2000, the Board has issued supervisory guidance that details the types of policies and procedures that the Board expects banking organizations to maintain in connection with engaging in equity investment activities.[8] This supervisory guidance applies to the equity investment activities of a bank holding company conducted under any investment authority, including the merchant banking authority in the GLB Act. This supervisory letter indicates that bank holding companies are expected to maintain systems that monitor and manage the risk of

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[7] 12 U.S.C. 1843(k)(7)(A).

[8] Federal Reserve SR Letter No. 00-09 (SPE) (June 22, 2000).

investment activities across the organization, to assess accurately the value of investments, to monitor the full range of exposures of the bank holding company to each portfolio company, to address diversification of investment risk, to assure corporate separateness between the bank holding company and portfolio companies, and to assure compliance with the regulatory restrictions governing investment activities.

The final rule streamlines the provisions of the rule governing policies and procedures to account for this detailed supervisory guidance. In addition, the final streamlines the record-keeping requirements of the interim rule to remove the requirement that FHC maintain at a central location records documenting its policies, procedures and investment activities. Instead, the final rule requires FHCs to make appropriate records available to examiners on request.[9]

The GLB Act requires that each FHC provide notice to the Board within 30 days of acquiring any company under section 4(k) of the BHC Act (the section that includes the merchant banking authority). Because merchant banking investments must, by definition, be temporary investments, the final rule implements this reporting requirement by requiring that the FHC provide notice to the Board within 30 days only after making certain large investments. These notices would be required for any investment in a single company or private equity fund in an amount that

[9] The interim rule required two types of routine reports: a quarterly report that focuses on the aggregate levels of exposure of the FHC to all of its investments, by the nature and type of investment (i.e., distinguishing between investments in publicly traded securities, private equity funds, and private companies); and an annual report that focuses on investments held for at least 5 years. The Board does not typically detail periodic reporting requirements in its regulations governing activities, and instead issues forms under a procedure sanctioned by the Office of Management and Budget. Appropriate forms are currently under development. Consequently, the final rule has been modified to provide that FHCs must provide reports as prescribed by the Board. It is anticipated that the forms for these reports will request the same types of information contained in the interim rule.

exceeds the lesser of 2 percent of the FHC's Tier 1 capital or $200 million. Commenters generally supported this provision.

H. Cross marketing and 23A restrictions.

The GLB Act prohibits a depository institution controlled by a FHC from cross-marketing any products or services with or through any company held using the merchant banking authority. The GLB Act does not apply this restriction to cross-marketing activities between a portfolio company and the FHC or a nondepository institution subsidiary of the FHC.

The final rule includes the statutory restriction and applies this restriction to any U.S. branch or agency of a foreign bank. By definition, the cross-marketing restriction applies to any Federal branch and any insured State branch of a foreign bank. The rule, for competitive equity, also applies the cross-marketing restriction to uninsured State branches and agencies.

The final rule provides that the cross-marketing restrictions do not apply between a depository institution and a portfolio company in which the FHC owns less than a 5% interest. A FHC may make 5% investments under other authority in the BHC Act without complying with the cross-marketing restriction. The provision is designed to remove the incentive for a FHC to claim that certain small investments in the FHC's merchant banking portfolio are held under different authority and removes the burden associated with documenting such a claim.

The final rule also provides that the cross-marketing restrictions do not apply to portfolio companies held by a private equity fund that is not controlled by the FHC. In cases where the FHC does not control the private equity fund, the FHC is not considered to control the portfolio company and the concerns for the separation of banking and commerce that motivated the cross-marketing restriction are less likely to be present. In addition, the final rule clarifies that the cross-marketing restrictions do not apply to the sale, offer or marketing of an interest in a private equity fund, whether or not the fund is controlled by the FHC.

The GLB Act also changes the definition of "affiliate" for purposes of applying the restrictions contained in sections 23A and B of the Federal Reserve Act to transactions between a depository institution and a portfolio company. The GLB Act establishes a presumption that a portfolio company is an affiliate of a depository institution for purposes of those restrictions if the FHC owns or controls more than 15% of the equity of the portfolio company. The rule adopts this presumption.

Commenters requested that the agencies identify situations when the presumption would be considered to have been rebutted. The final rule incorporates three such safe harbors: (1) where the FHC has no interlocks among the directors, officers or employees of the portfolio company; (2) where an unaffiliated investor owns or controls more equity of the portfolio company than the FHC and the FHC has no more than one representative on the board of the portfolio company; and (3) where an unaffiliated investor owns or controls more than 50 percent of the shares of the portfolio company and officers or employees of the FHC do not represent a majority of the directors of the company. In each case, the FHC may not own more than 25 percent of the voting shares of the portfolio company, and there must not be other evidence that indicates that the FHC in fact controls the portfolio company. A FHC is not required to seek Board approval to claim these safe harbors.

The final rule also retains a provision of the interim rule that provides that the statutory 23A presumption would not apply to portfolio companies held through a private equity fund unless the FHC controls the private equity fund. In other words, a FHC that owns a 20 percent nonvoting investment in a private equity fund sponsored and advised by another company would not be presumed to control the portfolio companies held by the private equity fund unless the FHC controls the private equity fund.

The rule allows FHCs to rebut the 23A presumption in other situations, and does not limit the types of information that a FHC may provide in attempting to rebut this presumption.

CONCLUSION:

The attached final rule, including the ways in which it modifies the interim rule, and the proposed Federal Register notice have been discussed and developed with the staff of the Treasury Department. System staff recommend that the Board adopt this rule, in final form, jointly with the Secretary. Staff also requests authority, in consultation with Governor Meyer as appropriate, to make changes prior to publication to assure conformity with the rule adopted by the Secretary.