ShawPittman LLP
A Limited Liability Partnership Including Professional Corporations

MEMORANDUM

May 4, 2001

RE: The Federal Reserve's Final Rule on Merchant Banking and Revised Capital Proposal for Investment Activities

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The Federal Reserve Board (the "FRB") has taken two important steps in regard to the investment activities of bank holding companies and foreign banks deemed to be bank holding companies. First, the FRB has issued its final rule on merchant banking investments by financial holding companies (the "Merchant Banking Rule"). Second, the FRB released for comment its controversial revised proposal regarding the capital treatment of equity investments (the "Capital Proposal").[1] The Merchant Banking Rule and the Capital Proposal were the subjects of recent congressional hearings. While the FRB defends them as necessary to ensure safety and soundness, opponents criticize them as overly restrictive. Section I of this memorandum summarizes the key provisions of the Merchant Banking Rule. Section II briefly describes the new Capital Proposal and the impact it would have on merchant banking and other permissible nonfinancial investments.

I. SUMMARY OF KEY PROVISIONS OF THE MERCHANT BANKING RULE

The final Merchant Banking Rule implements provisions of the Gramm-Leach-Bliley Act (the "GLBA") that permit a financial holding company to engage in merchant banking activities.[2] The Merchant Banking Rule took effect on February 15, 2001 and replaced the interim rule regarding merchant banking activities (the "Interim Rule")[3] which had been in effect since March 28, 2000.

Historically, bank holding companies were prohibited by the Bank Holding Company Act (the "BHCA") from making equity investments in nonfinancial companies with a few, relatively narrow exceptions. However, the GLBA relaxes this prohibition for financial holding companies and permits them to make merchant banking investments. A bank holding company that has not qualified and filed with the FRB to become a financial holding company is not eligible to make merchant banking investments.

The Merchant Banking Rule authorizes "a financial holding company, directly or indirectly and as principal or on behalf of one or more persons, to acquire or control any amount of shares,

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[1] The FRB issued the Merchant Banking Rule through a joint release with the Department of the Treasury and the Capital Proposal through a joint release with the Office of the Comptroller of the Currency.

[2] 12 C.F.R. §§ 225.170-177.

[3] 65 Fed. Reg. 16,460 (Mar. 28, 2000).

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assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for the financial holding company under section 4 of the BHCA.[4] A "merchant banking investment" is an investment by a financial holding company in a nonfinancial entity made pursuant to the financial holding company's merchant banking authority. Investments in nonfinancial companies that are made pursuant to other authority, such as sections 4(c)(6) and (7) of the BHCA, the portfolio investment provisions of Regulation K, or the authority to invest in a small business investment company ("SBIC"), are not merchant banking investments and are not subject to the Merchant Banking Rule.

Part A of this section describes threshold issues including the means of making merchant banking investments, permissible investments, and notice requirements to commence merchant banking. Part B discusses ongoing regulatory requirements that apply once a financial holding company has begun merchant banking including aggregate investment limitations, policies and procedures, record-keeping, holding period limits, and reporting. Part C sets forth the limitations on interactions between a financial holding company, or the financial holding company's affiliates, and an entity in which the financial holding company has made a merchant banking investment.

A. Threshold Requirements

1. A Financial Holding Company Must Qualify to Make Merchant Banking Investments

Before a financial holding company may engage in merchant banking, it must qualify under the Merchant Banking Rule. To qualify, the financial holding company must be affiliated with either (i) a securities affiliate, or (ii) an insurance affiliate and an investment adviser affiliate that advises an insurance company. For the purposes of the Merchant Banking Rule, a "securities affiliate" is either a registered broker-dealer or a registered municipal securities dealer, including a separately identifiable department or division of a bank that is registered as a municipal securities dealer.[5] If the financial holding company does not have a securities affiliate, the financial holding company must have both (i) an insurance company affiliate that is predominantly engaged in insurance underwriting or providing and issuing annuities and (ii) a registered investment adviser that provides investment advice to an insurance company.

2. Means of Making Merchant Banking Investments

A financial holding company may make merchant banking investments directly or indirectly. A financial holding company may make merchant banking investments indirectly through any subsidiary other than a depository institution or a subsidiary of a depository institution. A foreign

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[4] 12 C.F.R. 225.170(a).

[5] The final version of the Merchant Banking Rule expanded the definition of securities affiliate that had been used in the Interim Rule to allow a financial holding company to engage in merchant banking if it is affiliated with a municipal securities dealer.

bank, however, is not a depository institution for purposes of the Merchant Banking Rule and, therefore, a foreign bank may make a merchant banking investment. A U.S. bank subsidiary of a financial holding company may not make merchant banking investments. In addition, a U.S. branch or agency of a foreign bank is a depository institution for purposes of the Merchant Banking Rule; thus, a branch or agency of a non-U.S. bank cannot make a merchant banking investment.

There are three principal means by which a financial holding company can make merchant banking investments. First, a financial holding company may acquire an ownership interest in a company that engages in nonfinancial activities. When a financial holding company holds ownership interests in an entity in its merchant banking portfolio, that entity is called a "portfolio company." An entity is not a portfolio company if the financial holding company holds the ownership interest in the company through some authority other than its merchant banking authority.

Second, a financial holding company may hold merchant banking investments through a private equity fund that the financial holding company does not control. Stated simply, a private equity fund is a pooled investment vehicle that is created for the sole purpose of making merchant banking investments. To be a qualified private equity fund under the Merchant Banking Rule: (i) the fund must engage exclusively in the business of investing and may not be an operating company; (ii) no more than 25 percent of the total equity of the fund may be held, owned or controlled by the financial holding company, its directors, officers, employees or principal shareholders; (iii) the duration of the fund may not exceed 15 years; and (iv) the fund may not be formed or operated for the purpose of making investments inconsistent with, or to evade limitations of, merchant banking authority.[6] The private equity fund may be a corporation, partnership, limited liability company or other entity that issues ownership interests in any form. If a fund qualifies as a "private equity fund," the merchant banking investments held by that fund will be given special treatment as described below. If the financial holding company does not control the private equity fund, the private equity fund may routinely manage and operate its portfolio companies.

Third, a financial holding company may make merchant banking investments through a private equity fund that is controlled by the financial holding company. The Merchant Banking Rule states that a financial holding company "controls" a private equity fund if the financial holding company: (i) serves as a general partner or serves in a similar capacity with respect to the fund; (ii) controls 25 percent or more of any class of voting securities or similar interests in the fund; (iii) selects, constitutes or controls the majority of directors, trustees or managers of the fund; or (iv) controls more than five percent of any class of voting securities or similar interests in the fund and is the investment adviser to the fund. If the financial holding company controls the private equity fund, the private equity fund will generally be prohibited from routinely managing and operating its portfolio companies.

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[6] The Merchant Banking Rule removes the requirement that a private equity fund be held by at least ten investors unrelated to the financial holding company.

3. Permissible Types of Merchant Banking Investments

A financial holding company may acquire a variety of types of ownership interests including debt or equity securities, warrants, options, partnership interests and trust certificates under merchant banking authority. The ownership interests may be voting or nonvoting and the financial holding company may acquire 100 percent of the portfolio company's ownership interests. Subject to limitations, a financial holding company may also acquire or control assets of a company under merchant banking authority.[7]

4. Notice is Required for an Initial Merchant Banking Investment

A financial holding company must notify the FRB within 30 days after making its initial merchant banking investment by filing either form F.R.Y-7A or F.R. Y-6A.[8] As discussed below, a financial holding company need not report subsequent merchant banking investments unless the investment qualifies as a "large" merchant banking investment.

B. Ongoing Regulatory Requirements

1. Aggregate Limit on Merchant Banking Investments

The Merchant Banking Rule limits the aggregate amount of merchant banking investments a financial holding company may hold. Until the final rules are issued regarding capital deductions for nonfinancial investments (the Capital Proposal is discussed below in section 2), the merchant banking investments of a financial holding company may not exceed, in the aggregate, 30 percent of the financial holding company's Tier 1 capital.[9] The aggregate of merchant banking investments, excluding investments made in private equity funds, may not exceed 20 percent of the financial holding company's Tier 1 capital. These aggregate limits will be eliminated when the final rule regarding the capital treatment of equity investments is adopted. Investments made under other authority, such as investments made by foreign banks in companies outside of the United States, are not subject to the aggregate merchant banking limits.

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[7] A financial holding company may acquire assets as a merchant banking investment when: (i) the assets are held by or transferred to a portfolio company; (ii) the portfolio company maintains a separate corporate existence from the financial holding company (including separate books, records, accounts and policies); and (iii) the portfolio company maintains separate management from the financial holding company.

[8] The FRB currently plans to replace forms F.R. Y-6A and F.R. Y-7A with forms F.R. Y-10 and F.R. Y- 10F on July 1, 2001. However, FRB staff has recently indicated that the proposed implementation date for the F.R. Y-10 and F.R. Y-10F may be delayed until this fall.

[9] The Interim Rule had also contained absolute dollar limits in addition to the percentage of Tier 1 capital limits, but the final Merchant Banking Rule removes those restrictions.

2. Risk Management and Record-keeping Requirements

A financial holding company that makes merchant banking investments must establish and maintain policies, procedures, records and systems reasonably designed to conduct, monitor and manage the merchant banking investments and the risks associated with those investments. First, the financial holding company must be able to assess and monitor the carrying value, market value and performance of each investment as well as the aggregate portfolio. Second, the financial holding company must be able to identify and manage the market, credit, concentration and other risks associated with its investments. Third, the financial holding company must monitor and guard against risks that arise from transactions and relationships among the financial holding company, the portfolio company, and affiliates of the financial holding company. Fourth, the policies must ensure the maintenance of corporate separateness between the financial holding company, financial holding company affiliates, and each portfolio company. Finally, the policies, procedures and systems must ensure that the financial holding company, the portfolio company, and all affiliates of the financial holding company abide by and conform to all applicable laws and regulations. A financial holding company must make the policies, procedures and records available to the FRB upon request.[10]

3. Holding Period Limits

A financial holding company may not generally hold a merchant banking investment for more than ten years unless the investment is held through a private equity fund. A financial holding company may hold a private equity fund investment for the fifteen-year duration of the fund. The financial holding company may apply for an extension beyond the ten-year holding period by submitting an extension application to the FRB no later than 90 days before the expiration of the ten-year holding period. The request must provide the reasons for the request and describe the financial holding company's plan for divesting the investment.

The FRB will consider a number of factors when determining whether to grant an extension request. Among the factors are: the cost to the financial holding company of disposing of the investment within the holding period; the risks incurred by the financial holding company if it continues to hold the investment; market conditions; the nature of the portfolio company's business; and the extent and history of the financial holding company's involvement in the management and operations of the company.

If the FRB grants an extension, the financial holding company must hold capital against the investment in an amount set by the FRB that is greater than the highest capital charge applicable to the financial holding company under the capital rule regarding equity investments. The amount of the capital charge set by the FRB will be no less than 25 percent of the adjusted carrying value of the investment.

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[10] The Merchant Banking Rule eliminates the Interim Rule requirement that the financial holding company must maintain these policies, procedures and records at a central location.

4. Reporting Requirements

A financial holding company that engages in merchant banking must report large merchant banking investments and submit quarterly and annual reports on all merchant banking investments. In addition to reporting the commencement of merchant banking, a financial holding company must notify the FRB within 30 days after making each subsequent "large" merchant banking investment. A merchant banking investment is "large" if the amount of the investment constitutes more than a five percent interest in a company at a total cost that exceeds the lesser of five percent of the financial holding company's Tier 1 capital or $200 million. A financial holding company may provide notice by filing form F.R. Y-7A or F.R. Y-6A.

The FRB is currently developing forms by which a financial holding company will submit quarterly and annual reports regarding merchant banking activities.[11] Though the forms have not yet been released, the FRB will require more detailed information for merchant banking investments that have been held by the financial holding company for longer periods. As the holding period for a merchant banking investment approaches the holding period limit, the reports will require more detailed information about the portfolio company and about the financial holding company's strategy for divesting its interest.

C. Limitations on Interactions Between a Financial Holding Company and a Portfolio Company

1. A Financial Holding Company may not Routinely Manage or Operate a Portfolio Company

Although the Merchant Banking Rule permits for the first time a financial holding company to own 100 percent of the shares of a nonfinancial company, the rule prohibits a financial holding company from participating in the day-to-day management of a portfolio company. The Merchant Banking Rule states the general prohibition, establishes how a financial holding company may rebut a presumption that it is routinely managing a portfolio company, and establishes an exception to the general prohibition.

As a general rule, a financial holding company may not "routinely manage or operate" a portfolio company. A financial holding company is considered to be routinely managing a portfolio company when: (i) an officer or employee of the financial holding company serves as an executive officer of the portfolio company; (ii) an executive officer of the financial holding company, or certain of its major subsidiaries, serves as a non-executive officer or employee of the portfolio company; or (iii) the financial holding company and the portfolio company enter into covenants that would restrict the managers of the portfolio company from making routine business decisions. When any of these circumstances exist, the financial holding company is conclusively presumed to

[11] The Interim Rule contained specific reporting requirements regarding merchant banking investments. These requirements were replaced in the final Merchant Banking Rule by a mandate that the FRB release forms that will solicit virtually the same information.

be routinely managing the portfolio company. In these circumstances, the presumption is not rebuttable.

Other circumstances will suggest that a financial holding company is routinely managing a portfolio company. For example, an employee or officer interlock between the financial holding company and a portfolio company, other than an interlock described in the above paragraph, will trigger a presumption that the financial holding company is routinely managing or operating the portfolio company. However, the financial holding company may rebut this presumption if the financial holding company can demonstrate that it does not routinely manage or operate the portfolio company.

The Merchant Banking Rule also describes specific activities in which a financial holding company may engage that would not constitute routinely managing or operating a portfolio company. For example, a financial holding company may require by written agreement that a portfolio company consult with, or obtain the approval of the financial holding company, before taking actions outside the ordinary course of business of the portfolio company, including: (i) the acquisition of control or significant assets of other companies; (ii) significant changes to the company's business plan; (iii) the redemption, authorization or issuance of any shares of capital stock of the company; and (iv) the sale, merger, consolidation or liquidation of the company or any of its subsidiaries. A financial holding company, or a financial holding company subsidiary, may also provide underwriting, investment advisory, or management advisory services to the portfolio company. A financial holding company may also select directors of the portfolio company or have officers or directors of the financial holding company or one of its subsidiaries serve as directors of the portfolio company. However, the directors appointed by the financial holding company may not participate in the routine management of the portfolio company.

As an exception to the general rule, there are circumstances under which a financial holding company is permitted to routinely manage or operate a portfolio company. A financial holding company may routinely manage or operate a portfolio company when "it is necessary or required for the financial holding company to obtain a reasonable return on the resale or disposition of the investment".[12] Examples of circumstances under which a financial holding company may routinely manage or operate a portfolio company include the loss of key management, a significant operating loss or a change in the strategic direction of the company. If a financial holding company routinely manages or operates a portfolio company, the financial holding company must give written notice to the FRB if it continues to do so for more than nine months.[13] A financial holding company must maintain a written record describing its involvement in routinely managing or operating a portfolio company.

[12] 12 C.F.R. § 225.171(e).

[13] Under the Interim Rule, the financial holding company was required to obtain FRB approval in order to continue the routine management for more than six months.

2. Transactions Between a Portfolio Company and a Depository Institution Affiliate of the Financial Holding Company Are Subject to Certain Restrictions

Under sections 23A and 23B of the Federal Reserve Act, a depository institution is limited in the transactions it may enter into with an affiliate. These restrictions are imposed to protect the depository institution from the risks encountered by the affiliate and to prevent improper use of the depository institution by the affiliate. Section 23A imposes quantitative and qualitative limits on extensions of credit and other covered transactions between a depository institution and its affiliate. Section 23B requires that a transaction between a depository institution and its affiliate be conducted on an arms-length basis. Sections 23A and 23B generally do not apply to branches and agencies of foreign banks but GLBA applies sections 23A and 23B to branches and agencies in the context of merchant banking activities. Sections 23A and 23B apply to all covered transactions between a U.S. branch or agency of a foreign bank and (i) any portfolio company controlled by the foreign bank or an affiliate of the foreign bank and (ii) any company controlled by the foreign bank or an affiliate of the foreign bank that is engaged in merchant banking activities if the proceeds of the covered transaction are used to fund merchant banking activities.

If a financial holding company "controls" a portfolio company, the portfolio company is an affiliate of any depository institution that is an affiliate of the financial holding company. The Merchant Banking Rule establishes a presumption of control for the purposes of sections 23A and 23B and three safe harbors that, when met, shield the financial holding company from the presumption of control.

If a financial holding company owns 15 percent or more of the equity of a portfolio company as a merchant banking investment, the financial holding company is presumed to control the portfolio company for purposes of sections 23A and 23B.[14] Thus, sections 23A and 23B would restrict transactions between the portfolio company and the depository institution. However, a financial holding company may rebut the presumption by demonstrating that the financial holding company does not control the portfolio company. The presumption of control does not apply to investments made solely through a private equity fund that the financial holding company does not control.

In response to comments, the Merchant Banking Rule establishes three safe harbors from the presumption of control of a portfolio company under sections 23A and 23B. The safe harbors are: (i) the financial holding company has no interlocks among the directors, officers or employees of the portfolio company; (ii) an unaffiliated investor controls more equity of the portfolio company than the financial holding company and the financial holding company has no more than one representative on the board of the portfolio company; or (iii) an unaffiliated investor controls more than 50 percent of the shares of the portfolio company and officers or employees of the financial holding company do not represent a majority of the directors of the company. In order for the

[14] Convertible instruments are included as equity for the 15 percent test.

presumption to be rebutted, other evidence may not indicate that the financial holding company in fact controls the portfolio company. A financial holding company is not required to seek FRB approval to claim one of these safe harbors.

3. A Financial Holding Company may not Cross-Market Products or Services between a Portfolio Company and a Depository Institution

The Merchant Banking Rule implements the GLBA's prohibitions against cross-marketing products or services between a portfolio company and a depository institution controlled by the financial holding company. In general, the GLBA and the Merchant Banking Rule prohibit cross marketing only when it involves a U.S. depository institution or its subsidiaries. U.S. branches and agencies of foreign banks are considered to be U.S. depository institutions for this purpose. A U.S. depository institution controlled by the financial holding company may not offer or market any product or service of a portfolio company of its parent financial holding company and a portfolio company may not offer or market the products or services of a U.S. depository institution controlled by the financial holding company. The cross-marketing restrictions do not apply if the financial holding company owns or controls less than five percent of the voting equity of the portfolio company. Also, the cross-marketing restrictions do not apply to a portfolio company that is owned by a private equity fund, unless the financial holding company controls the private equity fund.

II. THE CAPITAL PROPOSAL

On April 16, 2001, the public comment period closed on the FRB's proposed amendment to the capital requirements imposed on U.S. banks, bank holding companies, and financial holding companies.[15] The Capital Proposal would require a capital charge for equity investments made in nonfinancial companies including those made under merchant banking authority.

The Capital Proposal would apply to investments by U.S. banks, bank holding companies and financial holding companies in nonfinancial companies pursuant to: (i) merchant banking authority; (ii) the portfolio investment provisions of Regulation K;[16] (iii) section 24 of the Federal Deposit Insurance Act (the "FDIA"); (iv) section 4(c)(6) or (7) of the BHCA; and (v) the investment authority granted for investments made by SBICs. The Capital Proposal amends capital requirements that apply only to domestic companies and, therefore, does not apply to a non-U.S. financial holding company or a foreign bank that is deemed to be a bank holding company. Consequently, a foreign bank or a non-U.S. financial holding company could continue to make investments without taking a capital deduction as long as its investments are not made through a U.S. bank holding company or its subsidiaries.

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[15] 66 Fed. Reg. 10212 (Feb. 14, 2001).

[16] 12 C.F.R. § 211.5(b)(1)(iii).

Under the Capital Proposal, a covered financial institution must deduct from its Tier 1 capital the appropriate percentage of the adjusted carrying value of all nonfinancial equity investments held by the investor and its subsidiaries. The amount of the deduction increases as the aggregate amount of nonfinancial equity investments held by the investor and its subsidiaries increases as a percentage of the investor's Tier 1 capital. These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within specified ranges of the parent holding company's Tier 1 capital.

The specified ranges are as follows: (i) if the aggregate of all nonfinancial investments remains below 15 percent of the investor's Tier 1 capital, the capital charge is equal to eight percent of the aggregate adjusted carrying value of covered nonfinancial investments; (ii) if the aggregate of all nonfinancial investments falls between 15 and 25 percent of the investor's Tier 1 capital, the capital charge is equal to eight percent of the aggregate adjusted carrying value of covered nonfinancial investments for the portion below the 15 percent threshold and 12 percent for the portion that falls above the 15 percent threshold; (iii) if the aggregate of all nonfinancial investments exceeds 25 percent of the investor's Tier 1 capital, the capital charge is equal to eight percent of the aggregate adjusted carrying value of covered nonfinancial investments for the portion below the 15 percent threshold, 12 percent for the portion that falls between the 15 percent threshold and the 25 percent threshold, and 25 percent for the portion above the 25 percent threshold. For example, if the adjusted carrying value of all nonfinancial equity investments held by a financial holding company equals 20 percent of the Tier 1 capital of the financial holding company, then the amount of the deduction would be (i) eight percent of the adjusted carrying value of all investments up to 15 percent of the company's Tier 1 capital, and (ii) 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the company's Tier 1 capital.

An investment in an SBIC is exempt from the capital charge requirement, if the aggregate of the adjusted carrying value of SBIC investments is below 15 percent of the investor's Tier 1 capital. However, if the aggregate of SBIC investments exceeds 15 percent of the investor's Tier 1 capital, the exemption is lost and all the SBIC investments are subject to the capital charge. Also, regardless of whether the SBIC investments are exempt from the capital charge, the SBIC investments are included in the aggregate of all nonfinancial investments for the purpose of calculating the percentage of the capital charge for the other covered nonfinancial investments.

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If you have any questions about this memorandum, or would like additional information concerning the Merchant Banking Rule or Capital Proposal, please contact Thomas J. Pax or any other member of our Financial Institutions Group.