April 24, 2000

VIA EMAIL

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th St. and Constitution Avenue, N.W.
Washington, D.C. 20551

Merchant Banking Regulation
Office of Financial Institution Policy
U.S. Department of the Treasury
1500 Pennsylvania Ave., N.W.
Room SC 37
Washington, D.C. 20220

Re: **Merchant Banking and Capital Requirement Rules**
Docket Nos. R-1065, R-1067

Ladies and Gentlemen:

The Securities Industry Association ("SIA")[1] welcomes the opportunity to comment on the interim rules issued by the Board of Governors of the Federal Reserve System ("Board") and the Secretary of the Treasury ("Treasury") governing merchant banking activities of financial holding companies permitted by the Gramm-Leach-Bliley Act ("GLB Act") and the Board's proposed rule establishing the capital requirements for merchant banking investments and other equity investments in non-financial companies. We are in the process of carefully reviewing both rules and assessing their effect on our membership. However, we are very troubled by the restrictiveness of the rules and felt that it was crucial to bring certain matters to your attention early in the comment period, rather than in several weeks when our detailed comment letter will be filed.

SIA is concerned that the rules 1.) impose several restrictions on merchant banking activities that extend well beyond the authority granted to the Board and

[1] The Securities Industry Association brings together the shared interests of more than 740 securities firms throughout North America to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in U.S. and foreign markets and in all phases of corporate and public finance. 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 more than 600,000 individuals. (More information about SIA is available at our Internet web site, http://www.sia.com.)

Treasury under the GLB Act; and 2.) undermine the Congressional intent that the legislation, by removing the Glass-Steagall Act restrictions on affiliations between bank and securities firms, create a "two way street" between the securities and banking industries. We believe that the severe limitations placed on merchant banking activities by the rules will negate many of the intended benefits of the GLB Act and adversely impact the financial services industry.

SIA views the merchant banking provisions of the GLB Act as an essential component of the legislation, and the legislation itself as vital to the U.S. financial services industry and the nation's economy. The GLB Act removes the prior restrictions that had been placed on bank holding companies' merchant banking activities and permits financial holding company ownership of interests, including controlling interests, in any non-financial company not otherwise permissible for financial holding companies. The merchant banking provisions not only allow financial holding companies to diversify their investments and remain competitive in a global market, but also are critical to promoting capital raising and the cost-effective allocation of capital in the U.S. economy.

As proposed, the merchant banking and capital rules impose several restrictions on merchant banking activities that extend well beyond the limits imposed in the GLB Act. The GLB Act placed a full set of restrictions on merchant banking activities: investments must be part of a bona fide underwriting or merchant or investment banking activity; investments may only be held for a period of time that will permit their sale or disposition "on a reasonable basis consistent with the financial viability" of the activity; and during the period that an investment is held, a financial holding company may not "routinely manage or operate such [merchant banking] company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition." Furthermore, merchant banking investments must be held by a "securities affiliate" or an affiliate of a securities affiliate (or if the financial holding company is owned by an insurance company, a subsidiary that advises insurance companies as a registered investment advisor) and cannot be owned by a depository institution.

The many restrictions placed on merchant banking were thought by Congress to be fully adequate to assure the separation of commerce and banking and to address safety and soundness concerns. In fact, earlier versions of the legislation in the House of Representatives contained additional restrictions on merchant banking that were thought to be unnecessary and were removed from the final bill. As the staff surely remembers, the merchant banking provisions were the subject of much focus and were hotly debated. That debate resulted in a compromise by all parties – including the securities and banking industries and the Board and Treasury – that is reflected in the language of the GLB Act. Indeed, the rules now put forth by the Board and Treasury, by adding new restrictions to merchant banking, undo the compromise that was so delicately achieved.

The interim merchant banking rules and the proposed capital rules establish a complex framework that has no basis in the GLB Act within which financial holding companies may undertake merchant banking investments. Among the provisions of the

rules that we find most troubling are the aggregate investment limits placed on the amount of a financial holding company's merchant banking portfolio and the 50 percent capital requirement. The GLB Act is devoid of any provision granting the Board or Treasury authority to limit the amount of merchant banking activity, and these caps will not achieve the intended purpose of limiting potential risk, as the rule's release claims. Similarly, the Board's requirement of a 50 percent capital charge on all investments made by a bank holding company in non-financial companies also has no basis in the GLB Act. In addition, such a requirement is inconsistent with industry practice and with the successful manner in which these businesses have been operated without the requirement of such capital charges. The capital requirement would also substantially increase the cost of engaging in merchant banking for financial holding companies. Furthermore, the capital requirement, as proposed, would apply not only to merchant banking investments authorized by the GLB Act, but also to investments under the Board's Regulation K, investments under section 24 of the Federal Deposit Insurance Act, investments through small business investment companies, and investments under section 4(c)(6) or (7) of the BHC Act. We believe extending the capital requirements to these activities is an inappropriate use of the regulatory authority of the Board under the GLB Act.

We believe the rules also undermine a fundamental purpose of the GLB Act, and clearly the intent of Congress, to enable the affiliations between different segments of the financial services industry -- the so-called "two way street"-- by removing the Glass-Steagall and Bank Holding Company Acts' prohibitions. Clearly, the severe restrictions imposed by the merchant banking and capital rules will effectively close the "two way street" by deterring securities firms from becoming financial holding companies and diminishing the opportunities for financial holding companies. As the staff may remember, during the negotiations of the legislation, there was general recognition among all parties that a true "two way street" would not exist if the ultimate legislation adopted imposed restrictions on the existing merchant banking activities of securities firms. As a result, the merchant banking provisions were crafted so that securities firms could become financial holding companies without limiting their existing merchant banking activities. The GLB Act's merchant banking provisions also addressed the concern that bank holding companies would be at a competitive disadvantage if they could not engage in merchant banking activities to the same extent as securities firms. In sum, the merchant banking and capital rules, as drafted, are at odds with those essential purposes of the GLB Act.

Furthermore, many of the restrictions of the rules cannot be justified as necessary to protect the safety and soundness of depository institutions or to maintain the separation of banking and commerce – the restrictions contained in the GLB Act address those goals. Nor can these restrictions be claimed as necessary to control risk because the financial services industry – both securities firms and banking organizations – have extensive experience managing equity investments.

SIA urges the Board and Treasury to reconsider their approach to regulating merchant banking activities as reflected in the merchant banking and capital rules in light of these comments. We will be filing an additional comment letter in a few weeks that addresses all of our concerns with the rules. If we can provide any further information, please contact Alan E. Sorcher, Assistant Vice President and Assistant General Counsel, at (202) 296-9410.

Sincerely,

Stuart J. Kaswell
Senior Vice President
and General Counsel