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By Hand and Via Electronic Mail

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Secretary
Board of Governors of the Federal Reserve System
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Merchant Banking Regulation
Office of Financial Institution Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, 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") submits this letter to supplement the comments that it filed on April 24, 2000, regarding (1) the interim rule issued jointly by the Federal Reserve Board ("Board") and the Department of Treasury ("Treasury") governing the merchant banking activities of financial holding companies ("FHCs"), and (2) the proposed rule issued by the Board establishing capital requirements for merchant banking and other investments in non-financial companies by FHCs and bank holding companies.

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.[1] SIA believes that its membership and focus make it particularly well-positioned to comment on the merchant banking rules from the perspective of the securities industry and securities firms, whether or not such firms have partnered with banks.

[1] 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.

As we noted in our initial comment letter, SIA and its members are deeply concerned that in several key respects the merchant banking rules set forth by the Board and Treasury are not in accordance with what Congress intended in enacting the Gramm-Leach-Bliley Act ("GLB Act"). Among SIA's primary concerns are that: 1.) the rules extend beyond the restrictions authorized by the GLB Act and undermine the Congressional intent that there be a "two-way street" between the securities and banking industries; 2.) the capital charge is not in accord with industry practice, will require FHCs to increase their capital levels, and should not be applied retroactively to investments made under other pre-existing authority; 3.) the aggregate investment limits are arbitrary, have no basis in the GLB Act, and will unfairly penalize both FHCs with large investment banking operations and those with successful merchant banking operations; 4.) the holding periods are inconsistent with the terms of the GLB Act and will cause FHCs to dispose of investments prematurely; 5.) the definition of private equity fund is too narrow and does not reflect the economic and business realities of how such funds are operated; and 6.) the internal controls, recordkeeping and reporting requirements are overly burdensome. In addition, our letter addresses many other issues raised by the rules that are of concern to our membership.

I. Introduction

SIA believes that the merchant banking rules -- and, in particular, the proposed capital haircut and the total cap on merchant banking activity -- will have a significantly adverse affect on the ability of securities firms within FHCs to make merchant banking and other permissible investments on the same scale and to the same extent as securities firms that are not part of a FHC family. In addition, because merchant banking is such an important part of the business of many securities firms, the existence of these restrictive rules will discourage securities firms from becoming FHCs and will hamper and limit affiliations between securities and banking companies. In short, the merchant banking rules will recreate the segmentation of and the "unlevel playing field" in the financial services industry that is at the very core of what Congress sought to abolish with the repeal of Glass-Steagall and the enactment of the GLB Act.

SIA recognizes that the Board and Treasury may have legitimate concerns about the conduct of merchant banking activities by some FHCs and that the agencies wish to foster the development of safe and sound merchant banking practices – although the GLB Act's provisions adequately address safety and soundness concerns. Yet, the instant rules -- which treat all FHCs alike regardless of their expertise and experience with venture capital and merchant banking investments -- will have the perverse effect of actually increasing, rather than reducing, the risks of merchant banking activities. SIA respectfully submits that the Board's and Treasury's safety and soundness concerns can be better addressed through the Board's ample supervisory authority over FHCs and with rules that are far less intrusive and restrictive than what has been set forth in the instant rulemaking. Such a course would allow the Board to differentiate poorly managed firms from others; would encourage and reward institutions that develop sound internal merchant banking practices; and, perhaps most importantly, would be consistent (in a way that the current rulemaking is not) with the authority vested by Congress with the Board and Treasury to adopt

merchant banking rules that foster rather than stymie the flow of capital to small and mid-sized companies and that permit full and effective competition in a unified financial services industry.

Finally, SIA believes that this rulemaking sends a powerful and unambiguous signal to the securities industry that, congressional directives notwithstanding, the Board and Treasury are still taking a pre-GLB Act view of the financial services marketplace in which bank-affiliated securities firms will for no good reason be treated differently from firms that are not part of FHCs. SIA submits that the needlessly restrictive posture taken in this rulemaking, and what this augurs for how the Board will regulate and supervise other aspects of FHC securities activities, will very likely deter securities firms from seeking FHC status and may be one of the chief reasons why -- contrary to what most industry observers had predicted prior to passage of the GLB Act -- major securities firms have thus far not elected FHC status. In short, with due respect, unless the Board and Treasury take a different tack, the financial services reform born of years of painstaking effort by Congress, the Board, Treasury and industry participants, including SIA, may be aborted by the regulatory implementation of the merchant banking provisions of the GLB Act.

II. Legislative History of the GLB Act

As the Board and Treasury are well aware, SIA and other industry representatives were important advocates for financial services reform. SIA's support for the legislation, like that of the Board's, was predicated on the establishment of what Chairman Greenspan aptly called a "two-way street," in which securities firms and banks could freely affiliate with each other and in which the activities of securities firms -- whether or not affiliated with banks -- would not be artificially restricted.[2] To advance this "two-way street," the Board and SIA also supported granting full merchant banking authority to FHCs. SIA advocated a broad description of merchant banking activities in the legislation so as to assure the "continuance of industry [3]

Congress heeded these calls from the Board, SIA and others. First, it expressly authorized FHCs to engage fully in the business of merchant banking. Second, it sought to ensure that, consistent with the creation of a true "two-way street," securities firms would have the same opportunities to engage in merchant banking (and other financial activities) whether or not they joined forces with banking partners. To this end, both the House and Senate Banking

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[2] *See* Testimony of Chairman Greenspan, Before the Senate Banking Committee (June 17, 1998); *see also* Testimony of Chairman Greenspan, Before the Subcomm. on Financial and Hazardous Materials of the House Commerce Committee (Apr. 28, 1999) (to prohibit bank-related investment banks from participating in merchant banking activities "would put them at a competitive disadvantage").

[3] *E.g.*, Testimony of Marc E. Lackritz, SIA President, Before the Senate Banking Comm. (Feb. 25, 1999); Testimony of Roy J. Zuckerberg, SIA Chairman, Before the House Banking and Financial Services Comm. (Feb. 10, 1999).

Committees emphasized that the merchant banking provisions are intended to permit securities firms that affiliate with FHCs to continue their merchant banking activities "in substantially the same manner as at present." H. Rep. No. 106-74, at 123; S. Rep. No. 106-44, at 9 (mandating that securities firms affiliated with FHCs "should not be placed at a competitive disadvantage with firms unaffiliated with any depository institution").

To safeguard against any potential risks that poorly run merchant banking programs could pose to FHCs and their depository institutions (as well as to ensure that the line between banking and commerce would not be breached), Congress imposed specific statutory restrictions on merchant banking activities. As the Board and Treasury well know, these restrictions were the subject of much debate during the legislative process. The Board, Treasury and industry participants, including SIA, each gave their views to Congress about the merits of these and other proposed limits on the merchant banking activities of FHCs. Industry participants, including SIA, argued strongly that some of these limits on merchant banking should be eliminated or modified; others argued equally vociferously that additional restrictions were warranted.[4]

Congress weighed these conflicting views and apparently concluded that the restrictions that it ultimately included in the GLB Act represented the proper balance between keeping open the "two-way street" and ensuring that merchant banking activities do not expose insured depository institutions to unacceptable potential risks or allow an impermissible combination of banking and commerce. Participants in the legislative debate may have disagreed then (or may disagree now) with the congressional calculus, but the restrictions in the GLB Act are what Congress chose. Ultimately, since the Board, Treasury and industry groups all supported enactment of this bill, this is also what everyone determined was an acceptable compromise and one with which they could live.

III. General Concerns with the Board's and Treasury's Rulemaking

Congress, of course, did grant the Board and Treasury authority to issue implementing regulations. But Congress limited the rulemaking authority that it granted to the agencies: it forbade the Board and Treasury from upsetting the delicate statutory balance that it crafted and from doing anything to close or narrow the "two-way street." *E.g.*, H. Rep. No. 106-74, at 123 (in adopting rules governing merchant banking investments, the Board and Treasury "*shall* take into account that investment banking firms affiliated with depository institutions should be able to compete on an *equal basis* . . . with firms unaffiliated with any depository institutions") (emphasis added). Thus, the regulatory authority granted by Congress was by no means a blank check for the Board and Treasury to write whatever rules they felt appropriate, much less to override the legislative compromise that Congress painstakingly achieved. Had there been such a grant of open-ended discretion, the specific limits that were imposed by Congress in the statute would not have been the subject of such strenuous debate and so much legislative attention. After all, what would have been the point of quibbling over the wording of the statutory

[4] *See, e.g.*, S. Rep. No. 106-44, at 73.

language if the Board and Treasury could simply do whatever they deemed best after the legislation was enacted?

SIA submits that, in several respects, the Board's and Treasury's rules have cast aside the legislative compromise that is reflected in the statutory language of the GLB Act. They have imposed restrictions in the two merchant banking rules -- such as the maximum cap on merchant banking investments and the 50-percent capital charge on merchant banking and other nonfinancial investments -- that are not found anywhere in the GLB Act and were never contemplated by Congress. They have imposed other restrictions -- such as the inflexible maximum holding period for merchant banking investments -- that have some basis in the GLB Act but are being implemented in a manner that is at odds with what Congress clearly directed.

In this regard, SIA suggests with all due respect that these extra-statutory elements in this rulemaking represent a complete and unfair surprise. During the extensive legislative debates on merchant banking, the Board and Treasury never suggested that capital charges, maximum caps or inflexible holding period limits were necessary limits on FHC merchant banking activities. Had the Board and Treasury felt such rules would be necessary, this should have been part of the debate before Congress. In that case, SIA (and, most likely, other industry groups) would have argued strongly against such restrictions (as they are doing now). Moreover, had such limits been part of S. 900 when it emerged from the Conference Committee, SIA (and other industry groups) might well have determined not to support this legislation because it would not have allowed the creation of the "two-way street."

Let us be clear on what these rules do: they destroy the "two-way street" that is at the very core of the GLB Act by placing unwarranted restrictions on securities firms that are part of FHCs. The capital hit, the total investment limit and the inflexible maximum holding period are not limits that are imposed on securities firms that are unaffiliated with banks. Consequently, these limits place securities firms that are part of FHCs at a decided competitive disadvantage by artificially restricting FHC merchant banking activities and making it prohibitively more expensive for FHCs to make venture capital investments. For this reason, many securities firms -- for which, as Chairman Greenspan stated, the ability to make venture capital investments is a key activity[5] -- will be discouraged, if not effectively barred, from acquiring banks and becoming FHCs. This outcome is at odds with what Congress intended (and what the Board, Treasury and SIA all supported) when the GLB Act authorized merchant banking activities for FHCs.

The Board and Treasury seem to justify their action on two principal grounds, which are baseless. First, they regard the extra-statutory measures as warranted because, in their view, the new merchant banking powers will permit FHCs to engage in a novel and particularly risky activity. Second, the Board and Treasury believe that the extra-statutory measures are fully

[5] Testimony of Chairman Greenspan, Before the Subcomm. on Financial and Hazardous Materials of the House Commerce Committee (Apr. 28, 1999).

consistent with current industry practice. SIA respectfully disagrees with these positions, as explained below.

A. *Risk*.

As to the first point, SIA acknowledges that merchant banking investments do entail potential risks. But it is an open question -- and one that the Board and Treasury do not attempt to answer in the rulemaking -- as to whether merchant banking activities do, in fact, expose firms to greater risks than other securities and financial activities, such as underwriting, dealing, market making or complex derivatives transactions for which there are no 50-percent capital charges or activities limits akin to what is contained in the instant rulemaking. The experiential history suggests strongly that the risks of merchant banking are no more significant than the risks of other financial activities. Indeed, as Chairman Greenspan recently pointed out, securities firms and bank holding companies have both participated in venture capital markets for several decades -- a span of time that includes both bull and bear equity markets -- "without significant [6]

Surprisingly, the Board and Treasury act as if they are entirely unaware of this successful history. The merchant banking rules are written as if venture capital activities are novel for securities firms affiliated with FHCs. This is not the case; securities firms affiliated with banks have engaged in merchant banking, in some instances, for several decades. Accordingly, these firms have well-established policies and procedures for making, managing and monitoring their venture capital businesses.

There is no reason to believe that the new merchant banking powers granted to bank-affiliated securities firms will lead to riskier conduct or to conflicts that cannot be managed as successfully as securities and banking firms have managed them in the past. In fact, the Board and Treasury do not appear to dispute this point: They argue that the risks of equity investments are the same regardless of the statutory authority for those investments. After all, it is on this basis that the Board proposes that a capital charge apply both to merchant banking investments made under the GLB Act and to other investments made under long-standing, prior authority.

Of course, the new merchant banking powers granted to FHCs by the GLB Act will likely result in a deeper involvement in the venture capital markets by securities firms that were bank affiliated prior to the passage of the GLB Act. But such increased involvement will also permit more successful diversification and less concentration within venture capital portfolios. Moreover, in the past, bank-affiliated securities firms were generally restricted to taking minority (and largely non-voting) stakes in portfolio companies. Under the GLB Act, FHCs will be able to take controlling stakes, which are more liquid and permit quicker exit by FHCs. FHCs will also be able to exercise control over portfolio companies, and thus have the ability to intervene in situations of excessive risk-taking by portfolio companies.

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[6] Speech by Chairman Greenspan at the Fed'l Res. Bank of Chicago (May 4, 2000).

Finally, in the preamble to the rulemaking, the Board and Treasury appear to suggest that the capital charge and other extra-statutory measures contained in this rulemaking are necessary because the GLB Act contains provisions that are designed only to maintain the separation of banking and commerce. This is not correct. As noted above, Congress was fully aware of the potential risks posed by merchant banking, and it adopted a full set of statutory measures to safeguard against these risks. For example, Congress prevented merchant banking investments from being held by depository institutions; adopted special rules under sections 23A and 23B of the Federal Reserve Act to govern transactions between merchant banking portfolio companies and commonly controlled depository institutions; and imposed a five-year moratorium on the financial subsidiaries of depository institutions engaging in merchant banking activities. Congress nowhere suggests that these safeguards are incomplete and that they need to be supplemented by significant new measures, such as 50-percent capital haircuts or total investment caps, by the Board and Treasury.

In addition, as the Board and Treasury well know, the GLB Act requires that a bank holding company seeking to take advantage of the new venture capital authority must meet certain qualifying criteria. Specifically, the firm must ensure that all of its subsidiary insured depository institutions are well capitalized and well managed. SIA submits that these requirements -- when added to the special section 23A and 23B restrictions adopted by Congress with respect to merchant banking -- fully protect insured depository institutions from any risks posed by the venture capital activities of their affiliated securities firms.

For these reasons, SIA submits that the safety and soundness concerns of the Board and Treasury should be dealt with by implementing the specific restrictions that Congress chose and spelled out in the GLB Act and through the careful exercise of the Board's ample supervisory authority. Should an examination indicate that a particular institution is engaged in unsafe merchant banking activities, that institution can be restrained through supervisory measures. Should examinations reveal industry-wide practices that are problematic -- which, notably, the Board and Treasury do not claim to have found -- then the agencies may consider extra-statutory rules (provided that those rules accord with the "two-way street").

B. *Industry Practice*.

The Board and Treasury also justify this rulemaking as consistent with industry practice. According to the preamble, Treasury and Federal Reserve System staff interviewed several securities and banking firms to gauge current industry practices. On the basis of these several interviews, the agencies believe that their rules do nothing more than formalize the industry's approach to making, managing and monitoring merchant banking investments.

SIA's own informal survey of its members and its conversations with other industry participants (all of which is no more, but no less, scientific than the agencies' apparent approach) reveals that industry practice is, in fact, far more varied than the Board and Treasury suggest. For example, some firms indicated that, while they do maintain internal capital charges for merchant banking positions, those charges vary significantly depending on a variety of factors,

including the nature of the portfolio investment and internal risk models. Other firms indicated that portfolio investments are at times held for longer than the 10 years at which the agencies propose to cap merchant banking investments. This leads SIA to believe that in many respects -- and particularly with regard to the capital haircut -- industry practice is simply not in accord with the Board's and Treasury's rulemaking. In fact, SIA respectfully submits (a point that hopefully the Board and Treasury have come to recognize), were industry practice in-line with what the Board and Treasury claim, the outcry over this rulemaking from both the securities and banking industries would have been far more muted.

If the Board and Treasury wish to base their rulemaking on how the securities and banking industries actually conduct their venture capital activities, then a far more systematic and thorough analysis is warranted before this rulemaking goes forward. To be fair to the industry and to gain an accurate picture of what is actually occurring, the agencies should not only conduct a few interviews with random and unnamed industry participants (as they have done) but also gather information through public comments, comprehensive surveys, on-site examinations and research analysis. SIA submits that the two agencies have significant tools at their disposal to gather the necessary information, which SIA thinks will reveal practices quite different from what the Board and Treasury currently believe to be common. SIA commits to assist in such information gathering.

IV. Particular Concerns with the Board's and Treasury's Rulemaking

A. *The 50-Percent Capital Charge*

SIA believes that, in several respects, the Board's 50-percent capital charge is the most troublesome aspect to the merchant banking rulemaking. SIA is aware that others have addressed in detail both the significant adverse effect that the capital charge will have on FHCs and bank holding companies, and the unfairness of applying a capital charge retroactively on pre-existing bank holding company investments; SIA will not repeat all of those points here. Suffice it to say that, in SIA's view, the capital charge will increase the cost of merchant banking and other nonfinancial investments to securities firms owned by FHCs and bank holding companies and, thereby, disadvantage these institutions as compared to securities firms that are unaffiliated with banks, which are not required to hold excess capital in the fashion mandated by the Board.

One of the Board's principal defenses of the capital charge is that some securities firms, as part of their internal risk modeling, apply high capital charges to their equity investment activities. First, SIA's own review and discussions indicate that a 50-percent capital deduction is by no means universally applied. Instead, securities firms apply varied capital deductions to portfolio investments. They often make distinctions between securities holdings involving public and private equities -- with investments in the former typically requiring less capital because such investments are more liquid and less risky than the latter. Securities firms also distinguish between portfolio companies based on the firm's experiences with a company, or the firm's knowledge of the industry or market in which the company operates. The Board's

uniform capital deduction does not leave room for such common, necessary and wise adjustments.

Second, even if the Board is correct that some securities firms do maintain high capital charges for equity investments as part of their internal models, the Board ignores the fact that those internal models also apply lower capital charges to other assets, which the firms regard as comparatively safe. SIA respectfully submits that it is inappropriate and unfair for the Board to take a single part of an *internal securities* capital model and to apply it out of context in an entirely different arena -- to mandate a *bank regulatory* capital requirement.

The Board seems to believe that, whatever the flaws of its proposed capital charge, those flaws have no practical significance because FHCs and bank holding companies will remain well capitalized even after application of the 50-percent capital deduction. The Board is incorrect in this view.[7] Although institutions may not, by imposition of this rule, immediately fall from well-capitalized status, institutions typically need to maintain higher internal capital to have a cushion above their regulatory capital requirements. That cushion serves a variety of purposes, including providing protection from unanticipated events. A mandatory increase in the required regulatory capital for merchant banking does *not* eliminate the need for institutions to maintain a cushion above their regulatory minimums. Thus, the proposed capital charge will require FHCs and bank holding companies to increase their capital levels, which will have a real effect on earnings, stock prices and possibly debt ratings.

Despite these real business and economic consequences, consideration of some form of extraordinary capital treatment for merchant banking investments (albeit, treatment that is far less draconian than the proposed 50-percent charge) might have been warranted if the Board perceived some deficiency or industry-wide problem with respect to the industry's merchant banking activities. But the Board has found no such issues or problems; instead, the Board applies the charge as a preemptory measure to safeguard against the mere possibility of excessive risk. SIA submits that it is wrong for the Board to impose such a harsh charge on an entire industry without any evidence of inadequate practices or inappropriate internal controls, especially when the effect of this charge is to undermine the statutory authority to engage in merchant banking and the "two-way street" that is at the core of the GLB Act.

Moreover, SIA does not believe that the capital charge will actually improve FHC safety and soundness. To begin with, the capital haircut will raise the cost of making merchant banking investments; those increased costs, in turn, will pressure FHCs to make riskier investments in search of the greater rates of return necessary to offset the capital hit. In addition, SIA submits that the Board's proposal is flawed because it does not promote the development of better merchant banking practices. By applying a single uniform capital charge on all investments

[7] The prevalent industry view is that the proposed capital charge will require an eight-fold increase in the regulatory capital required for merchant banking investments. Whether or not eight is the correct figure, there can be no denying that the capital charge would increase by a significant and dramatic percentage the amount of capital necessary to support equity investments.

made by all institutions, institutions do not gain incentives to manage or monitor more carefully their portfolio investments. Instead, FHCs are penalized by the capital charge regardless of what they do. Proper incentives can only be supplied through an individualized approach.

The Board has requested comment on alternative approaches to the special capital charge. SIA submits that the best approach would be for the Board to utilize flexible standards and to rely on the very internal capital models that it cites in the preamble to the rulemaking. Such an approach would require FHCs to maintain a higher internal capital level for equity investments but allow that capital charge to vary according to such factors as the size and nature of the investments made; the size of the overall venture capital portfolio; and the extent of the securities firm's experience with merchant banking activities. Such a flexible approach would, indeed, be in line with industry practice (in a way that the Board's 50-percent charge is decidedly not) and would address the Board's safety and soundness concerns. Through the supervisory process, the Board should monitor the internal capital models applied by individual institutions to ensure that the models appropriately account for the risks of the firm's merchant banking activities. If a FHC fails to develop and maintain an adequate internal capital model, then that institution may be subjected to an additional special capital charge.

SIA understands that other commenters also have suggested a variety of thoughtful alternatives to the 50-percent capital charge. For example, one of those approaches is applying a 200 percent risk weighting to equity investments. SIA (probably like many other commenters) has not had an opportunity to review and to consider all of these varied approaches with its membership, and believes that these approaches are generally less desirable than the flexible standards that it has suggested above. However, many of the suggested alternatives are at least preferable to the Board's 50-percent capital charge. Therefore, if the Board determines not to rely on the flexible approach that SIA recommends, the Board should submit the various capital alternatives suggested by individual commenters to the public for consideration and comment.

Whatever approach the Board ultimately takes, SIA strongly believes that investments made under pre-existing authority (such as section 4(c)(6) of the Bank Holding Company Act) by bank holding companies and FHCs should not be subjected to these charges. Limited equity investments under these authorities have been made for decades without an additional capital charge and without any adverse effects. SIA further submits that the Board would be unjustified in applying the capital charge *retroactively* to investments that are currently held. The imposition of a capital charge retroactively on existing investments would have significant adverse consequences. The capital charge would alter the economics of existing investments, and in some cases render unprofitable once cost-effective and sound investments. The result could be to force a "fire sale" of investments that have been rendered too costly only because the Board has changed the rules in the middle the game. All of this will occur even though there has been no change in the risk posed by the investment. With all due respect, this does not make any sense.

Finally, SIA strongly believes that the Board's decision to treat senior loans to a 15-percent owned portfolio company as common equity for capital reserve purposes is particularly

unwarranted. To begin with, SIA believes that the internal capital models of securities firms do not apply extra capital charges to debt instruments. Thus, the Board cannot rely on the same justification with respect to debt instruments that it attempts to use to support its treatment of equity investments. Second, the Board's position is that senior debt does not bear the same risk as an equity investment; after all, that is the Board's justification for this proposal. Assuming that the Board's position is correct, it is logically inconsistent to treat senior loans to the same charge as equity investments by mere virtue of the fact that the FHC holds a minority equity stake in the borrower. Moreover, senior loans made to merchant banking portfolio companies are subject to the same approval and monitoring process as any other loan to any other firm. In fact, such loans typically are made by departments that are entirely different from the one that has made the venture capital investment decision and are often made without consideration of any equity stake hold.

B. *Aggregate Investment Limits*

The interim rule establishes aggregate investment limits or caps on FHC merchant banking investments. Such caps -- which are nowhere to be found in the GLB Act -- are based on the lesser of a fixed dollar limit ($6 billion or $4 billion, after excluding private equity fund investments) or a set percentage of Tier I capital (30 percent of Tier I capital or 20 percent, after excluding private equity investments). The Board permits a FHC to invest a greater amount only with prior approval.

SIA finds several aspects of the caps to be highly objectionable. First, the Board and Treasury provide no explanation in the interim rule on why they believe percentage or dollar limits set at these levels are appropriate. These limits seem quite arbitrary and certainly do not reflect the securities industry's past practice in making merchant banking investments.

In addition, the $6 billion flat dollar cap unfairly penalizes FHCs with large securities and investment banking operations -- even those FHCs that have plenty of Tier I capital to support their investment banking programs. For example, under this dollar cap, a FHC with $60 billion in Tier I capital will hit the flat dollar limit at the same time as another FHC that has less than half that amount in Tier I capital. SIA submits that the two institutions do not warrant the same regulatory treatment.

A percentage cap that is based on the carrying value of equity investments -- as is the case in the interim rule -- has the further perverse effect of penalizing firms with *successful* merchant banking programs. Another example illustrates the point: If two FHCs have invested the same amount of money in merchant banking, the FHC with a strong merchant banking program, whose portfolio has shown significant gains, runs the danger of hitting the cap. The other FHC, with a poor merchant banking program that has achieved only losses, will not hit the cap and can continue making additional merchant banking investments. SIA respectfully submits that this is not a sensible result and cannot be what the Board and Treasury are trying to achieve.

SIA also believes that the dollar limits are set at such a low level that securities firms with significant merchant banking operations will quickly reach -- or, in some cases, may have already passed -- the limit and, then, will be automatically precluded from further merchant banking investments or prohibited from merging with other firms. For example, securities firms with significant merchant banking activities are not likely to take any chance of running into this type of barrier to their investment banking and venture capital business; rather, they may merely avoid affiliating with banks or becoming FHCs. In addition, a FHC with a significant investment banking business may be prevented by the caps from acquiring a securities firm that also engages in significant venture capital activities. In this case, the caps would have significant antitrust consequences.[8] In any event, it is clear that the caps defeat the "two-way street."

Perhaps in recognition of these adverse consequences, the Board and Treasury suggest that the caps are a temporary measure until the agencies become more familiar with merchant banking. But the possible temporary nature of the caps does not mitigate their adverse effects. SIA believes that securities firms are not likely to merge with banking firms until and unless the caps are eliminated. In addition, to the extent that the aggregate investment caps and other aspects of the merchant banking rules are motivated principally by the Board's and Treasury's confessed unfamiliarity with the merchant banking business, SIA respectfully submits that the proper regulatory approach is not to impose severe and extra-statutory limits on the conduct of an activity that Congress specifically authorized. Rather, the Board and Treasury should first undertake a comprehensive and systematic analysis of the market (which they have not done) and then, based on their understanding of how the market operates, propose rules that are in line with their statutory authority to govern certain market practices. *Cf.* Securities and Exchange Commission Release No. 34-38672 (SEC "concept release" soliciting comment on a broad range of questions concerning the oversight of alternative trading systems, national securities exchanges and foreign market activities in the United States, and basing a decision to propose regulations on what is learned from those comments).

C. *Maximum Holding Periods*

The interim rule imposes a maximum holding period on FHC merchant banking investments, which the Board and Treasury believe implements the GLB Act requirement that a merchant banking investment be held for no longer than such "period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability" of the investment. The interim rule generally permits FHCs to hold merchant banking investments for a period of up to 10 years. The Board and Treasury allow a longer holding period, only in extraordinary circumstances, with Board approval and subject to a 100-percent capital charge. Written requests for approval must be filed at least one year prior to the expiration of the normal holding period.

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[8] *Cf. SIA v. Board*, 839 F.2d 47 (2d Cir.) (finding, in the context of section 20 of the Glass-Steagall Act, that the Board did not have any justification for imposing a market-share limitation on the underwriting and dealing activities of securities firms affiliated with banks), *cert. denied*, 486 U.S. 1059 (1988).

As an initial matter, SIA strongly believes that the imposition of a uniform maximum holding period is inconsistent with both the plain meaning of the GLB Act and its unambiguous legislative history. As noted above, the language of the GLB Act requires only that a merchant banking investment be held for no longer than such period of time as will allow the sale or disposition of the investment, consistent with the financial viability of that investment. What the GLB Act specifically avoids is placing a pre-set time limit on how long an investment may be held. Had Congress intended such a fixed time period, it clearly could have and would have established such a limit.

The legislative history makes it even clearer that Congress intended the holding period for an investment to be flexible and left within the discretion of the FHC. For example, the House-Senate Conference Committee explicitly noted that the decision to dispose of an investment should be made by a FHC on the basis of a variety of factors, including the "overall conditions in the financial or other markets, the nature of the portfolio company's business, the financial condition and results of operation of the portfolio company, opportunities for selling or disposing of all or part of the investment or portfolio company in a manner which will maximize investment return, and any fiduciary, contractual, or other duties to co-investors and advisory clients." H. Rep. No. 106-74, at 123. In addition, the Senate Banking Committee stated that the Board's authority was limited to challenging a FHC's exercise of its discretion in cases involving clear abuse. *See* S. Rep. No. 106-44, at 9 ("the Board should challenge the [FHC's] *exercise of discretion* regarding the duration of an investment *only if* [it is] clearly inconsistent with the purposes of this section") (emphasis added).

On this basis, SIA respectfully submits that the GLB Act does not permit the Board and Treasury to impose a pre-set limit on how long investments may be held. SIA also believes that there is no statutory basis for the prior application requirement for a longer investment period; in fact, this "application" requirement is contrary to the entire approach in the GLB Act, which is designed to do away with applications and prior requests to the regulatory agencies to engage in permissible financial activities. The truly draconian capital charge that applies to investments held beyond the prescribed time limit is unjustifiably punitive and also should be deleted. With all due respect, SIA believes that there is no valid reason for such a charge to apply merely because a FHC could not dispose of a *bona fide* merchant banking investment on an arbitrary date picked by the regulators.

SIA submits that the maximum holding period will have undesired safety and soundness effects. The holding period will pressure FHCs to dispose of investments prematurely at a price below true value just to avoid the regulatory burdens and capital hits imposed by this rule. SIA's membership indicates that, under securities industry practice, it is not common for venture capital investments to be held for 10 years, but investments may be held for 10 years or more if there are circumstances that prevent their profitable sale or disposition. In any event, merchant banking investments are rarely held for 15 years. SIA believes that, when unusual circumstances require a FHC to hold an investment for more than 10 years, it is counterproductive and unsafe for the Board and Treasury to impose rules that force a FHC to abandon that investment. Such

an outcome is plainly not in the best interest of the FHC that is forced to dump its investment, its shareholders or the Board.

SIA believes that the restriction found in the GLB Act -- that merchant banking investments be held for only for such period of time so as to enable their reasonable sale or disposition -- was designed to ensure that the merchant banking authority was not used for impermissible strategic investments or joint ventures with non-financial companies. SIA submits that the Board can rely on the supervision and examination process to ensure that a FHC is not using its merchant banking authority as a subterfuge to carry out impermissible activities. We suggest as an alternative approach that the Board consider imposing additional reporting requirements for investments that are held more than 15 years -- such reporting should enable the Board to engage in the necessary additional monitoring of long-standing investments. Such an approach not only would be consistent with the clear intent of Congress, but also would help ensure that FHCs are not forced to "fire sale" *bona fide* merchant banking investments merely because a random pre-set age limit had been crossed.

If, despite all of these arguments, the Board and Treasury still determine to impose a maximum holding period, SIA suggests that this uniform holding period should be 15 years for all merchant banking investments. Nor does SIA believe that the Board should require one-year prior notice for an extension beyond this maximum holding period limit. A FHC may not know one year in advance whether or not it will need an extension -- for instance, a planned sale could get derailed months before the 10-year period lapses due to a change in market conditions or a variety of other factors. SIA suggests that a three-month prior notice should more than suffice. Lastly, if the Board has approved the holding of an investment beyond the prescribed holding period, no special 100-percent capital charge should apply.

D. *Private Equity Funds*

The Board's and Treasury's rulemaking distinguishes between direct investments of FHCs and investments made through private equity funds. The interim rule imposes fewer restrictions and limits on portfolio investments made through private equity fund vehicles.

SIA supports, and believes quite appropriate, the decision to treat investments made through private equity funds differently from direct investments. SIA believes, however, that the definition of private equity fund adopted by the Board and Treasury is far too narrow and does not reflect the economic and business realities of how such funds are currently operated. In fact, the experience of SIA's members indicates that most private equity funds will not meet the stringent definitions adopted by the agencies.

For example, the agencies' definition restricts private equity funds to 12-year terms (with a maximum of three annual extensions thereafter). SIA's members indicate that the tenure of private equity funds typically is not limited to 12 years. In fact, investors in private equity funds demand flexibility in the terms of such funds; for this reason, private equity funds at times have

durations that extend beyond the 15-year maximum imposed by the Board. SIA suggests that there is no reason to limit the life of a private equity fund artificially to 12 years.

The Board and Treasury also have stated that (a) a qualifying private equity fund must be held by at least 10 investors that are unrelated to the FHC, *and* (b) the FHC may not own or control more than 25 percent of the equity capital of the fund. The Board and Treasury assert that these restrictions are based on prevalent industry practice. Again, SIA's members indicate that the 10-investor requirement is not a uniform securities industry practice; indeed, SIA's conversations with industry members indicate that private equity funds often have fewer than 10 investors. SIA also submits that the 10-investor requirement is not justified on legitimate safety and soundness grounds: why should a private equity fund with 8 or 9 investors that together own 95 percent of the fund not qualify, while another fund qualify because it has one or two more investors, even though those investors together only own 75 percent of the fund? It is actually in the latter case that the FHC has a greater stake and, presumably, greater potential exposure from a safety and soundness perspective. Moreover, a fund with fewer investors may give rise to fewer regulatory concerns, especially if there is one dominant outside investor who has a special interest in monitoring the fund's activities. SIA suggests that the minimum investor requirement is arbitrary and should be dropped; the definition of private equity fund should be based exclusively on the 25-percent FHC investment limit.

As yet another example, the Board and Treasury restrict the definition of private equity fund to those funds that have established plans for resale or disposition of investments and maintain policies and procedures for the diversification of their investments. SIA's conversations with its members indicate that private equity funds do not, typically, have such established plans for resale of investments and need not have procedures for diversification; many funds, in fact, have concentrated portfolios. SIA submits that by these restrictions the Board and Treasury are effectively regulating how the private fund market operates, which is beyond their jurisdiction. SIA suspects that these restrictions have been imposed by the Board and Treasury to ensure that private equity funds are not impermissibly used as operating companies or as vehicles to manage or operate portfolio companies. SIA respectfully submits that these concerns are significantly mitigated by the presence of outside investors, who own at least 75 percent of the fund and who will have a powerful incentive to prevent such impermissible conduct. Here again, the ordinary examination and supervision process is appropriate to guard against abuse.

The Board and Treasury have stated that the internal controls, recordkeeping and several other requirements that apply to direct investments by a FHC do not apply to a FHC's "passive" interest in a private equity fund that is controlled or sponsored and advised by a third party. SIA respectfully submits that the exception to these burdensome requirements is justified but that the "passive" test is too restrictive. SIA believes that the exception to these requirements, which are quite burdensome, should be broadened in two ways. First, the requirements should not apply to *any* qualifying private equity funds, which, as noted above, are those funds in which the FHC has less than a 25-percent investment stake. In this situation, the fact that the FHC's stake is so limited ensures both that the banking and commerce concerns of a direct FHC investment do not

arise and that, as noted above, any safety and soundness concerns are significantly mitigated by the market discipline imposed by the private investors in the fund. Second, these requirements also should not apply to any other fund in which the FHC has a greater than 25-percent stake (that is, a non-qualifying private equity fund), so long as the FHC does not control that fund. A FHC may have a 30 percent investment in a fund that is managed by a sophisticated third party, and the FHC will not be in a position to (nor should it be forced to) require that third party comply with the internal controls, recordkeeping and other requirements of the interim rule.

In conclusion, it is worth noting that the imposition of these various requirements on private equity funds will significantly affect the operations, cost and performance of these funds. The net result may well be to chill private investor interest in bank-affiliated private equity funds and, thereby, force FHCs to make more direct investments. This is the exact opposite result from what the Board and Treasury should hope to achieve.

E. *Limitations on Managing or Operating a Portfolio Company*

The GLB Act prohibits a FHC from routinely managing or operating a portfolio company -- other than as necessary to ensure the reasonable return, disposition or re-sale of an investment. To implement this restriction, the Board and Treasury impose a variety of limitations, including a restriction on any "director, officer, employee or agent" of a FHC serving as an "officer or employee" of a portfolio company.

SIA submits that the interlocks prohibition can be more narrowly drafted to achieve the GLB Act's statutory purpose. To begin with, SIA suggests that interlocks should be permitted at the junior officer and employee level. Such interlocks, although rare, may arise from time-to-time, sometimes unbeknownst to a FHC and sometimes because a particular employee needs to be seconded over to a portfolio company. These sorts of junior-level interlocks do not represent the type of routine management and operations involvement about which Congress expressed concern.

In addition, SIA requests that the Board remove the term "agent" from the rule. Agent is not defined, and it is unclear what or who might be an impermissible "agent."

Finally, the Board and Treasury have narrowed the exception to the prohibition on routine management of a portfolio company. They permit routine management only when necessary to address a material risk to the value or operation of a portfolio company, such as a significant operating loss or loss of senior management. The GLB Act, however, permits routine management when necessary to ensure the reasonable return, disposition or re-sale of an investment. That is, the statute applies a broader standard. The Board and Treasury should revise and broaden the interim rule's exception to track the language that was adopted by Congress in the statute. Respectfully, there is no authority to adopt an exception that appears to be materially narrower than the one that Congress itself chose to apply.

F. *Presumption of Control of Portfolio Company*

The Board and Treasury impose the limitations of sections 23A and 23B of the Federal Reserve Act on transactions between depository institutions and portfolio companies that are controlled by the same FHC. For these purposes, a FHC is rebuttably presumed to control a portfolio company if the FHC owns 15 percent or more of the equity capital of that company.

At the outset, SIA requests that the Board and Treasury clarify that the 15-percent "control" test will only apply when a FHC holds more than 15 percent of the equity of a portfolio company under the new merchant banking authority under the GLB Act. If, on the other hand, a FHC has achieved a 15-percent investment stake only through a *combination* of its merchant banking and pre-existing statutory authorities (such as section 4(c)(6) of the Bank Holding Company Act or SIBC), then that investment should not be subject to the "control" presumption. Such an approach would accord with section 121(b)(2) of the GLB Act, which added the new rebuttable presumption to section 23A. Section 121(b)(2) amends section 23A to state: "Rebuttable Presumption of Control of Portfolio Companies. In addition to paragraph (3) [the usual 25% control definitions of section 23A(b)(3)], a company or shareholder shall be presumed to control any other company if the company or shareholder, directly or indirectly, . . . owns or controls 15% or more of the equity capital of the other company *pursuant to subparagraph (H) or (I) of section 4(k)(4) of the Bank Holding Company Act* . . . ." (emphasis added). That is, under the plain reading of the statute, only investments that are made under the new statutory authority of the GLB Act should apply to the presumption of control; other investments should not apply. SIA urges the Board and Treasury to clarify the rule to indicate that it is, indeed, in line with the GLB Act.

SIA also requests that the Board and Treasury clarify specific instances in which the presumption of "control" will not apply. For example, SIA suggests that the presumption should be deemed to be rebutted when there is another investor or group of investors acting in concert, that has a larger stake in the portfolio company, and when there is only a single director interlock between the portfolio company and FHC and the FHC's stake is 25 percent or less of the portfolio company.

G. *Internal Controls, Recordkeeping and Reporting Requirements*

The interim rule imposes detailed internal controls, reporting and recordkeeping requirements on FHCs' merchant banking activities. SIA submits that in many respects, these requirements are written as if securities firms affiliated with banks were not engaged in any investment activities prior to the enactment of the GLB Act. With all due respect, such firms have an extensive and unblemished record of successfully managing their venture capital investments, and the Board has just as long a record of supervising these activities. The Board and Treasury can and should rely on the firms' existing policies and procedures -- coupled with existing supervisory and examination processes -- to monitor and manage merchant banking investments. In individual cases, where internal policies and procedures are inadequate, the Board may require additional safeguards or measures.

If the Board and Treasury determine to impose some additional risk-management, recordkeeping and reporting requirements, they should be far more mindful of the significant burdens that they are imposing on FHCs by means of such requirements. For example, it is quite difficult for a diversified FHC to maintain all records at a "central" location, as the rule appears to require.[9] SIA respectfully suggests that -- bearing in mind the burden imposed, and the GLB Act's dictate to the Board to reduce the regulatory burden that it inflicts on FHCs -- the Board and Treasury should pare down the instant requirements to the fullest extent possible. Moreover, SIA submits that, if any requirements are mandated, there should be a grace or transition period for complying with these requirements. Systems will need to be changed, new policies will need to be initiated and employees will need to be trained. All of this will take time, and the Board and Treasury should give FHCs at least five years to come into full compliance. In the meantime, the traditional supervisory and examination processes can be relied upon to ensure safety and soundness.

In addition, and as noted above, SIA requests that the Board and Treasury acknowledge that different rules should apply to FHC fund investments. The instant requirements are burdensome, will chill bank-affiliated private equity funds, and are not necessary to achieve safety and soundness or other legitimate regulatory concerns. For this reason, SIA submits that these requirements should not be applied to (1) *any* qualifying private equity funds, whether or not a FHC controls the funds; or (2) any other fund investments of a FHC, unless the FHC has control of those funds.

SIA also urges the Board and Treasury to clarify that these internal controls and other requirements do not apply to (either existing or new) investments that are made under pre-existing statutory authorities. Concerns about investments made under pre-existing authorities have been adequately addressed for many years by the routine examination and supervisory process; there is no need to impose these requirements on those investments. In addition, investments made under pre-existing authority (such as SBICs, for example) are often made in different departments or in different parts of the FHC than investments made under the GLB Act's merchant banking authority. For this reason, it will be exceedingly difficult for a FHC to collect all of these investment records "at a central location," as the rule appears to require or to require that the same policies and procedures should apply to those investments as apply to *bona fide* merchant banking investments. (This is not to imply that there are no aggregate controls; FHCs and securities firms affiliated with FHCs have established systems in place to monitor aggregate positions for bank regulatory and federal securities law purposes. In fact, SIA believes that the Board and Treasury should rely on those existing controls and policies rather than imposing this new scheme on all investments.)

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[9] In discussions with SIA, Board staff indicated that the internal controls and recordkeeping requirements were not intended to force securities firms with existing well-run systems and operations to alter or revise those systems. If this is the intent of the Board and Treasury, SIA hopes that this intent will be clarified in the final rule.

In discussions with SIA on May 19, 2000, Board staff requested that SIA and its members provide specific and detailed examples of how the rules would affect the business of private equity funds and securities firms and detailed alternatives for the Board to consider in lieu of the instant rulemaking. Much of the requested information is contained in this comment letter. SIA would be pleased to provide additional information if the Board or Treasury staffs have questions not addressed by this letter. To the extent that SIA members have additional information responsive to the issues raised by Board staff at the May 19th meeting, SIA will file a supplementary comment letter.

SIA appreciates the opportunity to comment on the Board's and Treasury's merchant banking rules. Please contact Alan E. Sorcher, Assistant Vice President and Assistant General Counsel at (202) 296-9410, if you have any questions with respect to these comments.

Sincerely,

Stuart J. Kaswell
Senior Vice President and
General Counsel