



Securities Industry Association

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January 30, 2001

By Hand

The Honorable Paul H. O'Neill
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue
Washington, D.C. 20220

Governor Laurence H. Meyer
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Re: **Final Rule Governing Merchant Banking Activities**

Dear Secretary O'Neill and Governor Meyer:

The Securities Industry Association ("SIA")¹ is writing with respect to the final rule issued on January 10, 2001, by the Board of Governors of the Federal Reserve System ("Board") and the Department of the Treasury ("Treasury Department") governing the merchant banking activities of financial holding companies ("FHCs").

As you know, SIA and its members have been deeply concerned about the merchant banking regulations of the Board and Treasury Department since the agencies issued their interim rule and the Board issued its initial capital proposal. SIA shared its concerns about these rules with the two agencies in detailed comment letters that it filed last spring. SIA also presented those concerns to Congress in a series of hearings that were held on Capitol Hill during the summer. At these times, SIA offered as well to assist the Board and Treasury Department to understand better prevailing industry practices because SIA believed that the agencies'

¹ SIA's membership includes more than 740 securities firms, including investment banks, broker-dealers, and mutual fund companies throughout North America. SIA member firms 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 for 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>.)

misapprehension of those practices led them to issue overly restrictive rules that would adversely affect the industry. We still remain available to provide whatever industry feedback is needed.

SIA is pleased that the Board and Treasury Department have acknowledged many of the significant issues and concerns raised by SIA and other industry members in the final rulemaking. The revisions made to the interim rule in response to those concerns represent positive -- albeit partial -- steps towards devising a set of merchant banking rules that meet the congressional objective in the Gramm-Leach-Bliley Act ("GLB Act") of permitting securities firms that choose to affiliate with FHCs to continue their merchant banking activities to the same extent as before they were so affiliated. In particular, SIA commends the agencies for removing the dollar cap on total merchant banking investments and establishing a "sunset" provision that will eliminate the cap that is based on Tier 1 capital once the Board issues final capital rules. SIA also supports the expanded definition of "private equity fund" and the adoption of safe harbors that allow FHCs to make certain merchant banking investments without being subjected to affiliate-transaction limitations.

Although SIA believes that these changes are moves in the right direction, SIA continues to have serious concerns about the final merchant banking rule. In its totality, the final rule presents an overly burdensome array of restrictions and limitations on merchant banking activities that are neither mandated by safety and soundness concerns nor in keeping with the language or spirit of the GLB Act. SIA respectfully submits that safety and soundness can be addressed through supervisory guidance, such as the Supervisory Letter that the Board issued in June 2000, and with rules that are far less restrictive and complicated than what has been adopted.

Moreover, as SIA pointed out in its comment letters and congressional testimony, Congress, when it passed the GLB Act, sought to create a true "two-way street" between banks and securities firms. To this end, both the House and Senate Banking Committees emphasized that the merchant banking provisions were intended to grant securities firms the same opportunities to engage in merchant banking whether or not they chose to affiliate with FHCs. Unfortunately, the final rule simply does not reflect this approach; instead, the regulatory structure chosen by the Board and Treasury Department remains unnecessarily complicated given the statutory language and clear congressional intent.

It is plain that securities firms that are not part of a FHC family do not face the types of detailed and burdensome restrictions that are set forth in this rule. As a consequence, and because merchant banking is such an important part of the business of many securities firms, these rules will deter securities firms from becoming FHCs and will limit affiliations between securities firms and banking companies. This outcome is at odds with what Congress intended.

Particular aspects of the final rule also trouble SIA. To cite one example, the final rule retains the interim rule's arbitrary limits on the ability of FHCs to hold investments beyond 10 years (or 15 years for private equity fund investments). As SIA noted in its comment letter, these pre-set holding periods are plainly at odds with the flexible limits mandated by Congress in the GLB Act. Similarly, SIA remains concerned about the yet undefined reporting requirements in the final rule. SIA believes that detailed reporting and recordkeeping requirements impose

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needless costs on merchant banking activities and contradict the GLB Act's dictate to the Board to reduce the regulatory burden it inflicts on FHCs. The rule should also provide greater clarity as to the status of restrictive covenants commonly used by securities firms to protect their rights as minority investors. In addition, SIA continues to believe that the prohibition on interlocks between FHCs and portfolio companies can be more narrowly drafted to achieve the GLB Act's statutory purpose while granting securities firms needed flexibility in managing their merchant banking businesses.

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In sum, given the substance and number of concerns that were raised by SIA and others, the final rule represents only a modest improvement over the interim rule. SIA respectfully urges the Board and the Bush Administration Treasury Department to re-examine the final merchant banking rule in light of the clear congressional mandate embodied in the GLB Act's merchant banking provisions. SIA hopes that the agencies will, ultimately, fashion a rule that encourages rather than impedes the "two-way" street and new merchant banking investment activity.

We would be happy to meet with you to discuss our concerns with the rule further. If you have any questions, please contact Alan E. Sorcher, Vice President and Associate General Counsel, at (202) 296-9410. Thank you for your time and consideration.

Sincerely,

Richard T. Chase, Chair
Holding Company Committee

cc: The Honorable Richard Baker (By Hand)

The Honorable Michael G. Oxley (By Hand)

The Honorable Phil Gramm (By Hand)

The Honorable Spencer Bachus (By Hand)

J. Virgil Mattingly, Jr., General Counsel
Federal Reserve Board (By Hand)