ANALYSIS OF PROPOSED AND INTERIM RULES RELATING TO FINANCIAL HOLDING COMPANIES

SIMPSON THACHER & BARTLETT LLP

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INTRODUCTION

Between March 10, 2000 and March 28, 2000 the Board of Governors of the Federal Reserve System (the "Board") and the Department of the Treasury issued a series of interim and proposed rules pursuant to The Gramm-Leach-Bliley Act (the "GLBA"). This memorandum describes and analyzes the interim and proposed rules. Any questions concerning this memorandum may be directed to Gary Rice (212/455-7345, g_rice@stblaw.com), Lee Meyerson (212/455-3675, l_meyerson@stblaw.com), or John L. Walker (212/455-7365, j_walker@ stblaw.com).

PERMISSIBLE FINANCIAL ACTIVITIES

The GLBA amended Section 4 of the Bank Holding Company Act of 1956 (the "BHC Act") to permit a bank holding company or a non-U.S. bank that qualifies as a financial holding company to engage, pursuant to new Section 4(k) of the BHC Act, in a broader range of financial activities, including insurance underwriting, banking, securities underwriting and dealing, and merchant banking activities, than may be engaged in by bank holding companies and non-U.S. banks that do not qualify as financial holding companies.[1] On January 19, 2000 the Board issued interim regulations concerning the qualifications and procedures for becoming a financial holding company. As discussed in this Firm's memorandum concerning the interim regulations[2], the portion of the Board's regulations relating to U.S. banking organizations generally tracked the provisions of the GLBA, which required that each depository institution subsidiary of a financial holding company (but not the financial holding company itself) be "well capitalized", "well managed" and have at least a "satisfactory" record of compliance with

1. The GLBA is discussed in detail in this Firm's memorandum, "The Gramm-Leach-Bliley Act" (Nov. 17, 1999).

2. "Federal Reserve and Comptroller Issue Regulations Pursuant to The Gramm-Leach-Bliley Act (Jan. 31, 2000).

the Community Reinvestment Act of 1977 (the "CRA"). The Board's interim rule defined each of these criteria based on pre-existing regulatory standards.

On March 10, 2000 the Board issued an interim rule that describes the activities that are considered financial in nature and the procedure financial holding companies must follow to engage in such activities de novo or to acquire companies engaged in such activities.[3]

PERMISSIBLE ACTIVITIES

The first set of activities that are permissible for financial holding companies are those that the Board had determined, as of November 12, 1999, are permissible nonbanking activities pursuant to Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended (the "BHC Act"). These activities include the activities approved by regulation, which are already listed in Regulation Y, as well as activities that the Board has approved by order in a specific case. The interim rule amends Regulation Y to include a list of the activities that have been approved only by order, such as providing services to mutual funds, owning shares of a securities exchange, and acting as a certification authority of digital signatures.

As a result of the GLBA, the Board no longer has the authority to add (by regulation or order) activities to the list of activities that are permissible pursuant to Section 4(c)(8). There will be no means for a bank holding company or a non-U.S. bank to expand into nonbanking activities that had not been approved at the time the GLBA was enacted other than to make an effective election to become a financial holding company. The GLBA does give the Board the authority to modify the conditions applicable to activities previously approved under Section 4(c)(8) but, for the moment at least, the Board has not done so. This means, for example, that Section 20 affiliates of bank holding companies that are not financial holding companies will continue to be subject to a limitation on the amount of revenue that may be derived from securities underwriting and dealing activities even though the primary basis for the limitation, Section 20 of the Glass-Steagall Act, was repealed by the GLBA. Section 20 affiliates also continue to be prohibited from distributing mutual fund shares, another prohibition that was based on Section 20.[4] In the course of their dealing activities, such Section 20 affiliates will continue to be prohibited from acquiring more than 5% of the voting securities of a company and will continue to be required to include shares held as investments for purposes of calculating this limit.

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3. *Bank Holding Companies and Change in Bank Control*, 65 Fed. Reg. 14433 (interim rule with request for public comments) (March 17, 2000).

4. Section 20 prohibited a bank from being affiliated with a company that is principally engaged in issuing securities and the Board determined that a mutual fund is such a company and that the distributor of the mutual fund controls the fund.

The second group of financial activities that the interim rule includes as permissible for financial holding companies are those that, in the language of the GLBA, "the Board has determined, under regulations issued or interpretations issued pursuant to Section 4(c)(13) (as in effect the day before the date of the enactment of the Gramm-Leach-Bliley Act) to be unusual in connection with the transaction of banking or other financial operations abroad". The Board interprets this language to include only activities that the Board has approved pursuant to Section 4(c)(13) by regulation, not those that it has approved by order. This appears to be an unduly narrow interpretation of the statutory language. The interpretation will prevent financial holding companies from engaging in certain activities, such as real estate brokerage, that the Board has permitted bank holding companies to engage in abroad by order but not by regulation. Even with respect to activities approved pursuant to Section 4(c)(13) by regulation, the interim rule adds conditions that are not included in the regulation. For example, the regulation includes as a permissible activity:

> organizing, sponsoring, and managing a mutual fund if the fund's shares are not sold or distributed in the United States or to U.S. residents and the fund does not exercise managerial control over the firms in which it invests.[5]

The interim rule removes the references to engaging in the activity in the United States, which are not relevant for purposes of Section 4(k)(4)(G). However, it adds the condition that, if the financial holding company owns more than 25% of the equity of the fund, it must reduce its interest to below that level within one year of sponsoring the fund (or such additional period as the Board permits).

Another activity that the Board has approved by regulation pursuant to Section 4(c)(13) is commercial and other banking activities. The Board did not include these as activities that are financial in nature. Although the acquisition of a commercial bank that is engaged in business in the United States would require Board approval pursuant to Section 3 of the BHC Act, the inclusion of non-U.S. banking as financial in nature would permit financial holding companies to acquire non-U.S. banks without first obtaining Board review pursuant to the Regulation K notice procedures. It is odd to require a financial holding company to obtain prior Board review of an acquisition of a non-U.S. bank where no review is required in connection with the acquisition of a non-U.S. insurance company.

The third group of activities that the interim rule lists as permissible for financial holding companies are the activities that the GLBA lists as "financial in nature". The interim rule incorporates by reference the activities that the GLBA lists as financial in nature. Not surprisingly, the Board's discussion of the underwriting and dealing activities authorized for financial holding companies by Section 4(k)(4)(E) confirms that such activities are not subject to the ineligible revenue limitation or the prohibition on distributing mutual funds that continue

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5. 12 C.F.R. §211.5(d)(11).

to apply to Section 20 affiliates. Of greater interest is the Board's statement that dealing and market-making activities pursuant to Section 4(k)(4)(E) will not be subject to the Section 4(c)(6) limitation to 5% of the voting shares of an issuer and will not be treated as merchant banking investments. In other words, securities held in a dealing capacity pursuant to Section 4(k)(4)(E) are not viewed as investments—a view that applicants had unsuccessfully pressed on the Board as long ago as 1989 and as recently as last December. However, the Board has accepted this view only in the case of financial holding companies that engage in dealing activities pursuant to Section 4(k)(4)(E). Bank holding companies and financial holding companies that engage in securities dealing activities pursuant to Section 4(c)(8) will continue to be prohibited from acquiring more than 5% of the voting shares of a company.

Most of the eight "operating standards" that apply to Section 20 companies are also inapplicable to broker-dealers operating pursuant to Section 4(k)(4)(E). The Board adopted a separate interim rule to address this topic.[6] The first operating standard, which requires a bank holding company that controls a Section 20 company to be well capitalized (or strongly capitalized in the case of a non-U.S. bank), will not apply to financial holding companies that engage in securities activities pursuant to Section 4(k)(4). However, it will apply to non-U.S. banks because such banks are required to be well capitalized in order to become financial holding companies. Moreover, in recommending approval of the interim rule to the Board, Board staff stated that a depository institution would not be well managed if its parent holding company was not well capitalized.[7]

The second operating standard requires a bank holding company to have policies governing participation by its depository institution subsidiaries in transactions underwritten by its Section 20 subsidiary. The third operating standard prohibits a depository institution from providing a majority of the board of directors of an affiliated Section 20 company. The Board determined that it was not necessary to directly apply these operating standards to financial holding companies that engage in underwriting and dealing pursuant to Section 4(k)(4)(E). However, Board staff stated that satisfaction of these standards is also inherent in a depository institution being "well managed".

The fourth operating standard requires Section 20 companies to provide their customers with a disclosure statement that satisfies the Interagency Statement on Retail Sales of Non-deposit Investment Products. The essence of the Statement is the disclosure that a Section 20 company is not a bank and its products are not FDIC insured. Board staff does not believe it is necessary to apply this operating standard to broker-dealers authorized by Section 4(k)(E)(4), stating that it expected such broker-dealers to take appropriate steps to avoid customer

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6. *Securities Underwriting, Dealing, and Market-Making Activities of Financial Holding Companies*, 65 Fed. Reg. 14440 (interim rule with request for public comments) (March 17, 2000).

7. Memorandum from Board Staff to the Board of Governors, "Application of Section 20 operating subsidiary standards to financial holding companies" (March 8, 2000).

confusion and noting that the greatest risk of confusion on this point is where products are sold on the premises of a depository institution, which sales continue to be subject to the disclosure requirement.

The fifth operating standard requires that intra-day extensions of credit between a Section 20 subsidiary and affiliated depository institutions (including affiliated branches and agencies of a non-U.S. bank) be on an arm's length basis. The Board retained this operating standard for broker-dealers authorized by Section 4(k)(E)(4). However, this would have been the case in any event because the GLBA requires the Board to adopt rules by May 12, 2001 that treat intraday extensions of credit as "covered transactions" for purposes of Sections 23A and 23B. At a minimum this will mean that such transactions will be subject to the arm's length standard of Section 23B.[8]

The sixth operating standard prohibits a depository institution from extending credit to a customer for the purpose of purchasing, or secured by, a security while the security is being underwritten by an affiliated Section 20 subsidiary and for 30 days thereafter, with exceptions for preexisting lines of credit and credit for clearing purposes. The Board will not apply this operating standard to broker-dealers operating pursuant to Section 4(k)(4)(E). Section 23A arguably covers such transactions if the customer purchases a security from the underwriting subsidiary (as opposed to another member of the syndicate), because a loan to a third party is treated as a "covered transaction" if the proceeds of the loan are transferred to the affiliate. In any event, Board staff indicated that it was not necessary to apply the operating standard to broker-dealers operating pursuant to Section 4(k)(4)(E) because this issue will be addressed by a new rule that the staff is drafting concerning the applicability of Sections 23A and 23B to credit extended by a depository institution to customers of an affiliate.

The seventh operating standard requires the filing of a report demonstrating compliance with the ineligible revenue limit. Broker-dealers operating pursuant to Section 4(k)(4)(E) are not subject to the ineligible revenue limit and will not have to file the report.

The eighth operating standard treats a U.S. branch or agency of a non-U.S. bank as an insured bank for purposes of the restrictions that Sections 23A and 23B apply to transactions between an insured bank and an affiliated Section 20 company. The Board will apply this operating standard to transactions between U.S. branches and agencies and affiliated broker-dealers that underwrite and deal in securities pursuant to Section 4(k)(4)(E).

In the past, when a bank holding company or a non-U.S. bank established a Section 20 company or acquired an existing broker-dealer to be operated as a Section 20 company, the

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8. The GLBA permits but does not require the Board to treat intra-day loans as extensions of credit for purposes of Section 23A, which would require such loans to be fully collateralized by U.S. Treasury securities or, if other types of collateral are used, to be over collateralized up to 140%, depending on the nature of the collateral.

proposed Section 20 company was required to undergo an "infrastructure review" by Board examiners prior to commencing operations. The purpose of the infrastructure review was to ensure that adequate policies and procedures for compliance and risk management were in place at the broker-dealer. Financial holding companies are permitted to acquire companies that underwrite and deal in securities without prior Board approval. However, Board staff contemplates that it will continue to conduct some form of after the fact infrastructure review. The Board staff memo cited above states that: "It is expected that examination of the risk management systems and internal controls of a financial holding company will be conducted promptly after an affiliation between a securities firms and a financial holding company as appropriate."[9]

Bank holding companies have primarily engaged in securities underwriting and dealing activities outside the United States pursuant to 211.5(d) of Regulation K. Such a non-U.S. broker-dealer is typically a subsidiary of an Edge Act corporation, which is in turn a subsidiary of an insured bank. One important advantage of conducting securities activities in this manner is that there is no percentage limit on the amount of revenue that may be derived from such activities. For banking organizations that qualify as financial holding companies this is no longer an advantage. There is no limit on the percentage of revenue that a broker-dealer that operates pursuant to Section 4(k)(4)(E) of the BHC Act may derive from underwriting and dealing activities.

Another advantage of engaging in such activities pursuant to Regulation K is that the insured bank is permitted to provide senior loans to the non-U.S. broker-dealer without being restricted by Section 23A because a subsidiary of a bank is generally treated as part of the bank rather than an affiliate of the bank for purposes of Section 23A. This will continue to be in advantage in comparison with engaging in securities underwriting and dealing activities through a broker-dealer operating pursuant to Section 4(k)(4)(E) (a "Regulation Y broker-dealer").[10]

This advantage must be weighed against a number of disadvantages. First, the amount that a bank can invest in its Edge Act subsidiaries is limited to 20% of the capital of the bank, which places an indirect limit on the amount that bank can invest in its Regulation K broker-dealers. Second, in contrast to Regulation K broker-dealers, broker-dealers operating pursuant to Section 4(k)(4)(E) of the BHC Act are not subject to limits on (i) the size of individual commitments to underwrite equity securities ($60 million under Regulation K); (ii) the size of

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9. Board Staff memo, footnote 4 above, at 5.

10. Although transactions between a Regulation K broker-dealer (which is part of the bank for purposes of Section 23A) and a Regulation Y broker-dealer (which is an affiliate of the bank for purposes of Section 23A) generally are covered transactions for purposes of Section 23A, in practice many such transactions would be eligible for the exemption that applies to purchases and sales of assets having a readily identifiable market value.

individual holdings of equity securities in dealing accounts ($30 million under Regulation K); (iii) the percentage voting interest of an issuer that may be held in dealing and investment accounts (under Regulation K, 5% for companies that do, and 19.9% for companies that do not, engage in activities in the United States); or (iv) the aggregate amount of securities held in dealing accounts and for investment (under Regulation K, an amount equal to the Tier 1 capital of the Edge Act subsidiary of the bank).[11] Finally, in contrast to Regulation K broker-dealers, broker-dealers operating pursuant to Section 4(k)(4)(E) of the BHC Act are not subject to a prohibition on selling shares of U.S. issuers to U.S. customers.

PROCEDURES FOR ENGAGING IN FINANCIAL ACTIVITIES

As contemplated by the GLBA, the procedures for engaging in financial activities that are contemplated in the interim rules are not burdensome. In the case of engaging in financial activities de novo, a financial holding company need only provide the appropriate Reserve Bank with a simple notice within 30 days of commencing the activity. No notice is required to engage in securities underwriting and dealing activities pursuant to Section 4(k)(4)(E) if the financial holding company already controls a Section 20 company.

Similarly, a simple after-the-fact notice to the appropriate Reserve Bank suffices in the case of the acquisition of control of a company that is engaged in financial activities. A financial holding company may also acquire control of a company that is "substantially" but not exclusively engaged in activities that are financial in nature. The interim rule does not contain a definition of "substantial". The Board's discussion of this exception suggests that whether an impermissible activity is "substantial" will be based on each legal entity within the business being acquired, rather than on the business as a whole, which means the exception may have little practical significance. The post-acquisition notice filed in connection with such an acquisition must commit to terminate or divest impermissible activities within two years of consummation and, immediately upon consummation of the acquisition, not to "engage in or acquire shares of any company engaged in" impermissible activities.[12] The authority to engage in an impermissible activities for two years is contradicted by the requirement to terminate such

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11. In 1997 the Board proposed to increase several of these limits in the case of well capitalized and well managed banks by stating them as a percentage of capital. For example, in the case of equity underwriting commitments, the limit would be the lesser of 3% of the Tier 1 capital of the parent bank or 15% of the tier 1 capital of the Edge Act corporation. In the case of dealing in the equity shares of a company, the limit would be the lesser of 2% of the Tier 1 capital of the parent bank or 10% of the tier 1 capital of the Edge Act corporation. *International Banking Operations*, 62 Fed. Reg. 68424 (proposed rule) (Dec. 31, 1997). Some of speculated that the Board did not finalize this proposal prior to the enactment of the GLBA because the expansion of underwriting and dealing activities through Regulation K subsidiaries of banks might appear to be inconsistent with the Board's position in the GLBA debates that underwriting and dealing activities should only be allowed through holding company rather than through bank subsidiaries.

12. 12 C.F.R. §225.85(a)(3)(i).

activities on closing. Board staff has indicated that the restriction that applies as of the closing refers to engaging in, or acquiring shares of a company engaged in, impermissible activities that were not engaged in at the time of the acquisition. The Board's approach in this regard is more generous than it has applied to bank holding companies, which typically are required to terminate impermissible activities at the time of closing or within six months.

No notice is required in connection with the acquisition of a noncontrolling interest in a financial company.[13] No notice is required to acquire shares in the course of engaging in securities underwriting, dealing or market-making pursuant to 4(k)(4)(E) or merchant banking activities under 4(k)(4)(H) (except, as discussed below, for investments that exceed the lesser of 5 percent of the financial holding company's Tier 1 capital or $200 million).

The interim rule contains procedures for requesting a determination from the Board that an activity is financial in nature, within the scope of a previously approved activity, or permissible as a "complementary" activity. Neither the GLBA nor the Board provide any guidance on what type of activity should be approved as "complementary" to a financial activity or how a "complementary" activity might differ from an "incidental" activity. The GLBA does require the Board to consider, in connection with authorizing a complementary activity, whether the activity would "pose a substantial risk to the safety or soundness of financial institutions or the financial system generally".

MERCHANT BANKING ACTIVITIES THAT ARE FINANCIAL IN NATURE

RELATIONSHIP TO OTHER AUTHORITY

The GLBA added to the BHC Act a new Section 4(k)(4)(H) that permits financial holding companies to make investments in nonfinancial companies as part of a "bona fide underwriting or merchant or investment banking activity". The GLBA authorized the Board and the Secretary of the Treasury (the "Secretary") to issue regulations implementing Section 4(k)(4)(H) "to assure compliance with the purposes and prevent evasions of" the GLBA and the Board and the Secretary published such a regulation on March 28, 2000.[14]

The GLBA added a similar provision, Section 4(k)(4)(I), that permits a financial holding company to make and hold such investments through an insurance underwriter in accordance

13. This exemption is not by its terms limited to the acquisition of a noncontrolling interest in a *financial* company. *See* 12 C.F.R. §225.87(b)(1). However, the only authority to acquire more than 5% of the voting shares of a nonfinancial company is the merchant banking authority, discussed below.

14. *Bank Holding Companies and Change in Bank Control – Part II*, 65 Fed. Reg. 16460 (interim rule with request for public comments) (March 28, 2000).

with state law. The Board and the Secretary do not have authority to issue regulations to govern Section 4(k)(4)(I) and the merchant banking regulations published by them do not apply to merchant banking investments by insurance companies.

Section 4(k)(4)(H) requires that merchant banking investments be held by a "securities affiliate or an affiliate thereof" or by an affiliate of an insurance underwriter that is, or is affiliated with a registered investment adviser. As expected, this requirement is not a significant obstacle to utilizing the new authority. A financial holding company that controls a registered broker-dealer will be permitted to engage in merchant banking activities through any affiliate other than a depository institution.

The merchant banking regulation does not apply to investments in companies that are engaged in activities that are financial in nature. The Board interpreted Section 4(k)(4)(H), which authorizes merchant banking investments in companies "engaged in any activity not authorized pursuant to this section [4(k)]" to mean not only that it is not necessary to use Section 4(k)(4)(H) to make investments in financial companies, but that it is not permissible to do so. This interpretation would also apply to merchant banking investments by insurance companies pursuant to Section 4(k)(4)(I). The only circumstance in which a financial holding company might want to make an investment in a financial company pursuant to Section 4(k)(4)(H) or 4(k)(4)(I) is if a depository institution subsidiary has received a less than satisfactory CRA rating. In that circumstance, a financial holding company is permitted to continue to make merchant banking investments and to make investments pursuant to Section 4(c)(8) but is not permitted to acquire companies pursuant to Section 4(k)(4) (other than Section 4(k)(4)(H) or (I)).[15]

The merchant banking regulation does not displace Section 4(c)(6) of the BHC Act, which continues to allow a financial holding company to acquire up to 5% of the voting shares of any company, or the investment provisions of Regulation K, which allow a financial holding company to acquire less than 20% of the voting shares and up to 40% of the equity of a nonfinancial company that is not engaged in business in the United States. However, merchant banking investments must be included for purposes of determining whether an investment made pursuant to Section 4(c)(6) or Regulation K is in compliance with the limitations of Section 4(c)(6) or Regulation K.

The merchant banking regulations do not apply to the acquisition of shares in the course of securities underwriting, dealing or market making activities conducted under Section 4(k)(4)(E). This exclusion differs from the Board's treatment of shares acquired in the course of dealing activities pursuant to Section 4(c)(8) and Regulation K, which are treated as investments for purposes of the 5% limit of Section 4(c)(6) and the 19.9% limit of Regulation K. The exclusion of dealing activities from the merchant banking regulation is less important because, even in the absence of the exclusion there would be no limit on the percentage of a company that could be

15. 12 C.F.R. §225.84(b)(1).

held in the course of dealing activities; however, the exclusion will make it easier to comply with and to track compliance with the aggregate limitations on merchant banking activities (discussed below).

MAINTAINING THE SEPARATION OF FINANCE AND COMMERCE

A primary purpose of the BHC Act, which is continued in the amendments made by the GLBA, was to maintain the separation between finance and commerce. In the past, the Board ensured that the venture capital activities of bank holding companies would not breach this separation by adopting policies and regulations that prevented bank holding companies from exercising control over nonfinancial companies. The merchant banking authority contained in the GLBA allows financial holding companies to acquire control of commercial and industrial companies. In adopting the merchant banking regulations, the Board and the Secretary needed to find other ways to maintain the separation of finance and commerce.

Bona Fide Merchant Banking Investments

In adopting the merchant banking regulation, the Board and the Secretary stated that only bona fide merchant banking investments were authorized. The authority could not be used to make "strategic investments" or to engage activities that have not been found to be financial in nature. They offered real estate development as an example. Although it is permissible for a financial holding company to acquire an interest in a real estate development company as a merchant banking investment, the regulation "would not allow a financial holding company to acquire a real estate development company if that acquisition represented all or substantially all of the holding company's investments claimed under this part." This comment should be noted, although it is difficult to see what the size of an investment relative to other merchant banking investments has to do with it being bona fide or not.

Section 4(k)(4)(H) authorizes investments in "share, assets, or ownership interests . . . of a company or other entity". The Board acknowledges that real estate is an "asset" but takes the position that in order for it to be a permissible merchant banking investment, it must be an asset "of a company." A financial holding company may acquire real estate pursuant to Section 4(k)(4)(H) only if it promptly transfers the real estate to a company and if its ownership interest in the company otherwise satisfies the merchant banking regulation. As discussed below, this means that if the financial holding company is to be the general partner of a company formed to own real estate, or is to place a director on the board of such a company, then the company must have independent management.

Prohibition on Routine Management

Section 4(k)(4)(H)(iv) provides that a financial holding company may not "routinely manage or operate" a company in which it has made a merchant banking investment "except as may be necessary to obtain a reasonable return on investment upon resale or disposition." The interim regulations implement this provision by permitting a financial holding company to

place on the board of directors of a company in which it has made a merchant banking investment as many of the financial holding company's own officers, employees and directors (including those of a depository institution subsidiary) as it is entitled to under the terms of the investment.[16] Such directors may participate in the affairs of the portfolio company in the manner that is customary for directors, including participation in the selection of senior officers of the portfolio company. However, the portfolio company must have its own officers and employees, none of whom may also be an officer, employee or director of the financial holding company.

A financial holding company may also secure, in the course of making a merchant banking investment, the right to participate in such extraordinary corporate events as: the acquisition of assets of another company; a significant revision of the business plan; the redemption, authorization or issuance of any shares of capital stock by the portfolio company; the sale, merger, consolidation, spin-off, recapitalization, liquidation or dissolution of the portfolio company or any of its significant subsidiaries, or all or substantially all of the asset of such company or subsidiary.

Moreover, it is permissible for a financial holding company to exercise day-to-day control of a portfolio company when that is necessary to address a material risk to the value or operation of the portfolio company. The financial holding company must document such involvement and must obtain the prior approval of the Board if it intends to exercise day-to-control for more than six months.

Limitation on Holding Period

Section 4(k)(4)(H)(iii) permits merchant banking investments to be held "only for a period of time that enables the sale or disposition of the investments on a reasonable basis consistent with the financial viability of merchant banking investment activities." The interim regulations provide that the holding period should not exceed 10 years for investments in portfolio companies or 15 years in the case of an investment in a "qualifying private equity fund".[17] The 10-year holding period does not apply to investments held by a qualifying private equity fund.

For purposes of the 10 year holding period ownership interests previously owned by a financial holding company "under any other provision of the Federal banking laws *that imposes*

16. If the portfolio company is a private equity fund, the financial holding company, through a separately incorporated subsidiary, may be the general partner of the fund.

17. A "qualifying private equity fund" is any company that: is not an operating company; engages exclusively in merchant banking activities; in which the financial holding company owns 25% or less of the equity capital; has at least 10 investors unrelated to the financial holding company; and has a limited life of not more than 12 years with up to three one-year extensions, if approved by majority of holders.

a limited holding period will be considered to have been acquired by the financial holding company under this subpart on the date the financial holding company first acquired . . . . [such] ownership interests under such other provision of law."[18] This means that the merchant banking authority cannot be used to extend the holding period for shares and assets acquired in satisfaction of a debt previously contracted ("DPC") or acquired pursuant to the debt-for-equity provisions of Section 211.5(f) of Regulation K.

A financial holding company may apply to the Board for permission to hold merchant banking investments for a longer period. The interim regulations provide that, in acting on such a request (which must be filed at least one year in advance of the expiration of the normal holding period), the Board will consider the cost of disposing of the investment, the total exposure to the company, market conditions, and the extent and history of involvement of the financial holding company with the portfolio company or private equity fund. (This analysis differs from the analysis currently used by the Board to decide whether to extend a DPC holding period, in which the focus is on the cost of continuing to hold the asset and the efforts that have been made to date to divest.) If the request is approved, it will be subject to the following conditions: 100% of the investment must be deducted from Tier 1 capital (in contrast to the normal 50%); all unrealized gains must be excluded from Tier 2 capital; and, without Board approval, the financial holding company may not enter into any additional "contractual relationships" with the company or extend it additional credit.

Cross-Marketing Restrictions

Cross marketing is not permitted between a depository institution subsidiary (or any subsidiary thereof other than a "financial" subsidiary) of a financial holding and a portfolio company of which the financial holding company, directly or through a private equity fund that it controls, has acquired more than 5% of the voting shares.[19] For this purpose, a U.S. branch or agency of a non-U.S. bank that is a financial holding company is treated as a depository institution.

Although the GLBA contemplated that the restrictions on cross-marketing would apply only between depository institutions and portfolio investments held by affiliates, it is interesting that, in keeping with its concern to maintain the separation of finance and commerce, the Board did not more broadly restrict cross marketing between companies controlled pursuant to Section 4(k)(4)(H) and financial holding company affiliates other than depository institutions.

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18. 12 C.F.R. §225.172(b)(3).

19. The cross marketing restriction does not apply to portfolio companies in which a financial holding company has invested through a private equity fund that it does not control.

PRUDENTIAL LIMITATIONS

Section 23A

Section 23A of the Federal Reserve Act restricts transactions between insured depository institutions and nonbank companies (other than subsidiaries of such depository institutions) that are under common control. The primary restriction is a requirement that loans by the depository institution to such nonbank companies be fully collateralized by government securities or, if other types of collateral are used, by collateral equal to as much as 140% of the amount of the loan.

The GLBA establishes a rebuttable presumption of control (and thus, of affiliation for purposes of Section 23A) if a financial holding company owns 15% or more of the "equity" of a company pursuant to Section 4(k)(4)(H) or Section 4(k)(4)(I).[20] For this purpose, equity includes instruments convertible into capital but does not include nonconvertible subordinated debt. The rebuttable presumption applies to investments in private equity funds as well as direct investments in portfolio companies unless the private equity fund is controlled or sponsored and advised by an unrelated third party. In addition, a financial holding company is viewed as controlling a private equity fund if it sponsors and advise the fund, regardless of the amount of equity it may hold in the fund.

U.S. branches and agencies of non-U.S. banks are treated as insured depository institutions for purposes of this restriction.

Aggregate Merchant Banking Investment Limitations

The merchant banking regulations provide a limit on the amount of merchant banking investments that a financial holding company may make without obtaining prior Board approval. A financial holding company may not make any additional investments pursuant to Section 4(k)(4)(H) if the aggregate carrying value of its prior investments exceeds the lesser of 30% of Tier 1 capital or $6 billion, or the "aggregate carrying value" of such investments, excluding investments in qualifying private equity funds exceeds the lesser of 20% of Tier 1 capital or $4 billion.

This limit would not prevent a private equity fund that is controlled by a financial holding company from making additional investments, but would prevent the financial holding company from making additional investments in such a fund. For purposes of calculating this limit, equity investments made pursuant to other authority, such as Regulation K and Section 4(c)(6) are excluded.

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20. Although the interim regulations generally do not apply to merchant banking investments made by insurance companies pursuant to Section 4(k)(4)(I), the GLBA provides that Section 23A applies to such investments to the same extent as investments made pursuant to Section 4(k)(4)(H).

Risk Management

The Board and the Secretary, in the course of preparing the new regulation, interviewed securities firms and other that make merchant banking investments. Those firms indicated that such investments are often riskier, less liquid and more volatile than other types of investments and, consequently, require "greater capital support, careful monitoring and valuation systems, specific policies for addressing diversification of investments, and carefully developed limits on the amount of funds put at risk in the activity." In light of these findings, the merchant banking regulations require financial holding companies to establish policies and procedures to monitor and assess the risks associated with making merchant banking investments, for assuring corporate separateness and for limiting the potential for affiliated banks to be liable for the financial obligations of these companies.

The regulations also require such financial holding companies to maintain centralized records that document the company's policies for making merchant banking investments and for managing and monitoring the various risks and exposures created by these activities. The Board intends to review these policies and systems of each financial holding company that makes merchant banking investments shortly after the holding company commences the activity.

Procedural Aspects

A financial holding company must notify the Board within 30 days of commencing merchant banking activities. No notice is required thereafter in connection with making portfolio investments unless an investment involves the acquisition of more than 5% of the voting shares of a company *and* the cost of the investment exceeds the lesser of 5% of tier 1 capital and $200 million. If an investment exceeds these limits, then a notice must be filed within 30 days and it must include "an explanation of the risk management measures to be applied by the financial holding company to the investment".

The regulations also require a financial holding company that is engaged in merchant banking activities to file an annual report regarding them, including aggregate data for all investments (by industry, geography, and holding periods). The report is also required to include the historical cost, market valuation and divestiture schedule for each investment held for more than 5 years, in the case of direct investments, and held for more than 8 years, in the case of private equity funds. The regulations also require financial holding companies that are engaged in merchant banking activities to file a quarterly report containing aggregate data regarding the number, cost and value of its merchant banking investments.

CAPITAL TREATMENT OF MERCHANT BANKING INVESTMENTS

In addition to the interim rule issued by the Board and the Secretary that defines what merchant banking investments are financial in nature and the procedures applicable to such investments, the Board proposed deducting 50% of the carrying value of such investments from Tier 1 capital.[21]

The Board explained the 50% deduction in part as the result of its discussions with nonbanking firms that currently make private equity investments, which indicated that such firms typically impose internal capital charges of 25% to 100%. The Board also stated that the proposed capital treatment is similar to the approach that the FDIC has adopted for investments in subsidiaries that engage in principal activities that are not permissible for a national bank. The FDIC requires state nonmember banks to deduct their investments in such subsidiaries from their Tier 1 capital.[22]

CALCULATING THE DEDUCTION

Under the proposal, a bank holding company would be required to deduct from its regulatory Tier 1 capital an amount equal to 50 percent of the total carrying value, as reflected on consolidated financial statements of the bank holding company, of all merchant banking investments. The bank holding company would deduct 100 percent of the carrying value of such investments from the assets of the bank holding company for capital purposes.

Investments that are booked using "available for sale" ("AFS") accounting do not recognize unrealized gains in net income. Under the current bank holding company capital rules, 45 percent of the gain on AFS equity securities may be included in Tier 2 capital and the unrealized losses on such investments are deducted from Tier 1 capital. This would continue to be the case under the proposal, but 50% of the recorded cost (or fair value, if lower) of the investment would be deducted form Tier 1 capital and the recorded cost (or fair value) would be deducted from total assets for regulatory capital calculation purposes.

A bank holding company also would deduct from its tier 1 capital 50 percent of its investment[23] in portfolio companies that are consolidated for accounting purposes. The portfolio companies would remain fully consolidated for purposes of determining risk-weighted assets.

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21. *Bank Holding Companies and Change in Bank Control — Part II*, 65 Fed. Reg. 16480 (proposed rule) (March 28, 2000).

22. 12 C.F.R. §362.4(e).

23. The company's investment would be determined under the equity method of accounting.

CAPITAL DEDUCTION ONLY AT THE BANK HOLDING COMPANY LEVEL

The proposed capital deduction would only apply at the bank holding company level, not at the bank subsidiary level. The Board emphasized that the capital deduction would not affect the ability of any bank holding company to become a financial holding company because financial holding company status is determined based on the capital of depository institution subsidiaries. This may not be entirely true in light of the stated view of Board staff that a depository institution may not be well managed if its holding company is not well capitalized. Moreover, the proposed capital deduction reflects a view that financial holding company capital ratios are important, an emphasis that is inconsistent with the functional regulatory scheme adopted in the GLBA.

The discussion accompanying the proposed rule does not address non-U.S. banks. Board staff has informally and preliminarily advised that the rule will not apply to non-U.S. banks that do not have U.S. bank subsidiaries. This is consistent with the GLBA, which instructed the Board to permit non-U.S. banks to become financial holding companies based on capital standards that are comparable to those for U.S. depository institutions. However, it is not clear whether the capital deduction will be applied to non-U.S. banks that own U.S. bank subsidiaries.

INVESTMENTS BY INSURANCE COMPANIES

The proposed capital deductions will not apply to merchant banking investments by insurance companies that are financial holding companies or subsidiaries thereof. The Board also stated that it expects to seek comments on a proposal to de-consolidate functionally regulated insurance underwriting companies from the financial holding company for purposes of applying the Board's consolidated capital rules.

There are two basic types of capital charges applicable to investments by insurance companies: risk-based capital ("RBC") rules, which apply to both life insurance companies and property and casualty insurance companies; and the asset valuation reserve ("AVR"), which applies only in the case of life insurance companies. The RBC and AVR formulas are determined by the National Association of Insurance Commissioners. Insurance company investments are also limited by state insurance law, principally in the company's state of domicile.

The RBC rules measure insurance risk (relating to underwriting and reserving), general business risk and asset risk. An insurer without sufficient risk-based capital is subject to varying degrees of regulatory action depending upon the magnitude of the deficiency. The asset risk component of RBC is addressed by assigning a capital weighting to each asset based upon its risk characteristics. For life insurance companies, the RBC risk weights generally range from zero for AAA-rated bonds to 30% for common stock; real estate has a 10% RBC weight (15% for foreclosed real estate). For property and casualty insurance companies, the RBC risk weight is generally 15% for most common stock investments and 10% for real estate.

Unlike RBC, the AVR has a direct effect on a life insurance company's balance sheet. Since the AVR is a reserve, it is carried as a liability and, therefore, reduces policyholders' surplus. Policyholders' surplus is the most important component of an insurance company's balance sheet in that most solvency tests are based on policyholders' surplus. Policyholders' surplus also affects how much new business an insurer may write, and the amount of stockholder dividends that an insurer may pay. The required AVR ranges from zero for the highest quality bonds to up to 30% for common stock. The AVR for real estate is 7.5% (11% for foreclosed real estate).

In addition to the capital charges discussed above, insurance company investments are regulated by state law. For example, a life insurance company domiciled in New York generally may invest no more than 2% of its admitted assets in the common equity of one company. A New York property and casualty insurance company generally may invest no more than 1% percent of its admitted assets in the common equity of one company. Aggregate common equity investments are also limited: to 20% of admitted assets for life insurers; and to the lesser of (a) policyholders' surplus, and (b) 10% of admitted assets, for property and casualty insurers.

The deconsolidation of insurance companies from financial holding companies for purposes of holding company capital analysis is consistent with the GLBA emphasis on function regulation. However, the capital charges incurred by insurance companies under insurance company regulation are less onerous than those proposed by the Board for other financial holding companies. The Board stated that it would monitor financial holding companies for signs of regulatory arbitrage and address such incidents on a case-by-case basis.

SCOPE OF INVESTMENTS COVERED BY THE PROPOSAL

The proposed capital deduction would apply not just to investments made pursuant to the new merchant banking authority of Section 4(k)(4)(H), but to investments in non-financial companies made by small business investment company subsidiaries of banks and bank holding companies (which in the past had not been affected by Board regulation) and to investments made pursuant to Section 4(c)(6) and 4(c)(7) of the BHC Act, pursuant to which bank holding companies may acquire up to 5% of the voting shares and up to 24.9% of the equity of a nonfinancial company. The deduction also will apply to investments made pursuant to investments in nonfinancial companies pursuant to Section 211.5(b)(1)(iii) of Regulation K and to investments made by state nonmember banks pursuant to Section 24 of the Federal Deposit Insurance Act. The deduction will not apply to equity securities held in trading accounts pursuant to the authority to engage in underwriting and dealing activities.

As discussed above, Board staff has informally indicated that the capital deduction for investments in nonfinancial companies generally will not apply to non-U.S. banks, although they may apply to non-U.S. banks that have U.S. bank subsidiaries. Non-U.S. banks hold investments in non-U.S. nonfinancial companies and in U.S. nonfinancial companies pursuant to Section 211.23(f) of Regulation K. The proposed rule regarding capital deductions refers only to Section 211.5(b)(1)(iii) of Regulation K, the provision authorizing investments by U.S.

banking organizations in non-U.S. nonfinancial companies, and so it would not affect the Regulation K investments of non-U.S. banks even if such banks were generally subject to the capital deduction for merchant banking investments.

The definition of "investment" in the proposed capital deduction rule includes any debt instrument with "equity feature (such as conversion rights, warrants or call options)". A bank holding company can make a loan that includes, as an "equity kicker", warrants or options for equity securities without relying on any of the authorities cited by the Board in its definition of "portfolio investment." Such a loan could be made by a nonbank lending subsidiary pursuant to Section 225.28(b)(1) of Regulation Y, and by a bank subsidiary pursuant to the authority granted in its charter. Under the language of the proposed regulation, such a loan would not be subject to a capital deduction and would require no more than 5% Tier 1 capital. If, however, the banking organization adds a single share of stock in the borrower, the entire transaction would require Tier 1 capital equal to 50% of the amount of the transaction.

The term "investment" also applies to any loan (excluding secured, short-term working capital loans) to a company if the banking organization owns 15% or more of the equity of the company, unless at least half of loan has been participated to unaffiliated third parties. The theory behind excluding participated loans is that the necessity of selling them in the market will result in them having arm's length terms. However, since such loans will often be participated to parties that are also making an equity investment in the company, the fact of participation will not necessarily demonstrate that a lender without an equity investment would have made the loan on the same terms.

NON-U.S. BANKS AS FINANCIAL HOLDING COMPANIES

Most non-U.S. banks engage in banking activities in the United States through branches and agencies rather than through depository institution subsidiaries. For purposes of determining whether a non-U.S. bank qualifies as a financial holding company, it would not have been meaningful to apply the well capitalized standard solely to the U.S. branches and agencies, which are not separately incorporated. The GLBA required the Board to establish "comparable" capital and management standards for non-U.S. banks that wished to be treated as financial holding companies, "giving due regard to the principle of national treatment and equality of competitive opportunity". The approach that was included in the interim regulations issued by the Board in January was adverse to non-U.S. banks in several ways. First, although the Board necessarily applied the well capitalized and well managed standard to the non-U.S. bank itself where the non-U.S. bank did not operate a U.S. depository institution, the Board also applied these standards to the non-U.S. bank where it did control a U.S. depository institution. Thus, in determining whether Bank of America Corporation qualified as a financial holding company, the Board considered only whether the bank and thrift subsidiaries of Bank of America were well capitalized and well managed. Bank of America itself was not required to

satisfy those criteria. However, Deutsche Bank AG, for example, must meet these standards both at the Deutsche Bank level and at its U.S. bank subsidiary (formerly known as Bankers Trust).

Second, the Board included a leverage ratio requirement in the "well capitalized" standard applicable to non-U.S. banks. Few countries other than the United States impose a leverage requirement on banking organizations. The Basle Accord, the international agreement among the major industrial countries that is the basis for risk-based capital guidelines applicable to banks in those countries, does not include a leverage ratio requirement. To require non-U.S. banks to meet such a test has the effect of exporting to other countries a capital requirement that is unique to the United States. Many non-U.S. banks will need to make adjustments to their operations in order to meet this criterion.

Third, the interim rules contemplates that a non-U.S. bank will be considered "well managed" only if the Board determines that the non-U.S. bank meets standards "comparable to those required of a U.S. bank owned by a financial holding company." This approach could have the effect of exporting U.S. supervisory standards to the non-U.S. operations of non-U.S. banks.

On March 10, 2000 the Board issued a list of 117 companies that had qualified as financial holding companies. Only 9 of these were non-U.S. banks. The list did not include any banks from France, Germany, Italy, Japan, or Switzerland. On March 23, 2000 the Board issued a list of 27 additional companies that had been granted financial holding company status. The list included only two non-U.S. banks, Deutsche Bank AG and Credit Suisse Group.

Representatives of the European Commission, an arm of the European Union, stated publicly that the Board was discriminating against non-U.S. banks and that many European banks had been dissuaded by Board staff from applying for financial holding company status. A member of the Board, Governor Laurence Meyer, replied to the European Commission's criticisms in a letter that was publicly distributed.[24] Governor Meyer stated that, in the case of non-U.S. banks, the quantitative capital levels contained in the interim rule were merely a screening device. Non-U.S. banks that did not satisfy the quantitative levels would be provided with an opportunity to demonstrate (based on asset quality, external debt ratings, or other factors), that their capital was equivalent to that of a well capitalized U.S. bank. Governor Meyer stated that two non-U.S. banks that did not satisfy the leverage measure had been granted financial holding company status pursuant to this "alternative method". The Board has not disclosed any details regarding its use of the alternative method. A key issue is what will be required of such banks if their capital ratios decline slightly. Under the normal method, a banking organization that no longer meets the "well capitalized" standard may not make acquisitions (including merchant banking investments) or engage in new financial activities and

24. Letter from Gov. Meyer to Mr. John F. Mogg, Director General, Internal Market and Financial Services, European Commission (April 17, 2000).

is given 180 days to meet the well capitalized standard or terminate activities that require financial holding company status. This approach, which is workable for financial holding companies that are already somewhat above the minimum standards, will not work well for financial holding companies that require the second method because they do not meet one or more of the standards: very slight reductions in one or more of the capital measures would force such a bank to delay activities or investments. It is our understanding that such banks will be required to report any reductions in capital ratios to the Board, but that such reductions will not automatically force such banks into a remediation process. Instead, the Board will exercise discretion in deciding whether or not such a bank continues to meet the well capitalized standard.

Governor Meyer also pointed to several changes in the interim rule that the Board had announced on March 15, 2000.[25] In order to level the playing field, a non-U.S. bank will not be required to wait for an affirmative Board decision that it qualifies as a financial holding company, which the Board had said it would attempt to provide within 30 days of filing. In the future non-U.S. banks will be subject to the rule that applies to a U.S. organizations, the election of which to become a financial holding company becomes effective on the 31st day after filing unless the Board finds the election ineffective or the organization agrees to extend the processing period. This amendment does not appear to have much practical significance.

Although it was not cited by Governor Meyer, another amendment to the rule removed the phrase “the Board determines” from the portion of the “well managed” standard that formerly required *the Board* to determine that “the management of the foreign bank meets standards comparable to those required of a U.S. bank owned by a financial holding company.” This change is consistent with Governor Meyer’s statements that the Board never contemplated the “well managed” standard to require a non-U.S. bank’s home supervisor to assess a non-U.S. bank under U.S. bank supervisory standards.

SIMPSON THACHER & BARTLETT LLP

25. *Bank Holding Companies and Change in Bank Control*, 65 Fed. Reg. 15053 (interim rule with request for public comments) (March 21, 2000); *Bank Holding Companies and Change in Bank Control*, 65 Fed. Reg. 16302 (interim rule; correction) (March 28, 2000).