



**Securities Industry Association**

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April 16, 2001

By Hand and Via Electronic Mail

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the  
Federal Reserve System  
20th Street and Constitution Ave., NW  
Washington, DC 20551  
(Docket No. R-1097)

Communications Division  
Third Floor  
Office of the Comptroller of the Currency  
250 E. Street, SW  
Washington, DC 20219  
(Docket No. 01-03)

Mr. Robert E. Feldman  
Executive Secretary  
Federal Deposit Insurance Corporation  
550 17th Street, NW  
Washington, DC 20429

Re: *Proposed Risk-Based Capital Rule for Nonfinancial Equity Investments*

Ladies and Gentlemen:

The Securities Industry Association (“SIA”) appreciates the opportunity to comment on the proposed rule issued jointly by the Board of Governors of the Federal Reserve System (“Board”), the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, “the Agencies”) setting forth the regulatory capital requirements for merchant banking and other equity investments in non-financial companies by banks, bank holding companies and financial holding companies. SIA represents more than 680 securities firms throughout North America, including investment banking firms and broker-dealers that are

affiliated with banking organizations. SIA member firms are active in U.S. and foreign securities and capital markets in all phases of corporate and public finance.<sup>1</sup>

SIA and its members have been extremely concerned about the capital requirements (and other regulatory restrictions) imposed on merchant banking and other equity investment activities of bank-affiliated securities firms and, consequently, have been active participants in the public policy debate regarding these capital and regulatory requirements. In several detailed comment letters to the Board, SIA expressed its serious concerns about the Board's proposal of March 2000, which would have imposed an excessive 50% capital charge on all investments in non-financial companies.

SIA believes that, although the Agencies' new proposal represents an improvement over the Board's original capital proposal, the instant proposal continues unnecessarily to restrict the merchant banking and other equity investment activities of bank-affiliated securities firms. For this reason, and as set forth in greater detail below, we continue to believe, as stressed in our earlier submissions, that the better approach would be to rely on internal capital allocation models, which may be supplemented by appropriate levels of supervisory oversight.

If, notwithstanding these comments, the Agencies decide to go forward with this rulemaking, SIA strongly urges the Agencies to set a specific date by which they will re-examine the need for these external capital charges. SIA also believes that the Agencies should exempt from the capital requirements all non-financial equity investments made prior to the date of any final rule pursuant to statutory authorities that existed prior to the enactment of the Gramm-Leach-Bliley Act ("GLB Act"), as well as all debt instruments and all overseas investments made through Edge Act and Agreement corporations. In addition, SIA requests that the Board clarify that the proposed capital charges do not apply to hedging positions and to investments made by financial holding companies in firms engaged in activities that are "complementary" to a financial activity.

#### I. Reliance on Internal Capital Allocation Models.

As set forth in its previous comment letters to the Board, SIA continues to believe that the Agencies should allow firms to rely fully on internal capital allocation models to control the risks of non-financial investment activities. While recognizing the new proposal is a significant improvement over its predecessor, SIA strongly believes that internal models are more accurately calibrated to the actual risks associated with merchant banking and other investment activities of a particular firm than the proposed additions to the risk-based capital guidelines. Each institution's internal capital model can best measure and capture the complexity of that firm's merchant banking and non-financial investment program, accounting for the risks and capital needs that are specific to the nature and level of the firm's portfolio investment activities. In addition, internal models can be fine-tuned on a continuous basis to accommodate

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<sup>1</sup> The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates more than \$300 billion of revenues yearly in the U.S. economy and employs approximately 700,000 individuals. (More information about SIA is available at our Internet site <http://www.sia.com>.)

developments and changes in economic, investment and portfolio conditions in a manner that the proposed rules simply cannot.

The Agencies express concern in their rulemaking proposal about the differences in the level of sophistication of models at various organizations; SIA submits that this issue can only be addressed through supervision and examination, as is currently done in connection with capital allocation for market risk. If a particular institution's capital allocation model, in conjunction with other aspects of its risk management program, is found to be inadequate by examiners, then that institution -- and only that institution -- should be required to hold additional capital commensurate with the level of its non-financial equity investment activities and the deficiencies found in its capital model. This individualized approach has the decided advantage of ensuring that each institution develops and maintains sound internal capital and risk management systems and of targeting supervisory and examination resources to precisely those institutions that evidence material capital allocation and risk management deficiencies.

In addition, reliance on an internal model/supervisory framework serves to encourage institutions to improve continuously risk management systems and capabilities so as to produce more sophisticated, reliable, and accurate capital measurements. By contrast, the Agencies' approach -- by applying the same capital charge to all institutions that make the same level of merchant banking and non-financial equity investments as a percentage of their Tier 1 capital -- penalizes institutions regardless of how carefully they monitor and manage their portfolio investment activities. In fact, the Agencies' proposed capital charge may encourage some firms to search for greater returns to offset the progressively higher proposed capital hits and, thus, to make progressively riskier investments.

The Agencies acknowledge that reliance on internal models represents a preferable method for determining the capital adequacy of an organization but, nevertheless, reject such reliance for the time being because they regard internal models to be "untested." SIA submits that, in taking this position, the Agencies have ignored the fact that securities firms and banking organizations have for many years actively participated in the venture capital markets relying exclusively on internal risk management systems -- including capital allocation models, valuation policies, internal reporting and similar safeguards -- without any additional external capital requirements of the sort proposed now.

As SIA pointed out in its previous comment letters to the Board, the industry's current risk management and capital allocation systems have allowed securities firms to make non-financial equity investments prudently and properly for decades, through both substantial bull and bear markets, without significant problems. In fact, it is these internal capital models that have allowed industry participants to withstand successfully the current equity market downturn.

SIA recommends that, if despite these arguments the Agencies determine to adopt their capital proposal, the final rule should contain a "sunset" provision or, at minimum, a specific date by which the Agencies will formally re-examine and re-evaluate the need for the capital haircuts. In testimony before Congress, Governor Meyer described the Agencies' revised capital

proposal as a temporary measure that would be used as “a bridge” to a system that relies on internal models.<sup>2</sup> Accordingly, SIA believes that it is entirely appropriate for the Agencies to commit now to re-evaluate these new capital guidelines within a set period of time, for example, in two years. At that time, the Agencies should survey the industry’s development of internal capital models and assess that development against a set of objective benchmarks that are developed in the next few months in conjunction with the industry.

## II. Specific Issues Under the Proposal

Should the Agencies determine to go forward with this rulemaking despite the above comments, SIA believes that any final rule should be revised in several respects from the proposal. In particular, SIA believes that any final capital rule should exempt from capital requirements (a) all investments that were made prior to the date of the final rule under pre-existing statutory authorities; (b) all debt instruments; and (c) all overseas investments made through the Edge Act and Agreement corporations. In addition, SIA requests that the Board clarify that the capital charge would not apply to investments in companies engaged in activities that the Board determines under the GLB Act to be complementary to a financial activity.

### A. Grandfathered Investments

SIA agrees with the Agencies’ decision not to apply the capital deduction to investments made through Small Business Investment Companies (“SBICs”). SIA is, however, disappointed by the Agencies’ refusal to extend this rationale to all investments held under statutory authorities that pre-dated the GLB Act (such as section 4(c)(6) of the Bank Holding Company Act). SIA urges the Agencies to reconsider their position.

SIA also strongly believes that, regardless of what regulatory capital standard is ultimately adopted, the retroactive imposition of any additional capital requirements to the *existing* equity investments of bank and financial holding companies made under statutory authorities that predated the GLB Act is fundamentally unfair, unjustified, and unnecessary. Imposing a capital charge on these investments, without any evidence that such investments pose a safety and soundness risk, would penalize institutions for engaging in long permissible activities. In addition, such a retroactive application of the capital requirements would produce some truly anomalous results: for instance, a bank holding company that may have no intention of engaging in new merchant banking activities and that holds the exact investments that it held prior to the passage of the GLB Act would be required to apply additional capital to support those investments, despite the fact that there has been absolutely no change in the holding company’s investment portfolio.

SIA respectfully submits that imposing a capital charge retroactively is akin to altering the rules in the middle of a game, and doing so could have adverse consequences. Specifically, the capital charge would change the economics of existing equity investments, lessen the

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<sup>2</sup> Testimony of Gov. Laurence H. Meyer, Before the Subcomms. on Capital Markets, Insurance, and Government-Sponsored Enterprises and Financial Institutions and Consumer Credit of the House Committee on Financial Services (April 4, 2001).

profitability of investments and may even turn some otherwise profitable investments into unprofitable ones. As a result, some institutions may be forced to sell certain perfectly safe and prudently managed investments, which sale could have an adverse impact not only on the bank, bank holding company, or financial holding company that holds the investment but also the portfolio company whose shares are being sold. All of these adverse consequences would occur although there has been no change in the true economics or actual risk profile of the investments.<sup>3</sup>

For all of these reasons, SIA urges the Agencies to “grandfather” entirely pre-existing investments that bank holding companies made under the Bank Holding Company Act and that banks made under other statutory authorities. In addition, SIA submits that the grandfather date should be the date of the issuance of a final capital rule, not March 13, 2000, as the Agencies have suggested. All non-financial equity investments made prior to the date of any final rule were made under a regulatory capital structure that is different from whatever structure the Agencies ultimately may determine should apply. Institutions should not be asked to manage their current investment activities in anticipation of a set of proposed rules that already have changed materially once and could well be revised substantially again. It is only after final rules are adopted that firms will have regulatory certainty as to the standards that will be applied and can reasonably be asked or expected to manage their businesses accordingly.

SIA also believes that grandfathered equity investments should be excluded when determining the aggregate size of an organization’s investment portfolio for purposes of applying the appropriate marginal rate. Not doing so merely penalizes those firms that have, in the past, successfully engaged in non-financial investment activities. Again, an example illustrates the point: If the rule is finalized as proposed, a financial holding company that is an experienced participant in the venture capital market and that, consequently, holds a sizeable portfolio of grandfathered investments may be forced to apply a higher capital charge of 12 or 25% to its new merchant banking investments. Another financial holding company that is entirely inexperienced in making non-financial equity investments would get the benefit of applying the lower 8% charge to its investments. This result appears to be flatly inconsistent with the Agencies’ goals.

B. Debt Instruments/Hedging

SIA is pleased that the Agencies’ proposal takes a different approach than its predecessor with respect to certain debt instruments. In particular, SIA agrees with the Agencies’ decision to depart from the Board’s original proposal by not treating loans to 15%-owned portfolio companies as equity for purposes of the capital rules.

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<sup>3</sup> As an alternative, the Agencies contemplate phasing in the proposed capital standards over time. SIA believes that a phase-in process would be preferable to applying the capital charge with full force to pre-existing investments on the date of the final rule. SIA requests that, if the Agencies determine to phase-in the capital standards, such rules be phased in over no shorter than five years.

SIA believes that the capital rules also should not apply to equity features of debt instruments or to debt instruments convertible to equity investments in non-financial companies. SIA submits that lenders do not make loans with equity features or that are convertible into equity for venture capital purposes; rather, such equity kickers, features, and conversion rights are often accepted by lenders to make the debt instrument more economical to and workable for the borrower and in lieu of other consideration for the extension of credit. Consequently, such equity consideration, which has been prudently accepted for decades without adverse effects, is mutually beneficial to both the borrower and the lending institution. As SIA has previously pointed out to the Board, such loans do not bear the same risks as equity and are made by departments that are entirely different from the departments that make venture capital investments. For these reasons, SIA respectfully submits that the Agencies should only apply the proposed capital treatment to debt instruments on a case-by-case basis, exclusively when the supervisory process reveals compelling circumstances that require a particular extension of debt to be treated like equity.

Additionally, it is SIA's understanding that the capital requirements of the proposal would not apply to stock positions held for hedging purposes regardless of where they may be held in the holding company structure. Clarification of this issue would be helpful in light of the specific exemption made for equity securities held by Edge and Agreement corporations for hedging equity derivative transactions for foreign customers.

C. Overseas Investments Through Edge Act & Agreement Corporations

The Agencies seek comment on whether it is appropriate to apply the capital charge to investments made through Edge Act and Agreement corporations in non-financial companies overseas. SIA firmly believes that it is not. Edge Act and Agreement corporations have been authorized to engage in international activities since 1919 and 1916 respectively, and they have a strong and unblemished track record of making international investments. Their activities are appropriately limited by Congress and do not present any new risks warranting new capital regulation.

D. Investments in Entities Engaged in Complementary Activities

The GLB Act permits the Board to allow financial holding companies to engage in activities that are complementary to a financial activity. Pursuant to this statutory authority, the Board recently proposed to permit financial holding companies to invest in firms that provide data processing, data storage, and electronic information portal services. The Board also proposed that such investments be restricted to 5% of the Tier 1 capital of the investing financial holding company so as to limit the risks of these investments.<sup>4</sup>

As currently phrased, the merchant banking capital rules appear to apply to all investments in entities that are engaged in any activities that are not "financial in nature or incidental under section 4(k) of the Bank Holding Company Act." Thus, it is at best unclear

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<sup>4</sup> 65 Federal Register 80,384 (Dec. 21, 2000). SIA commented separately on the Board's proposal. See SIA Letter to Ms. Jennifer J. Johnson, Secretary of the Board (Feb. 16, 2001).

whether the Agencies' proposed capital rules apply to investments made by financial holding companies in firms that engage in complementary activities

SIA believes strongly that the capital rules should not apply to complementary investments, which are different-in-kind from merchant banking and other non-financial equity investments. First, complementary investments serve a substantially different purpose and are more narrow than venture capital investments. As the Board has pointed out, financial holding companies may only make complementary investments in those entities that engage in businesses that relate to and enhance financial activities. Financial holding companies may, on the other hand, make merchant banking investments in companies engaged in any type of business or activity. Second, financial holding companies are required to provide the Board with 60 days' notice to engage in complementary activities. The Board also has authority to impose restrictions on the conduct of new complementary activities, just as the Board has proposed in the context of the new electronic data storage, processing, and transmission rule. By contrast, financial holding companies may make new merchant banking investments without providing prior notice or obtaining Board approval. Third, application of the capital rules to complementary investments may create practical difficulties: for example, financial holding companies could be faced with the need either to sell or to hold extra capital for a long-standing investment in a "financial" company merely because that company determines to engage in a single complementary activity.<sup>5</sup> Finally, and perhaps most importantly, application of an additional capital charge on complementary activities may well chill the desire of institutions to engage in new non-traditional activities and stymie the type of innovation in the financial services industry that Congress sought to ensure when it permitted financial holding companies to engage in complementary businesses.

Accordingly, whatever rationale may apply to imposing capital charges to merchant banking and other non-financial equity investments, there is no similar basis for imposing such capital requirements on complementary activities. For this reason, SIA respectfully urges the Board to clarify that any final capital rules do not apply to complementary investments of financial holding companies.

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<sup>5</sup> To this end, it seems inappropriate for the Board to apply the capital charge to an entire investment in a "financial" firm merely because some small percentage of that firm's business is devoted to engaging in a complementary activity.

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In conclusion, SIA believes that the Agencies' capital proposal represents a significant improvement over the Board's original capital proposal of March 2000. Nevertheless, SIA urges the Agencies to re-examine the need for any special capital charges for merchant banking and non-financial equity investments in light of both the successful track record that securities and banking firms have of making venture capital investments and the congressional mandate embodied in the GLB Act's merchant banking provisions.

SIA would be happy to meet with you to discuss our concerns regarding the Agencies' rulemaking. If you have any questions, please contact Alan E. Sorcher, Vice President and Associate General Counsel, at (202) 296-9410.

Sincerely,

James E. Reilly  
Chair  
Holding Company Committee