

FEDERAL RESERVE SYSTEM**12 CFR Part 225****[Regulation Y; Docket No. R-1065]****DEPARTMENT OF THE TREASURY****Office of the Under Secretary for Domestic Finance****12 CFR Part 1500****RIN 1505-AA78****Bank Holding Companies and Change in Bank Control**

AGENCIES: Board of Governors of the Federal Reserve System and Department of the Treasury.

ACTION: Interim rule, with request for public comments.

SUMMARY: The Board of Governors of the Federal Reserve System and the Secretary of the Treasury jointly adopt on an interim basis, effective March 17, 2000, and solicit comment on a rule that will govern merchant banking investments made by financial holding companies. This rule implements provisions of the recently enacted Gramm-Leach-Bliley Act (GLB Act) that permit financial holding companies to make investments as part of a bona fide securities underwriting or merchant or investment banking activity. A summary of the rule appears below in the executive summary in the **SUPPLEMENTARY INFORMATION** section.

DATES: The interim rule is effective on March 17, 2000. Comments must be received on both the interim rule and the capital proposal by May 22, 2000.

ADDRESSES: Comments should refer to docket number R-1065 and should be sent to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551 (or mailed electronically to regs.comments@federalreserve.gov) and to Merchant Banking Regulation, Office of Financial Institution Policy, U.S. Department of the Treasury, 1500 Pennsylvania Avenue, N.W., Room SC 37, Washington, D.C. 20220 (or mailed electronically to financial.institutions@do.treas.gov). Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between the hours of 8:45 a.m. and 5:15 p.m. and, outside of those hours, to the Board's security control room. Both the mail room and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street between

Constitution Avenue and C Street, N.W. Members of the public may inspect comments in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. on weekdays. Comments addressed to the Treasury Department may also be delivered to the Treasury Department mail room between the hours of 8:45 a.m. and 5:15 p.m. at the 15th Street entrance to the Treasury Building.

FOR FURTHER INFORMATION CONTACT:

Board of Governors: Scott G. Alvarez, Associate General Counsel (202/452-3583), Kieran J. Fallon, Senior Counsel (202/452-5270), or Camille M. Caesar, Senior Attorney (202/452-3513), Legal Division; Jean Nellie Liang, Chief, Capital Markets (202/452-2918), Division of Research & Statistics; Michael G. Martinson, Deputy Associate Director (202/452-3640) or James A. Embersit, Manager, Capital Markets (202/452-5249), Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. Users of Telecommunications Device for the Deaf (TDD) only contact Janice Simms at (202) 872-4984.

Department of the Treasury: Joan Affleck-Smith, Director, Office of Financial Institutions Policy (202/622-2740), Gerry Hughes, Senior Financial Economist (202/622-2740); Roberta K. McNerney, Assistant General Counsel (Banking and Finance) (202/622-0480) or Gary Sutton, Senior Banking Counsel (202/622-0480).

SUPPLEMENTARY INFORMATION:**A. Executive Summary**

This rule implements provisions of the recently enacted GLB Act that permit financial holding companies to make investments as part of a bona fide securities underwriting or merchant or investment banking activity. These investments may be made in any type of ownership interest in any type of nonfinancial entity (portfolio company), and may include any amount up to all of the ownership interests in the company. The investments that may be made under this new authority are substantially broader in scope than the investment activities otherwise permissible for bank holding companies, and are referred to as "merchant banking investments."

The interim rule does not address or apply to securities underwriting, dealing or market making activities conducted under section 4(k)(4)(E) of the Bank Holding Company Act (BHC Act). Moreover, the authority granted by section 4(k)(4)(H) of the BHC Act to

financial holding companies to make merchant banking investments is an alternative to any other authority that the financial holding company may have to make investments in nonfinancial companies under other provisions of the Bank Holding Company Act except as specifically noted in the rule.

The interim rule sets forth the parameters within which financial holding companies may make merchant banking investments. As an initial matter, the GLB Act allows a financial holding company to make merchant banking investments if the financial holding company controls a securities affiliate or controls both an insurance underwriter and a registered investment adviser. The rule defines a securities affiliate for this purpose to be any registered securities broker or dealer.

The GLB Act contains provisions that are designed to help maintain the separation between banking and commerce by limiting the time period that a merchant banking investment may be held by a financial holding company and the circumstances under which the financial holding company may routinely manage or operate a portfolio company. In particular, the GLB Act provides that merchant banking investments may be held only for a period of time that enables the sale or disposition of the investment on a reasonable basis consistent with the financial viability of merchant banking investment activities. The rule provides that, in most cases, merchant banking investments may be held for a 10-year period. The rule allows a financial holding company to invest in a qualifying private equity fund for the term of the fund, up to 15 years under certain circumstances.

With respect to routinely managing or operating portfolio companies, the rule clarifies that director interlocks at the portfolio company and certain types of agreements and covenants that affect only extraordinary corporate events would not, as a general matter, be considered routine management or operation. The rule also provides that a financial holding company would be considered to be routinely managing or operating a portfolio company if the financial holding company establishes interlocks at the officer or employee level of the portfolio company or has certain other arrangements involving day-to-day management or participation in ordinary business decisions. The rule sets forth those limited circumstances when it is permissible for a financial holding company to routinely manage or operate a portfolio company, requires

documentation of these interventions, and limits the duration of the involvement.

The interim rule contains other provisions that are also designed to serve this fundamental purpose of maintaining the separation of banking and commerce as well as to promote the safe and sound conduct of merchant banking activities. In particular, the rule requires financial holding companies to establish policies and systems to monitor and assess the various risks associated with making merchant banking investments. The financial holding company must also establish policies for assuring the corporate separateness of companies held under the rule and limiting the potential that the financial holding company or its affiliated depository institutions may be legally liable for the financial obligations or operations of those companies. In addition, the rule implements the cross-marketing prohibitions of the GLB Act and the provisions of sections 23A and B of the Federal Reserve Act that restrict transactions between a depository institution and a portfolio company controlled by the same financial holding company.

Recordkeeping and reporting requirements are also established in order to promote compliance with the provisions of the rule and the safe and sound conduct of the activity. These records include documentation of transactions and relationships between a financial holding company, including each of its subsidiaries, and a company held under the merchant banking authority, with special attention paid to transactions and relationships that are not on market terms.

Also to limit the potential level of risk to a financial holding company and its affiliated depository institutions from merchant banking investments, the interim rule establishes aggregate investment limits. The new Subpart provides that a financial holding company may not make additional merchant banking investments if the aggregate carrying value of all merchant banking investments made by the financial holding company under the GLB Act exceeds (1) the lesser of 30 percent of its Tier 1 capital or \$6 billion, or (2) the lesser of 20 percent of Tier 1 capital or \$4 billion after excluding investments made by the financial holding company in private equity funds. A financial holding company may invest a greater amount with prior approval. As explained below, the Board and the Secretary believe these limits are necessary until appropriate capital rules are put in place and

experience is gained in managing and supervising the risks of this activity.

Chief among the elements necessary to address safety and soundness is the appropriate capital treatment for merchant banking investments made by financial holding companies. The Board and the Secretary have developed a proposal to address the appropriate capital charge for merchant banking investments. This proposal seeks comment on an amendment to the Board's capital guidelines for bank holding companies that, in general, would apply a 50 percent capital charge to all merchant banking investments made under the interim rule. The capital proposal also requests comment on whether similar capital treatment should be applied at the holding company level to investments by bank holding companies and their subsidiaries in nonfinancial companies through small business investment companies (whether held directly by the bank holding company or by a depository institution controlled by the bank holding company), under Regulation K, in less than 5% of the shares of companies under section 4(c)(6) or 4(c)(7) of the BHC Act, or by an insured state bank subsidiary in accordance with section 24 of the Federal Deposit Insurance Act (FDI Act).

The interim rule is contained in a new Subpart J to the Board's Regulation Y and in a new Part 1500 of the rules of the Department of the Treasury. These new subparts are promulgated on an interim basis, effective on March 17, 2000, in order to provide guidance to financial holding companies regarding the definitions, limits and supervisory requirements that govern the activity of making merchant banking investments as soon as possible following the effective date of the relevant provisions of the GLB Act.

The capital proposal is described below, and is published separately in accordance with the requirements of the **Federal Register**.

The Board and the Secretary of the Treasury solicit comments on all aspects of the interim rule and will amend the rule as appropriate in response to comments received.

B. Background

Interviews With Securities Firms and Bank Holding Companies

In order to gather information about how firms currently make merchant banking investments, staff of the Federal Reserve System and the Department of the Treasury conducted interviews with a number of securities firms that currently make merchant banking

investments. System staff and Treasury staff also interviewed several bank holding companies that make more limited types of investments under existing authority. The attached rule reflects information collected in these interviews and the experience of the System in supervising the more limited types of investment activities permissible for bank holding companies.

The interviews indicated that merchant banking investment activities conducted by major securities firms most often are conducted through private equity funds, which pool a financial institution's capital with funds from third-party investors. These investors are generally either institutions (such as other investment companies, pension funds, endowments, charitable organizations, investment units of financial institutions, and other companies) or individuals with high net worth. The securities firm is typically the sponsor and advisor to the fund as well as an investor in the fund. The private equity fund may be organized in corporate, partnership or other form, and by contract has a limited life that typically spans 10 years, with the possibility of limited extensions.

Private equity funds typically have features, including compensation arrangements, that—in addition to the limited life of the fund—strongly encourage the resale of investments made by the fund. As a result of these incentives and structural arrangements, and given current economic conditions, investments made by private equity funds are typically sold within a period of between 3 and 5 years. In addition, private equity funds typically have policies, review committees or other measures that encourage funds to diversify holdings and/or limit the amount of the fund's capital invested in a single portfolio company.

Securities firms also at times make merchant banking investments for the account of the securities firm and not through a private equity fund. These investments tended to be less significant than investments made through a private equity fund. The investment period for direct investments ranged from less than one year to somewhat longer than 10 years, with investments most often held for an average of 5 years under current conditions.

Securities firms and bank holding companies uniformly indicated that they apply higher internal capital charges against merchant banking investments than are applied to many other types of activities. The industry practice regarding the appropriate

internal measures of capital required to support merchant banking activities reflects the greater risks associated with these investments, including the volatility and illiquidity of many investments, and the fact that portfolio companies are themselves often leveraged companies. Private equity funds supported their investment activities almost exclusively with capital contributed by investors. Occasionally, private equity funds rely on short-term leverage that is repaid with a capital call on investors. However, private equity funds do not appear to rely to any significant extent on debt to fund investment activities.

Firms that make merchant banking investments impose internal capital charges that differ by firm and, in some cases, by type of investment. These capital charges range from 25 percent to 100 percent of the investment. Firms typically record investments initially at the lower of cost or market. Investments may be assigned an adjusted carrying value if a significant event occurs (such as an initial public offering, follow-up financing, or secondary capital raising events), subject to a discount that reflects the size of the firm's holding, the liquidity of the market for the shares held, the volatility of the market and other factors and that is applied prior to recognizing any unrealized gains on the investment. The securities firms all have policies for reviewing and recording the value of individual investments and the appropriate discounts to apply to the unrealized gains on investments.

Securities firms use a variety of methods to monitor the condition of portfolio companies. The most important involve receiving formal and informal reports on both a periodic basis and in the case of significant events, and maintaining representation on the board of directors of the portfolio company. Securities firms typically participate to the fullest extent allowed under their ownership interest in selecting the board of directors of a portfolio company and often select officers and employees of the firm to serve on the board of the portfolio company. These directors exercise the full rights and responsibilities of a member of the board, but are not expected to become involved in the routine management or operation of a portfolio company, as a general matter.

In both the private equity fund context and the direct investment context, securities firms indicated that the firm would on occasion become involved in routinely managing or operating a portfolio company. These interventions occur in limited situations when the merchant banker determines

that intervention is necessary (1) to respond to an unusual event that directly affects the value of the investment, such as loss of portfolio company senior management, operational failures, major acquisitions, business plan changes and significant business losses, or (2) to facilitate the sale or disposition of the investment, such as participation in negotiations for sale of the portfolio company or the initial public offering of the company's shares. These interventions are temporary in most cases and usually take the form of increased consultation with the management of the portfolio company, exercise of review and veto rights over certain extraordinary decisions of management, replacement of management, and, in a small number of cases, temporary appointment of a representative of the investor as an officer of the portfolio company.

C. Interim Rule

The GLB Act specifically provides that the Board and the Secretary of the Treasury may issue regulations implementing section 4(k)(4)(H) that they jointly determine to be appropriate to assure compliance with the purposes and prevent evasions of the BHC Act and the GLB Act and to protect depository institutions, including limiting transactions between depository institutions and companies controlled under section 4(k)(4)(H) (12 U.S.C. 1843(k)(7)(A)) and reporting and recordkeeping requirements. The Board is also authorized by the BHC Act and other provisions of law to promulgate rules, including capital standards and reporting and recordkeeping requirements, consistent with the requirements and purposes of the BHC Act and other provisions.

The proposed interim rule reflects the information collected in the interview process in defining the parameters of merchant banking activities, allowable holding periods, involvement in the management and operation of portfolio companies and the monitoring and risk management systems these firms have developed. As noted above, securities firms and others that make merchant banking investments recognized that merchant banking investments are often riskier, less liquid and more volatile than many other types of investments and often involve an investment in a leveraged company. Consequently, these investments 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 each of these areas,

the interim rule and proposal are consistent with industry practices in making, monitoring and managing the risks associated with merchant banking investments.

At the same time, the Board and the Secretary recognize that, by its nature, an agency rule sets outside limits, and in several key areas—such as the duration of holding periods, internal capital charges, and level of involvement in management of portfolio companies—industry practice has been more conservative than—and well within—the outside parameters set by the rule and proposal. In setting outside limits, the Board and the Secretary do not intend to encourage behavior that is different than more conservative industry practice and expect to monitor merchant banking activities carefully and discourage migration from the norms for conducting these activities to the outer limits allowed under the rule and proposal.

While the rule is being adopted on an interim basis, the Board and the Secretary welcome comments on all aspects of the interim rule. These comments will be carefully considered and adjustments made to the interim rule as appropriate before its final adoption.

Section 225.170—What Investments Are Permitted Under This Subpart and Who May Make Them?

As noted above, section 4(k)(4)(H) and the interim rule permit a financial holding company to acquire or control shares, assets or ownership interests of any company that engages in activities that are not otherwise permissible for a financial holding company. Interests acquired or controlled under the interim rule are referred to as merchant banking investments, and a financial holding company must comply with the requirements of this interim rule in order to make such investments.

A financial holding company is not required to obtain the Board's approval or provide notice to the Board before the financial holding company begins making merchant banking investments or acquires a company that makes merchant banking investments. A financial holding company must, however, file notice with the Board under section 4(k)(6) of the BHC Act and section 225.87 of Regulation Y (12 CFR 225.87) within 30 days after commencing merchant banking investment activities or acquiring any company that makes merchant banking investments.

Section 4(k)(4)(H) provides that a financial holding company may acquire or control shares of a company under

that section "as part of a bona fide underwriting or merchant or investment banking activity." The Board and the Secretary wish to emphasize the importance of this requirement in preventing circumvention of one of the fundamental purposes of the GLB Act of maintaining the separation of banking and commerce.

This requirement prevents the merchant banking authority from being used to engage in a nonfinancial activity. It distinguishes authorized merchant banking investments from strategic or other types of investments that are not permitted under the BHC Act or the GLB Act, such as the purchase of a commercial company or a real estate project made for the purposes of engaging in a commercial or other nonfinancial activity. Thus, for example, this authority could not be used by the financial holding company to engage in real estate development or other activities that have not been found to be financial.

This "bona fide" requirement does not prevent the acquisition of an interest in a company engaged in real estate development as part of a diversified portfolio of investments by the financial holding company in connection with its merchant banking business and in accordance with the other restrictions in the interim rule. The Board and the Secretary recognize that investments in real estate are often part of a diversified merchant banking portfolio. The Board and the Secretary believe, however, that the subpart 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 subpart. The rule includes this "bona fide" provision, and the Board will carefully monitor merchant banking investments to ensure that they meet this requirement and that the merchant banking authorization is not used by a financial holding company to engage in impermissible nonfinancial activities.

Under the statute and the rule, merchant banking investments include the full range of ownership interests, including securities, warrants, partnership interests, trust certificates, and other instruments representing an ownership interest in a company, whether the interest is voting or nonvoting. They also include any instrument convertible into a security or other ownership interest.

Under the statute and the rule, merchant banking investments may represent any amount of ownership interests in a portfolio company, whether or not that amount results in

control for purposes of the BHC Act. Thus, this authority allows a financial holding company the flexibility to use its merchant banking authority to acquire or control a nominal amount of shares of a portfolio company or all of the ownership interests in a portfolio company.

The authority granted by section 4(k)(4)(H) is an alternative to the other authority granted to financial holding companies to make investments in nonfinancial companies under other provisions of the BHC Act.¹ Moreover, the rule does not address or apply to securities underwriting, dealing or market-making activities conducted under section 4(k)(4)(E) of the BHC Act.

The rule allows financial holding companies to make investments directly or through any subsidiary other than a depository institution or subsidiary of a depository institution.² The rule also incorporates the provision of the GLB Act that prohibits a financial holding company from making merchant banking investments on behalf of a depository institution or subsidiary of a depository institution. For purposes of the provisions of the rule, the term "financial holding company" refers to the financial holding company and any direct or indirect subsidiary of the holding company other than a portfolio company. The term "financial holding company" does not include a depository institution controlled by the financial holding company or any subsidiary of such a depository institution, except for purposes of the routine management provisions of section 171 and the recordkeeping and reporting provisions of section 174.

Subsection (e) allows a financial holding company to acquire and hold "assets" (other than shares or other ownership interests) of a company. In keeping with the stricture in section 4(k)(4)(H) that assets be "of a company," subsection (e) requires that assets acquired as a merchant banking investment, such as real estate or assets of a division of an operating company, be promptly placed in and held through a portfolio company that maintains strict corporate separation from the financial holding company in order to

¹ For purposes of determining whether an investment qualifies under the alternative authority for making investments granted by Regulation K and by sections 4(c)(6) and (7) of the BHC Act, a financial holding company must generally aggregate all investments held by the financial holding company in a single company.

² A subsidiary of a member bank may make merchant banking investments only if, after five years, the Board and the Secretary jointly adopt rules in accordance with section 122 of the GLB Act that permit financial subsidiaries of member banks to make merchant banking investments.

limit the liability of the financial holding company and its financial and depository institution affiliates for the financial obligations and operating risks of the asset.

To take advantage of this new authority, section 4(k)(4)(H) of the BHC Act requires that a bank holding company become a financial holding company.³ In addition, the financial holding company must control either (1) a securities affiliate or (2) both an insurance underwriter and an investment adviser, registered under the Investment Advisers Act of 1940, that provides investment advice to an insurance company. Subsection (f) incorporates this requirement.

Subsection (f) also defines a "securities affiliate" to include any broker or dealer registered with the Securities and Exchange Commission. The adoption of this definition would allow a broader range of financial holding companies to make merchant banking investments than a definition restricted to securities underwriting firms.

The Board and the Secretary request comment on whether this or another definition is appropriate. In particular, the Board and the Secretary request comment on whether "securities affiliate" should include a division of a bank that is registered as a municipal securities dealer. In this regard, the Board and Secretary seek comment on whether expertise or policies developed in the course of conducting specific types of securities activities may be necessary or appropriate for making merchant banking investments in a safe and sound manner.

As noted above, the rule adopts the language of section 4(k)(4)(H) of the BHC Act that allows investments in any company "engaged in any activity not authorized pursuant to [section 4 of the Bank Holding Company Act]," that is, any company engaged in an activity that is not financial in nature or incidental to a financial activity or otherwise permissible for a financial holding company to conduct.⁴ This provision appears to have been included in recognition of the fact that other provisions of the BHC Act permit a financial holding company to make investments in companies that conduct

³ The Board recently adopted, on an interim basis, regulations governing the process by which a bank holding company may become a financial holding company. See 65 FR 3785 (January 25, 2000).

⁴ Nothing in the merchant banking provision overrides the prior approval requirements of section 3 of the BHC Act that govern the acquisition of shares of a bank or bank holding company or the provisions of section 4(k)(6) and 4(j) of the BHC Act that govern the acquisition of shares of a savings association.

financial activities without resorting to merchant banking authority.

This distinction, however, may have practical consequences for private equity funds. As a result of this distinction in the statute and other provisions of the GLB Act, a private equity fund controlled by a financial holding company would appear to be prohibited from acquiring any additional financial company if any insured depository institution controlled by the financial holding company fails to have at least a satisfactory CRA rating, or, potentially, does not remain well managed and well capitalized. The Board and the Secretary request comment on this and on what, if any, amendments to the rule would be appropriate to deal with such affiliations within the requirements of the GLB Act.

Section 225.171—What Are the Limitations on Managing or Operating a Portfolio Company Held as a Merchant Banking Investment?

A financial holding company is prohibited by the GLB Act from routinely managing or operating a portfolio company except as may be necessary or required to obtain a reasonable return on the resale or disposition of the investment. Section 225.171 provides guidance on this statutory restriction.

Under this section, a financial holding company is considered to be engaged in routinely managing or operating a portfolio company if any director, officer, employee or agent of the financial holding company serves as or has responsibilities of an officer or employee of the portfolio company. The Board and the Secretary seek comment on whether any such interlocks would be appropriate.

Similarly, routinely managing or operating a company would include supervising any officer or employee of the portfolio company, other than through participation on the board of directors. The rule also defines routinely managing or operating a company to include any covenant or other contractual arrangement between the financial holding company and the portfolio company that would restrict the portfolio company's ability to make routine business decisions, such as entering into transactions in the ordinary course of business or hiring employees below the rank of the five most senior officers.

In addition, the rule defines routinely managing or operating a company to include participation in the day-to-day operations of the portfolio company. It also includes participation in

management decisions made in the ordinary course of business of the portfolio company (other than decisions in which directors of a company customarily participate in their capacity as a director).

A financial holding company is not considered to be engaged in routinely managing or operating a portfolio company by virtue of having one or more representatives on the board of directors of the portfolio company. For this purpose, the Board's existing interpretations consider selection of a general partner to be the equivalent of selecting the board of directors. A representative of the financial holding company that serves as a director of a portfolio company may not routinely manage or operate the portfolio company, as discussed more fully above. In addition, in order for the financial holding company to have a director interlock without being considered to be routinely managing or operating a portfolio company, the portfolio company must employ officers and employees responsible for managing and operating the company, and no other arrangements or practices may exist that constitute routine management or operation of the portfolio company by the financial holding company.

The rule anticipates that representatives of the financial holding company will participate fully in matters typically presented to directors to the same degree as any other director. This permits the current practice of merchant bankers of placing representatives on the board of directors of a portfolio company in order to monitor the success of the company and assist at the board of directors level in overseeing and providing strategic advice to the management of the portfolio company. At the same time, the rule is intended to define as routine management or operation situations in which a representative of the financial holding company takes on responsibilities or is involved in decisions that are typically made by officers or employees of a portfolio company and not customarily considered by directors.

The section identifies a set of covenants and other written agreements between a financial holding company and a portfolio company, that, in the absence of circumstances that would indicate otherwise, are not considered to represent routinely managing or operating a portfolio company. These agreements and covenants may require the portfolio company to seek the approval of, or to consult with, the financial holding company before taking

actions outside of the ordinary course of business, including (i) the acquisition of assets of another company; (ii) significant revision of the business plan; (iii) redemption, authorization or issuance of any shares of capital stock (including options, warrants or convertible shares) by the portfolio company; and (iv) the sale, merger, consolidation, spin-off, recapitalization, liquidation or dissolution of the portfolio company or any of its significant subsidiaries, or of all or substantially all of the assets of such company or subsidiary.

Under the Act and the rule, a financial holding company may routinely manage or operate a portfolio company under limited circumstances. The rule provides that this type of intervention is permitted only when necessary to address a material risk to the value or operation of the portfolio company. This might include a significant operating loss or a loss of senior management. This involvement must be temporary, and last only for the time necessary for the financial holding company to address the cause of involvement, obtain suitable alternative management arrangements, dispose of the investment or otherwise obtain a reasonable return on the investment. The rule would require a financial holding company to obtain Board approval to routinely manage or operate a portfolio company for a period greater than six months, and requires that a financial holding company document each instance of its involvement in routinely managing or operating a portfolio company.

The rule provides that a depository institution or subsidiary (other than a financial subsidiary held in accordance with section 5136A of the Revised Statutes or section 46 of the Federal Deposit Insurance Act) of a depository institution may not under any circumstances manage or operate a company held under this rule. This limitation would also apply to U.S. branches and agencies of foreign banks. The rule would, however, allow a director, officer or employee of a depository institution (or subsidiary of a depository institution) or U.S. branch or agency to serve as a director of a portfolio company to the same extent as would be permitted for a representative of a financial holding company.

As explained more fully below, the rule permits merchant banking investments to be made through so-called private equity funds that are subject to several limits different than those that apply to other merchant banking investments. The rule contemplates that a financial holding

company may control and manage a private equity fund or may be a passive investor in the fund. The restrictions on routinely managing or operating portfolio companies acquired or controlled by the private equity fund apply to both the financial holding company and the private equity fund.

The Board and the Secretary request comment on each of these provisions. In particular, comment is requested on whether there are additional situations in which a financial holding company should be permitted routinely to manage or operate a portfolio company consistent with the statute and its purpose of preventing the mixing of banking and commerce. Comment is also sought on whether additional agreements and covenants should be included in the list of arrangements that would not represent routine management or operation of the portfolio company.

Section 225.172—What Are the Holding Periods Permitted for Merchant Banking Investments?

The GLB Act requires that shares, assets and ownership interests be held only for a period of time that enables the sale or disposition of the interest on a reasonable basis consistent with the financial viability of the merchant banking activity. The rule incorporates this statutory limitation.

Consistent with industry practice, the rule generally would allow merchant banking investments to be held for a period of up to 10 years. Interests held by a financial holding company in private equity funds (defined below) could be held for the life of the fund, up to 15 years under circumstances described below.

The rule allows a greater period for holding merchant banking investments, including investments in or by private equity funds, in exceptional circumstances, with Board approval. To receive that approval, the financial holding company must explain the financial holding company's plan for divesting the investment. In determining whether to grant the extension, the Board may consider the cost to the financial holding company of disposing of the investment within the applicable time period. The Board may also consider the total exposure of the financial holding company to the portfolio company and the risks that disposing of the investment without an extension may pose to the financial holding company. In addition, the Board may consider market conditions and any other relevant information, such as the financial holding company's history of timely disposition of

investments. The rule provides that a request for additional time must be filed at least 1 year prior to the expiration of the normal holding period.

The rule also establishes several supervisory restrictions designed to discourage investments from being held beyond the applicable period described above (i.e., 10 years in general, and up to 15 years under certain circumstances for investments made in a private equity fund). First, the rule requires a financial holding company that has held, owned, or controlled a merchant banking investment for longer than the applicable period to deduct 100 percent of the carrying value of its investment from the holding company's Tier 1 capital and does not allow the financial holding company to include any of the unrealized gains on the investment in its Tier 2 capital for regulatory purposes. The financial holding company is also prohibited from entering into any additional contractual arrangements or other relationships with the company or extending any additional credit to the company without Board approval. These requirements would apply in addition to any restrictions that the Board might impose in granting approval for an extended holding period.

As noted above, the rule establishes somewhat different holding periods for investments made in private equity funds. The rule defines a "private equity fund" based on prevalent industry practice. A qualifying private equity fund is defined as any company that is not an operating company and that engages exclusively in merchant banking activities. The fund may be organized in any form, including a partnership, corporation or limited liability company. The fund may, but need not be, registered as an investment company under the Federal securities laws.

To meet the rule's definition, a private equity fund must be owned by at least 10 investors that are unrelated to the financial holding company (and are not officers, directors, employees or principal shareholders of the financial holding company) and the financial holding company (including its officers, directors, employees and principal shareholders) may not own or control more than 25 percent of the equity capital of the fund. The rule does not impose any limits on advisory fees or on the various types of incentive compensation that the financial holding company may receive for services rendered to the fund (except to the extent the fee increases the equity capital owned or controlled by the

financial holding company above the 25 percent threshold described above).

To qualify, a fund must invest in shares, assets or ownership interests of companies for the purpose of reselling or disposing of them and must establish a plan for the resale or disposition of its investments. In addition, the fund must have a limited life that does not exceed 12 years, with the possibility of three 1-year extensions with the approval of persons holding a majority of the fund's equity. The rule does not, however, impose the 10-year holding period on portfolio companies held by private equity funds.

A fund cannot "routinely manage or operate" the portfolio companies in which it invests except in the situations identified in section 225.171. A fund is also expected to have policies to address diversification of its portfolio, which may include single investment limits, review of large investments by investors other than the adviser, or other approaches. Finally, the fund must not be established or operated to evade the limitations on merchant banking activities contained in the GLB Act or the rule.

A financial holding company may, without Board approval, own or control a private equity fund that meets these requirements for the term of the fund up to 12 years, plus three additional one-year increments that may be obtained with the approval of a majority of the investors in the fund. In addition, different aggregate limits, reporting requirements and recordkeeping requirements apply to private equity funds and interests held by a financial holding company in private equity funds.

Moreover, as explained more fully below, the restrictions on cross-marketing, the limitations of sections 23A and 23B of the Federal Reserve Act, and the reporting and recordkeeping requirements of the rule, do not apply to a financial holding company that holds a passive interest in a private equity fund that is controlled or sponsored and advised by an unrelated third party. These requirements, however, would apply to a financial holding company that controls the private equity fund.

These differences recognize that private equity funds typically are established for the purpose of making investments for resale and have a limited term and a number of other incentives and terms that encourage the resale or disposition of investments within a reasonable period. Importantly, investments made by private equity funds also are monitored by outside

investors that encourage resale of investments.

A financial holding company may also own an interest in or control an investment vehicle or fund that makes merchant banking investments but that does not meet the rule's definition of a private equity fund. If a financial holding company controls the investment vehicle or fund, then investments made by the investment vehicle or fund are subject to the 10-year holding period and the other provisions of the rule governing ownership or control of a portfolio company. If a financial holding company owns an interest in, without controlling, such an investment vehicle or fund, the interest is treated as an interest in a portfolio company for purposes of the rule.

The rule also contains a provision that prevents a financial holding company from attempting to circumvent the holding periods by transferring merchant banking investments from one company or fund to another. The rule also provides that, for purposes of calculating compliance with the merchant banking holding periods, an investment acquired by the financial holding company under another authority that imposes a restriction on the amount of time that the financial holding company may hold the investment is considered to have been acquired on the original acquisition date.

The Board and the Secretary request comment on whether the approach taken in the rule is appropriate or whether more specific limits on investments should be adopted. The Board and the Secretary also request comment on whether additional incentives are necessary or appropriate to assure that merchant banking investments are held only for a reasonable period consistent with the financial viability of the activity.

The Board and the Secretary also request comment on whether it is appropriate or useful to establish different rules for holding periods and other requirements for merchant banking investments made in and through private equity funds than those made by a financial holding company directly or otherwise. If it is appropriate and helpful, comment is invited on whether the proposed rule properly defines private equity funds and whether the limits contained in the rule are consistent with the requirements and purposes of the GLB Act and the BHC Act.

Section 225.173—What Aggregate Limits Apply to Merchant Banking Investments?

The authority to make merchant banking investments is newly granted to those bank holding companies that have been certified as financial holding companies. As noted above, this authority is in addition to other authority provided to all bank holding companies (including financial holding companies) under the BHC Act to make investments. These existing authorities allow investments in nonfinancial companies to be made through small business investment companies, outside the United States under Regulation K, and in up to 5 percent of the voting shares of any company. In addition, a financial holding company may make investments under the GLB Act through insurance underwriting companies.

The Board and the Secretary are concerned that rapid expansion of merchant banking activities, particularly given the flexibility provided for such investments under the GLB Act, may pose new and potentially significant risks to the safety and soundness of depository institutions affiliated with financial holding companies engaged in these activities. These risks seem particularly apparent and material if the financial holding company commits a significant portion of its capital to merchant banking investments without appropriate systems for monitoring and managing the risks of these activities, or if the financial holding company does not reserve sufficient capital to take account of the risks of these investments.

Accordingly, until such time as the agencies and the industry have gained experience with supervising these activities and the rules governing the regulatory capital treatment of these investments are in place, the rule establishes two aggregate limits on merchant banking investments. The first threshold prevents a financial holding company from making additional merchant banking investments (including making additional capital contributions to a company held under the rule) if the aggregate carrying value to the financial holding company of all its merchant banking investments exceeds the lesser of 30 percent of the financial holding company's Tier 1 capital or \$6 billion. A second sublimit applies to the aggregate carrying value of all merchant banking investments excluding investments made by the financial holding company in private equity funds. This sublimit is the lesser of 20 percent of the financial holding company's Tier 1 capital or \$4 billion.

The rule provides that a financial holding company may exceed either threshold with the prior approval of the Board. This gives the Board flexibility to deal with circumstances that may arise before final action in this area on the Board's capital proposal.

In establishing these limits, the Board and the Secretary have considered that many securities firms that make merchant banking investments and many bank holding companies that conduct more limited investment activities already impose internal limits on the aggregate amount of capital that they will commit to these investments. The Board and the Secretary have also considered the current levels of investment activities of bank holding companies under existing authority. Neither threshold contained in the interim rule would apply to the existing activities of bank holding companies (or financial holding companies) conducted under other authority, such as authority to own a small business investment company, authority to make investments abroad under Regulation K, or authority to acquire 5 percent or less of the voting shares of any company.

The Board and the Secretary request comment on whether these thresholds are appropriate, and, if the thresholds are retained, whether they should be increased or decreased, whether the mechanism for Board approval to exceed the thresholds should be retained, and whether the thresholds should be based on the initial cost of investments or the carrying value of investments. The Board and the Secretary also request comment on whether the limits on merchant banking investments should be structured to take account of the types and levels of other kinds of investments made by financial holding companies. In particular, should a higher limit be set for financial holding companies that do not have significant investments under other authorities.

The Board and the Secretary expect to revisit these limits in connection with consideration of the final capital rules for this activity and as the agencies and the industry gain experience in conducting and supervising merchant banking activities and in implementing the proposed capital rules for investment activities.

Section 225.174—What Risk Management, Reporting and Record Keeping Policies Are Required To Make Merchant Banking Investments?

This section requires financial holding companies to adopt policies, procedures and systems reasonably designed to manage the risks associated

with making merchant banking investments. It also requires policies and systems designed to monitor compliance with the statutory and regulatory provisions governing these activities. A financial holding company that controls a private equity fund or other company that makes investments under the interim rule is expected to establish the same types of systems and policies for monitoring and managing the risks of merchant banking investments acquired or controlled by the private equity fund or company as those required for other types of merchant banking investments.

The list of policies, procedures and systems contained in the interim rule, as well as the recordkeeping requirements, are not intended to be exclusive. Instead, these lists are representative of the types of policies, procedures and systems that are important elements of a sound approach to monitoring merchant banking investment activities, and others will be needed to address the particular approach that each financial holding company takes to making merchant banking investments. Beyond the procedures and systems required by the rule, it is essential to prudently and profitably making merchant banking investments that a financial holding company retain qualified personnel and carefully manage and oversee investment decisions.

Each financial holding company is expected to institute appropriate policies and systems to monitor and manage investment activities before the company commences the activity. The Board expects to conduct a review of the policies and systems, in particular the investment and risk management systems, of each financial holding company that makes merchant banking investments within a short period after the holding company commences the activity.

Among the policies and systems that a financial holding company is expected to establish are policies and systems designed to identify and assess adequately the value of individual investments and of the aggregate portfolio. These systems must also adequately assess the total exposure of the financial holding company to each company acquired under the rule, and the diversification of the portfolio. A financial holding company must be able to identify and manage the market, liquidity, credit and other risks associated with merchant banking investments and the terms, amounts and types of transactions between the financial holding company (and each of its subsidiaries) and each company acquired under the rule.

In addition, the policies and systems must be adequate to maintain corporate separateness between the financial holding company and each portfolio company and sufficient to protect the financial holding company from legal liability for the conduct of operations and for the financial obligations of portfolio companies. The financial holding company must also develop policies and a business structure to limit the legal liability of the financial holding company for the financial obligations and operating risks that may flow through a private equity fund controlled by the financial holding company. This may include establishing a corporation or limited liability company that would be the general partner of a private equity fund controlled by the financial holding company.

Moreover, these systems and policies must be adequate for ensuring compliance with the statutory and regulatory provisions governing merchant banking activities, including the limits on holding period, routinely managing or operating a portfolio company, and the cross-marketing and inter-company transaction limits imposed under other provisions of the GLB Act or other law.

Subsection (b) requires generally that a financial holding company maintain at a central location certain types of records and supporting information. This section contemplates that financial holding companies will be able to satisfy these record keeping requirements by using reports and records that are prepared in the ordinary course of making a merchant banking investment or controlling a private equity fund and used to inform third-party investors of the type and status of merchant banking investments.

In particular, these records and materials must document the company's policies for making merchant banking investments and for managing and monitoring the various risks and exposures created by these activities. These records would include, for example, documentation of the review process for making investments and for properly assessing the value of each investment. In addition, these records must detail the investment amount, carrying value, market value, performance data and financial statements for each merchant banking investment.

These records must also include records of transactions between the financial holding company and companies held under the rule. In particular, these records must document

transactions that are not on market terms.

The financial holding company would be expected to make available any reports, including valuations of investments, given to co-investors by the financial holding company or given to other investors in a private equity fund. The financial holding company is also expected to document incentive arrangements (sometimes called overrides or carried interests) in connection with advising or controlling a fund under this rule, including the carrying value and market value of the arrangement and amounts distributed under the arrangement that may be contingent on future asset performance.

Subsection (c) establishes annual and quarterly reporting requirements regarding merchant banking investments. The annual report focuses on investments that have been held for a period longer than five years. A private equity fund controlled by a financial holding company is only required to provide annual reports regarding investments that have been held by the fund for a period longer than eight years. A financial holding company that has made a passive non-controlling investment in a private equity fund is only required to report its investment in the fund as part of an annual report after eight years and is not required to report investments held by the fund.

The annual report must list and describe each investment held for the applicable period (*i.e.*, longer than eight years in the case of private equity funds and longer than five years in all other cases) as of the date of the report. In addition, the report must briefly describe the historical cost of the investment, the market valuation of the investment as of the reporting date, and the schedule for divestiture of the investment. A financial holding company that does not sell or dispose of an investment within eight years (including in the case of private equity funds) must include in its annual report a detailed divestiture plan for the investment.

The annual report must also include aggregate data regarding the merchant banking investments made by the financial holding company broadly divided by category. These categories would be divided by general industrial sector, geography (national, international or regional as appropriate), and holding periods.

The quarterly report focuses entirely on aggregate data regarding the financial holding company's merchant banking portfolio. The report would require quarterly reporting of the total number

of investments made under the merchant banking authority, the aggregate cost of these investments, and the current valuation of the merchant banking portfolio (including any value assigned to any incentive arrangements related to a private equity fund). These aggregates would be reported for several categories of investment, such as investments made in private equity funds, investments made in publicly traded securities, and investments made in ownership interests that are not publicly traded.

The Board expects shortly to issue forms that may be used to comply with the annual and quarterly reporting requirements.

Section 4(k)(6) of the BHC Act requires a financial holding company to provide written notice to the Board within 30 days after acquiring any company under any authority granted in section 4(k). Merchant banking investments, by their nature, must be temporary and held for resale. Consequently, the Board believes that the filing of notice in connection with the acquisition of a company done in the course of conducting merchant banking activities is generally not needed, except in the context of large investments. Notice of substantial investments made under the merchant banking authority would allow the Board to monitor financial holding companies that have large exposures to single portfolio companies.

On this basis, the rule provides that a financial holding company will fulfill the notice requirements of section 4(k)(6) of the BHC Act in connection with its merchant banking activities if the company files a notice with the Board within 30 days of making an acquisition of a company under the rule only in the situation where both: (1) The acquisition represents in excess of 5 percent of the voting shares, assets or ownership interests of the company and (2) the cost of the investment exceeds the lesser of 5 percent of the Tier 1 capital of the financial holding company or \$200 million. This notice must briefly indicate the cost and funding of the investment, the percentage of regulatory capital that the investment represents, the nature of the company acquired and the type of investment, and the risk management measures that apply to this investment. A financial holding company qualifies for this streamlined notice procedure only if the financial holding company has notified the Board under section 225.87 of Regulation Y that the financial holding company has commenced or acquired a company engaged in making merchant banking investments.

Comment is invited on each of the recordkeeping and reporting requirements. In particular, comment is sought on whether the requested information would be readily available and valuable if provided in either a quarterly or annual report, and on the burdens associated with the proposed reporting requirements. Comment is also requested on whether it is appropriate to provide different reporting requirements for investments made by and in private equity funds than other types of merchant banking investments.

Section 225.175—How do the Statutory Cross-Marketing and Section 23A and B Limitations Apply to Merchant Banking Investments?

The GLB Act prohibits depository institutions controlled by the financial holding company from marketing or offering, directly or through any arrangement, any product or service of a company held under the rule or allowing any product or service of the depository institution to be offered or marketed, directly or through any arrangement, by or through any company held under section 4(k)(4)(H). Section 225.175 of the interim rule implements this prohibition. In addition, this section includes the statutory presumption regarding control by a financial holding company of a company held under section 4(k)(4)(H) for the purposes of sections 23A and 23B of the Federal Reserve Act.

Subsection (a) addresses the prohibition on cross-marketing. The cross-marketing restrictions would apply to cross-marketing between a depository institution controlled by a financial holding company and any portfolio company, private equity fund or other investment vehicle in which the financial holding company has an interest under this subpart. The restrictions would not apply to cross-marketing with a portfolio company that is owned by a private equity fund or other investment vehicle, however, unless the financial holding company controls the private equity fund or investment vehicle. Where control exists, the financial holding company is deemed by the BHC Act to indirectly own the shares of the portfolio company held by the private equity fund or investment vehicle.

The restrictions on cross-marketing are applied to the U.S. branches and agencies of foreign banks that conduct merchant banking activities in the United States or through a U.S. company. The cross-marketing restrictions also apply to any subsidiary of a depository institution, other than a

financial subsidiary held in accordance with section 5136A of the Revised Statutes or section 46 of the Federal Deposit Insurance Act.⁵ These so-called operating subsidiaries are considered to be and are authorized as a part of the depository institution.

Neither the GLB Act nor the rule applies these restrictions to cross-marketing by nondepository affiliates of the financial holding company. Moreover, the rule does not apply these restrictions to companies in which the financial holding company, either directly or through a private equity fund or other investment vehicle, owns less than 5 percent of the voting shares.

The rule does not define cross-marketing activities. Cross-marketing would not appear to cover efforts by a depository institution to syndicate a loan made to a portfolio company, the purchase by a depository institution for its own use of products or services of a portfolio company, or the provision of services or extensions of credit by the depository institution directly to the portfolio company. These latter two types of transactions would, of course, be governed by the requirements of sections 23A and 23B if the portfolio company is an affiliate of the depository institution.

The Board and the Secretary request comment on whether it would be useful to include a definition of cross-marketing activities in the rule, and if so, invite comment on an appropriate definition. The Board and the Secretary also seek comment on the scope of the cross-marketing restrictions. In particular, comment is invited on whether these restrictions should be applied more broadly than in the interim rule or whether the statute permits a more limited application.

Subsection (b) establishes a rebuttable presumption of control for purposes of the restrictions contained in section 23A and 23B of the Federal Reserve Act on transactions between an insured depository institution and its affiliates. Under sections 23A and 23B, certain types of transactions between an insured depository institution and an affiliate are subject to specific quantitative, qualitative and collateral requirements.

Under the presumption contained in the GLB Act, a financial holding company or other person that, directly or indirectly, or acting through one or more other persons, owns or controls 15 percent or more of the equity capital of

⁵ A financial subsidiary may engage in many of the activities permissible for a financial holding company, but may not engage in merchant banking activities, certain insurance underwriting activities, or real estate investment or development activities.

any company held under this subpart is presumed to control that company. Equity capital includes voting and nonvoting shares, warrants, options and other instruments convertible into equity capital. The presumption may be rebutted with the agreement of the Board and the rule allows a financial holding company to submit any relevant information in an effort to rebut this presumption.

The rule also applies sections 23A and 23B to covered transactions between a U.S. branch or agency of a foreign bank and (1) any portfolio company controlled by the foreign bank or an affiliate of the foreign bank, and (2) any company controlled by the foreign bank or an affiliate that is engaged in making merchant banking investments. For purposes of determining whether a foreign bank or affiliate controls a company, the rule applies the rebuttable presumption applicable to domestic financial holding companies. These provisions promote competitive equity and safe and sound banking. The rule is intended to restrict lending by a foreign bank's branches and agencies to portfolio companies and to affiliated companies that are actually engaged in making merchant banking investments. It is not intended to restrict otherwise permissible lending to parent companies or other affiliated companies, unless the proceeds of such lending would be used by these companies to make, or fund the making of, merchant banking investments under this subpart.

The rule recognizes that a financial holding company may make a passive investment in a private equity fund. In this case, the rule clarifies that a company controlled by a private equity fund will not be presumed to be an affiliate of a depository institution controlled by a financial holding company that has made an investment in the private equity fund unless the financial holding company controls the fund or has sponsored and advises the fund.

Comment is invited on each of these provisions. In particular, comment is requested on whether there are specific situations that should be included in the rule in which the presumption under section 23A and 23B should, by rule, be considered to be rebutted. Comment is also requested on the provisions applying sections 23A and 23B to certain transactions involving U.S. branches and agencies of foreign banks.

D. Capital Adequacy Proposal

As discussed above, many firms that make merchant banking investments and engage in other types of investment

activities internally allocate capital to these investments that is higher than they allocate to most banking assets in light of the greater risk, illiquidity and volatility of merchant banking and similar investments and the higher leverage that often is associated with portfolio companies. The internal capital allocation for these investments is generally many multiples of the current regulatory capital charge.

After consideration of the industry practice and in consultation with the Secretary, the Board is proposing to modify the methods of calculating the risk-weighted and leverage capital ratios for bank holding companies to better address the risks associated with merchant banking and other investment activities. This capital proposal, which is described below and published separately, is based on information about firm accounting and capital policies that System and Treasury Department staff gathered in interviews with securities firms and bank holding companies that currently conduct merchant banking and other investment activities. The Board and the Secretary also note that the proposed capital treatment is similar to the approach to capital sufficiency that the Federal Deposit Insurance Corporation has adopted under section 24 of the FDI Act for investment in subsidiaries that engage in principal activities that are not permissible for a national bank.

The Board and the Secretary view this capital proposal as a precaution that is necessary to prevent the buildup within banking organizations of excessive risk from merchant banking and other investment activities. In developing this proposal, they have considered the effect of the proposal on the existing activities of bank holding companies.

As an initial matter, adoption of the capital proposal would *not* prevent any bank holding company from becoming a financial holding company or from taking advantage of the new powers granted under the GLB Act. The capital charge would be applied only at the holding company level on the consolidated organization. Consequently, the capital proposal would not affect the capital levels of any depository institution—which, under the GLB Act, determine whether a company qualifies to be a financial holding company—controlled by a bank holding company.

In addition, the Board and the Secretary have reviewed a sampling of call reports of bank holding companies engaged currently in significant investment activities, including companies that are likely to seek to become financial holding companies.

This review indicates that, with virtually no exception, bank holding companies would remain well capitalized on a consolidated basis even after applying the proposed capital charge on all of the investments currently made by these companies. Moreover, nearly all of these companies would be able to increase significantly their level of investment activity and continue to be well capitalized on a consolidated basis after applying the proposed capital charge.

For these reasons, the capital proposal is not expected to have an effect on the level of investment activities conducted by bank holding companies. The capital proposal would, however, help to limit the potential harm to bank holding companies and depository institutions controlled by bank holding companies from the risks associated with investment activities.

The proposal is being published for comment and, unlike the rule discussed above, is not being made effective on an interim basis. During the comment period, the Board and the Secretary will discuss the issues raised by this proposal with the other Federal banking agencies and with other appropriate functional regulators.

Under the proposal, a financial 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 financial holding company, of all merchant banking investments. The financial holding company would deduct 100 percent of the carrying value of such investments from the assets of the financial holding company for capital purposes.⁶

This capital charge would apply to all equity instruments and all debt instruments that are convertible into equity held under the merchant banking authority. It also would apply to all debt extended by a financial holding company to a portfolio company in which the financial holding company owns 15 percent or more of the total equity. The proposal contains exceptions for short-term secured loans

⁶ Some investments are booked using "available for sale" (AFS) accounting. Under this accounting treatment, unrealized gains are *not* recognized in net income, and flow to a special segregated equity account that is not recognized as Tier 1 capital by the regulatory agencies. Under the current bank holding company capital rules, 45 percent of the gain on AFS equity securities may be included in Tier 2 capital. The proposal would continue this treatment but further require deduction from Tier 1 capital of 50 percent of the reported cost (or fair value if lower for equity securities) of investments recorded as AFS. The reported cost or fair value of these investments would be deducted from risk-weighted and average consolidated assets.

for working capital purposes, for loans in which at least half has been participated to third parties, and for loans that are guaranteed by the United States government. An exception is also proposed for extensions of credit by a depository institution controlled by the bank holding company that are fully collateralized in accordance with section 23A of the Federal Reserve Act and meet the other requirements of that section.

The proposal would apply the same capital treatment to investments in nonfinancial companies held under Regulation K, in less than 5% of the shares of any company under sections 4(c)(6) or (7) of the BHC Act, held through an SBIC that is controlled by the bank holding company or a subsidiary depository institution, or held by a state bank subsidiary in accordance with section 24 of the FDI Act. This capital treatment would not apply to investments that are held in a trading account in accordance with applicable accounting principles and that are part of an underwriting, market making or dealing activity. Comment is requested on whether this exclusion is appropriate. In addition, comment is invited on whether passive investments in less than 5 percent of the shares of publicly traded companies, where there is a ready market, should also be excluded or subjected to a lesser capital charge.

The proposal applies the capital treatment to nonfinancial investment activities conducted by bank holding companies and their subsidiaries as well as to merchant banking investments for several reasons. Importantly, the risks associated with these investment activities do not vary according to the authority used to conduct the activity. Thus, similar investment activities should be given the same capital treatment regardless of the source of legal authority to make the investment. In addition, current regulatory capital treatment, which applies an 8 percent minimum capital charge to investments, was developed at a time when the investment activities of banking organizations were relatively small. In recent years, some bank holding companies have greatly expanded the level of their investment activities. The Board's capital proposal reflects the judgment that it is appropriate at this time, when the investment authority of banking organizations has also been greatly expanded, to revisit and revise regulatory capital treatment for all investment activities.

The capital charge would not be applied to investments made by insurance company subsidiaries of

financial holding companies held in accordance with section 4(k)(4)(I) of the BHC Act. The Board expects soon to seek comments on a proposal to deconsolidate functionally regulated insurance underwriting companies from the financial holding company for purposes of applying the Board's consolidated capital rules. The proposal would take account of the different accounting standards, business practices, and capital and supervisory regimes that apply to insurance underwriting companies.

The Board and the Secretary recognize that the new authority accorded financial holding companies under the GLB Act may raise the possibility for arbitrage between an insurance company and its financial holding company affiliates designed to avoid the capital charges proposed for merchant banking and other investments. The Board and the Secretary seek comment on whether provisions should be included in the final capital rule that would apply to investments made through an insurance company the same capital charge at the holding company level as would be applied to merchant banking and other investments if the Board finds that such arbitrage is occurring within a particular holding company. The Board and the Secretary also invite comment on whether there are other mechanisms that would prevent such arbitrage.

During the period prior to adoption of a final capital rule, financial holding companies that engage in merchant banking activities will be expected to adopt and implement internal capital and accounting policies that reflect the liquidity, market and other risks associated with the company's investment activities. An initial criterion for these internal capital and accounting policies is that they be capable of enabling the financial holding company to meet the terms of the proposed capital rule on its effective date, with minimal adjustment, and remain in compliance with applicable regulatory capital standards.

The separate capital proposal requests comment on all aspects of the proposed capital charge, including the appropriateness of a separate capital charge for investment activities and the amount of the charge. For convenience, a detailed description of the proposed amendments to the Board's capital appendices follows.

Section II. B of Appendix A to Part 225 would be amended by adding a new clause (v) at the end of the introductory paragraph stating that portfolio investments must be deducted from the sum of core Tier 1 capital elements in

the manner provided by the proposal. Section II. B would also be amended by adding a new section II.B.5 governing portfolio investments. This new provision would provide that fifty percent (50%) of the value of all portfolio investments made by the parent bank holding company or by its direct or indirect subsidiaries must be deducted from the consolidated parent banking organization's core Tier 1 capital components.

The proposal defines a portfolio investment as any merchant banking investment made directly or indirectly by a financial holding company under section 4(k)(4)(H) of the BHC Act, and any investment made directly or indirectly in a nonfinancial company by any bank holding company pursuant to section 4(c)(6), or 4(c)(7) of the BHC Act, section 211.5(b)(1)(iii) of the Board's Regulation K, section 302(b) of the Small Business Investment Act of 1958, or by an insured state bank subsidiary in accordance with section 24 of the FDI Act.

For this purpose, an investment would include any equity instrument and any debt instrument with equity features (such as conversion rights, warrants or call options). If the bank holding company owns or controls 15 percent or more of the company's total equity, the term also would include any other debt instrument held by the bank holding company or any subsidiary, except for (i) any short-term, secured extension of credit provided for working capital purposes, (ii) any extensions of credit by an insured depository institution controlled by the bank holding company that is collateralized in accordance with the requirements of section 23A of the Federal Reserve Act and that meets the other requirements of that section, (iii) any extension of credit at least 50 percent of which is sold or participated out to unaffiliated persons on the same terms and conditions that applied to the initial credit, and (iv) any extension of credit that is guaranteed by the U.S. Government. The capital charge would not apply to investments that are held in the trading account in accordance with applicable accounting principles and that are part of an underwriting, market making or dealing activity. For portfolio investments that are reported at cost, under the equity method, or at fair value with unrealized gains (or losses) included in earnings, the deduction would be equal to 50 percent of the carrying value of the investment. For available-for-sale portfolio investments reported at fair value with unrealized gains (or losses) included in other comprehensive income, the amount of the deduction

would equal 50 percent of the reported cost of the investment.⁷ Any unrealized gains on available-for-sale investments are not included in core capital, but may be included in supplementary capital to the extent permitted under section II.A.2.e of the Appendix.

For portfolio investments in companies that are consolidated for accounting purposes, the deduction would equal 50 percent of the parent organization's investment in the company as determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the consolidated bank holding company's core capital in accordance with section II.B.1 of the Appendix). The company would remain fully consolidated for purposes of determining the banking organization's risk-weighted assets.

The total carrying value of any portfolio investment subject to the deduction is excluded from the bank holding company's weighted risk assets for purposes of computing the denominator of the company's risk-based capital ratio. For AFS portfolio investments, this exclusion would apply to the reported cost or, in the case of AFS equity investments where fair value is less than historical cost, reported fair value.

The proposal makes conforming changes to section II.b of Appendix D to include portfolio investments in the list of items that are excluded from Tier 1 capital.

Regulatory Flexibility Act Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the Board must publish an initial regulatory flexibility analysis with this rulemaking. The rule implements provisions of section 103 of the GLB Act that allow entities that have become financial holding companies to enter the merchant banking business.

The interim rule includes limited reporting and recordkeeping requirements that apply to all financial holding companies that engage in merchant banking, regardless of their size. The reporting and record keeping requirements that the rule establishes on an interim basis are necessary to enable the Board to execute properly its supervisory function and to ensure compliance by financial holding companies with the limitations imposed by the GLB Act on merchant banking

activities. These statutory limits apply to all financial holding companies, regardless of size, engaged in merchant banking activities. The Board believes that the information required to be submitted or retained, in most cases, would be contained in routine reports to management, to third-party investors, or to other regulatory agencies, including the Securities and Exchange Commission, or would be prepared and retained by an organization in the normal conduct of its investment activities.

The ability of financial holding companies to participate in the merchant banking business will likely enhance their overall efficiency and ability to compete effectively in the market for corporate financial services. The Board specifically seeks comment on the likely burden that the interim rule and proposed rule will impose on financial holding companies that engage in merchant banking activities and other financial holding companies.

Executive Order 12866 Determination

The Department of the Treasury has determined that this interim rule does not constitute a "significant regulatory action" for purposes of Executive Order 12866.

Administrative Procedure Act

The provisions of the rule are effective on March 17, 2000 on an interim basis. Pursuant to 5 U.S.C. 553, the Board and the Secretary of the Treasury find that it is impracticable to review public comments prior to the effective date of the interim rule, and that there is good cause to make the interim rule effective on March 17, 2000, due to the fact that the rule sets forth procedures to implement statutory changes that were recently enacted and that became effective on March 11, 2000. The Board and the Secretary of the Treasury are seeking public comment on all aspects of the interim rule and will amend the rule as appropriate after reviewing the comments.

Subject to certain exceptions, 12 U.S.C. 4802(b)(1) provides that new regulations and amendments to regulations prescribed by a federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. The interim rule imposes no additional reporting, disclosure, or other new requirements on an insured depository institution because the new activities

that the rule governs cannot be conducted by an insured depository institution. For this reason, section 4802(b)(1) does not apply to this rulemaking.

Paperwork Reduction Act

In accordance with section 3506 of the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 35; 5 CFR 1320 Appendix A.1), the Board reviewed the interim rule under the authority delegated to the Board by the Office of Management and Budget.

The collection of information requirements in the interim rule are found in 12 CFR 225.171(d)(3); 225.172, and 225.174. This information is required to evidence compliance with the requirements of Title I of the GLB Act (Pub. L. No. 106-102, 113 Stat. 1338 (1999)), which amends section 4 of the Bank Holding Company Act (12 U.S.C. 1843), and to allow the Board to properly exercise its supervisory responsibility for financial holding companies. The respondents are financial holding companies that choose to engage in merchant banking activities.

The interim rule requires that a financial holding company submit an annual report to the Reserve Bank relating to merchant banking investments that have been held for an extended period of time and providing aggregate information on merchant banking investments (see 12 CFR 225.174(c)(1)) and file quarterly reports with the Reserve Bank providing aggregate data on the company's merchant banking investments (see 12 CFR 225.174(c)(2)). The Board expects to publish a separate notice to issue reporting forms that may be used to comply with the annual and quarterly reporting requirements. The burden associated with these information collections will be addressed at that time.

The interim rule also requires that a financial holding company file a notice with the Reserve Bank within 30 days of making a large merchant banking investment (see 12 CFR 225.174(d)). The agency form number for this declaration will be the FR 4018. In addition, the rule allows a financial holding company to seek relief from the holding period and aggregate investment limits imposed by the rule by filing a request and supporting documentation with the Board (see 12 CFR 225.172(b) and 225.173). The agency form number for these requests will be FR 4019. There will be no formal reporting form for these notices and requests. The information may be submitted in the form of a letter. The Board expects to

⁷ For available-for-sale equity investments where fair value is less than historical cost, the amount of the deduction is equal to 50 percent of reported fair value. The unrealized losses on such investments are deducted from core capital in accordance with section II.A.1.a of the Appendix.

receive very few of these notices and requests. The Board estimates that approximately 250 financial holding companies will engage in merchant banking activities in the first year after adoption of the interim rule. Of the 250 financial holding companies, the Board estimates that 100 will file these notices and requests and that these companies will spend approximately 1 hour to prepare these filings, resulting in an estimated annual burden of 100 hours. Based on a rate of \$50 per hour, the annual cost to the public would be \$5000.

The interim rule also requires that a financial holding company engaged in merchant banking activities establish and maintain certain policies, procedures, and systems to appropriately monitor and manage its merchant banking activities and maintain certain records relating to the company's merchant banking activities (see 12 CFR 225.171(d)(3), and 225.174(a) and (b)). The Federal Reserve believes that most of these internal control and record keeping requirements are consistent with those established and maintained by organizations in the normal course of conducting a merchant banking business. The Board estimates that the 250 financial holding companies will spend approximately 5 hours in complying with these internal control and recordkeeping requirements, resulting in an estimated annual burden of 1,250 hours. Based on a rate of \$50 per hour, the annual cost to the public would be \$62,500.

The Federal Reserve specifically requests comment on the accuracy of these burden estimates. The Federal Reserve may not conduct or sponsor, and an organization is not required to respond to, an information collection unless the Board has displayed a currently valid OMB control number. The OMB control number for these information collections is 7100-0292. A financial holding company may request confidentiality for the information contained in these information collections pursuant to section (b)(4) and (b)(6) of the Freedom of Information Act (5 U.S.C. 552(b)(4) and (b)(6)).

Comments are invited on: (a) Whether the proposed collections of information are necessary for the proper performance of the Federal Reserve's functions, including whether the information has practical utility; (b) the accuracy of the Federal Reserve's estimate of the burden of the proposed information collections, including the cost of compliance; (c) ways to enhance the quality, utility, and clarity of the information to be collected; and (d)

ways to minimize the burden of information collections on respondents, including through the use of automated collection techniques or other forms of information technology. Comments on the collections of information should be sent to the Office of Management and Budget, Paperwork Reduction Project, Washington, DC 20503, with copies of such comments to be sent to Mary M. West, Federal Reserve Board Clearance Officer, Division of Research and Statistics, Mail Stop 97, Board of Governors of the Federal Reserve System, Washington, DC 20551.

Solicitation of Comments Regarding the Use of "Plain Language"

Section 722 of the GLB Act requires the Board to use "plain language" in all proposed and final rules published after January 1, 2000. The Board invites comments about how to make the interim rule easier to understand, including answers to the following questions:

(1) Has the Board organized the material in an effective manner? If not, how could the material be better organized?

(2) Are the terms of the rule clearly stated? If not, how could the terms be more clearly stated?

(3) Does the rule contain technical language or jargon that is unclear? If not, which language requires clarification?

(4) Would a different format (with respect to the grouping and order of sections and use of headings) make the rule easier to understand? If so, what changes to the format would make the rule easier to understand?

(5) Would increasing the number of sections (and making each section shorter) clarify the rule? If so, which portions of the rule should be changed in this respect?

(6) What additional changes would make the rule easier to understand?

The Board also solicits comment about whether including factual examples in the rule in order to illustrate its terms is appropriate. The Board notes that creating safe harbors in the rule may generate certain problems over time due to changes in technology or business practices. Are there alternatives that the Board should consider to illustrate the terms in the rule?

List of Subjects

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 1500

Administrative practice and procedure, Banks, banking, Holding companies

Federal Reserve System

12 CFR Chapter II

Authority and Issuance

For the reasons set forth in the preamble, the Board of Governors of the Federal Reserve System amends part 225 of Chapter II, Title 12 of the Code of Federal Regulations as follows:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 is revised to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1843(k), 1844(b), 1972(l), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. Section 225.1 is amended by redesignating paragraphs (c)(9) through (c)(13) as paragraphs (c)(11) through (c)(15), respectively, adding and reserving a new paragraph (c)(9), and adding a new paragraph (c)10 to read as follows:

§ 225.1 Authority, purpose, and scope.

* * * * *

(c) * * *

(10) *Subpart J* governs the conduct by financial holding companies of merchant banking investment activities permitted under section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)).

* * * * *

3. A new Subpart J is added to read as follows:

Subpart J—Merchant Banking Investments

Sec.

225.170 What investments are permitted under this subpart and who may make them?

225.171 What are the limitations on managing or operating a portfolio company held as a merchant banking investment?

225.172 What are the holding periods permitted for merchant banking investments?

225.173 What aggregate limits apply to merchant banking investments?

225.174 What risk management, reporting and recordkeeping policies are required to make merchant banking investments?

225.175 How do the statutory cross marketing and section 23A and 23B limitations apply to merchant banking investments?

Subpart J—Merchant Banking Investments

§ 225.170—What investments are permitted under this subpart and who may make them?

(a) *What investments are permitted under this subpart?* Section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) and this subpart authorize 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, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for a financial holding company under section 4 of the Bank Holding Company Act. For purposes of this subpart, shares, assets or ownership interests acquired or controlled under this subpart are referred to as “merchant banking investments.” A financial holding company may not directly or indirectly acquire or control any merchant banking investment except in compliance with the requirements of this subpart.

(b) *Must the investment be a bona fide merchant banking investment?* The acquisition or control of shares, assets or ownership interests under this subpart is not permitted unless it is part of a bona fide underwriting or merchant or investment banking activity.

(c) *What types of ownership interests may be acquired?* Shares, assets or ownership interests of a company or other entity include any debt or equity security, warrant, option, partnership interest, trust certificate or other instrument representing an ownership interest in the company or entity, whether voting or nonvoting.

(d) *Where in a financial holding company may merchant banking investments be made?* A financial holding company and any subsidiary (other than a depository institution or subsidiary of a depository institution) may acquire or control merchant banking investments. A financial holding company and its subsidiaries may not acquire or control merchant banking investments on behalf of a depository institution or subsidiary of a depository institution.

(e) *May assets other than shares be held directly?* A financial holding company may not under this subpart acquire or control assets, other than shares or other ownership interests in a company, unless:

(1) The assets are held within or promptly transferred to a portfolio company;

(2) The portfolio company maintains policies, books and records, accounts,

and other indicia of corporate, partnership or limited liability organization and operation that are separate from the financial holding company and that meet the requirements of § 225.174(a)(4) for limiting the legal liability of the financial holding company; and

(3) The portfolio company has management that is separate from the financial holding company to the extent required by section § 225.171.

(f) *What type of affiliate is required for a financial holding company to make merchant banking investments?* A financial holding company may not acquire or control merchant banking investments under this subpart unless the financial holding company qualifies under at least one of the following paragraphs:

(1) *Securities affiliate.* The financial holding company controls a company that is registered with the Securities and Exchange Commission as a broker or dealer under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*); or

(2) *Insurance affiliate with an investment adviser affiliate.* The financial holding company controls:

(i) An insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance), or providing and issuing annuities; and

(ii) A company that:

(A) Is registered with the Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 *et seq.*); and

(B) provides investment advice to an insurance company.

(g) *What do references to a financial holding company include?* The term “financial holding company” as used in this subpart means the financial holding company and each of its subsidiaries, but, except for §§ 225.171 and 225.174, does not include a depository institution or subsidiary of a depository institution. The term includes any private equity fund controlled by the financial holding company, but does not include any portfolio company controlled by the financial holding company.

(h) *What do references to a depository institution include?* For purposes of this subpart, the term “depository institution” includes a U.S. branch or agency of a foreign bank that acquires or controls, or is affiliated with a company that acquires or controls, merchant banking investments under this subpart.

(i) *What is a portfolio company?* A portfolio company is any company or entity:

(1) That is engaged in any activity not authorized for a financial holding company under section 4 of the Bank Holding Company Act; (12 U.S.C. 1843) and

(2) The shares, assets or ownership interests of which are held, owned or controlled directly or indirectly by the financial holding company pursuant to this subpart.

§ 225.171 What are the limitations on managing or operating a portfolio company held as a merchant banking investment?

(a) *May a financial holding company routinely manage or operate a portfolio company?* Except as provided in paragraph (d) of this section, a financial holding company may not routinely manage or operate any portfolio company in which it has a direct or indirect interest and any portfolio company held by any company (including a private equity fund) in which the financial holding company has an ownership interest under this subpart.

(b) *What does it mean to routinely manage or operate a company?* A financial holding company routinely manages or operates a portfolio company if:

(1) Any director, officer, employee or agent of the financial holding company serves as or has the responsibilities of an officer or employee of the portfolio company;

(2) Any officer or employee of the portfolio company is supervised by any director, officer, employee or agent of the financial holding company (other than in that individual's capacity as a director of the portfolio company);

(3) Any covenant or other contractual arrangement exists between the financial holding company and the portfolio company that would restrict the portfolio company's ability to make routine business decisions, such as entering transactions in the ordinary course of business or hiring employees below the rank of the five highest ranking executive officers;

(4) Any director, officer, employee or agent of the financial holding company, whether in the capacity of a director of the portfolio company, adviser to the portfolio company, or otherwise, participates in:

(i) The day-to-day operations of the portfolio company, or

(ii) Management decisions made in the ordinary course of business of the portfolio company other than decisions in which a director of a company customarily participates in that individual's capacity as a director; or (5) Any other arrangement or practice exists by which the financial holding company

routinely manages or operates the portfolio company.

(c) *What arrangements do not involve routinely managing or operating a company?* (1) *Director representation at portfolio companies.* A financial holding company may select any or all of the directors of a portfolio company or have one or more directors, officers, employees or agents serve as directors of a portfolio company if:

(i) The portfolio company employs officers and employees responsible for routinely managing and operating the company; and

(ii) The financial holding company does not routinely manage or operate the portfolio company as described in paragraph (b) of this section.

(2) *Covenants or other provisions regarding extraordinary events.* A financial holding company may, by virtue of covenants or other written agreements with a portfolio company, require the portfolio company to consult with or obtain the approval of the financial holding company to take actions outside of the ordinary course of the business of the portfolio company, including:

(i) The acquisition of control or significant assets of other companies;

(ii) Significant changes to the business plan of the portfolio company;

(iii) The redemption, authorization or issuance of any shares of capital stock (including options, warrants or convertible shares) of the portfolio company; and

(iv) The sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution or sale of substantially all of the assets of the portfolio company or any of its significant subsidiaries.

(d) *When may a financial holding company manage or operate a portfolio company?* (1) *Special circumstances required.* A financial holding company may routinely manage or operate a portfolio company only:

(i) When intervention is necessary to address a material risk to the value or operation of the portfolio company, such as a significant operating loss or loss of senior management; and

(ii) For the period of time as may be necessary to address the cause of involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return upon the resale or disposition of the investment.

(2) *Approval required for extended involvement.* A financial holding company may not routinely manage or operate a portfolio company for a period greater than six months without prior approval of the Board.

(3) *Documentation required.* A financial holding company must maintain and make available to the Board a written record describing its involvement in the management or operation of a portfolio company and the reasons therefor.

(e) *May a depository institution or its subsidiary manage or operate a portfolio company?* (1) *In general.* A depository institution or subsidiary of a depository institution may not under any circumstances manage or operate a portfolio company in which an affiliated company owns or controls an interest under this subpart.

(2) *Exceptions.* Paragraph (e)(1) of this section does not prohibit—

(i) A director, officer or employee of a depository institution or subsidiary of a depository institution from serving as a director of a portfolio company in accordance with the limitations set forth in this section; or

(ii) A financial subsidiary held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46(a) of the Federal Deposit Insurance Act (12 U.S.C. 1831w) from taking actions in accordance with the limitations set forth in this section.

§ 225.172 What are the holding periods permitted for merchant banking investments?

(a) *Must investments be made for resale?* A financial holding company may own or control shares, assets and ownership interests pursuant to this subpart only for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the financial holding company's merchant banking investment activities.

(b) *What period of time is generally permitted for holding merchant banking investments?* (1) *In general.* A financial holding company may not, directly or indirectly, own, control or hold any share, asset or ownership interest pursuant to this subpart for a period that exceeds 10 years, except that an investment in or held through a private equity fund may be held for the duration of the fund.

(2) *Ownership interests acquired from or transferred to companies held under this subpart.* For purposes of paragraph (b)(1) of this section, any interest in shares, assets or ownership interests—

(i) Acquired by a financial holding company from a company (including a private equity fund) in which the financial holding company held an interest under this subpart will be considered to have been acquired by the financial holding company on the date that the share, asset or ownership

interest was acquired by the company; and

(ii) Acquired by a company (including a private equity fund) from a financial holding company will be considered to have been acquired by the company on the date that the share, asset or ownership interest was acquired by the financial holding company if

(A) The financial holding company held the share, asset, or ownership interest under this subpart; and

(B) The financial holding company holds an interest in the acquiring company under this subpart.

(3) *Interests previously held by a financial holding company under limited authority.* For purposes of paragraph (b)(1) of this section, any shares, assets, or ownership interests previously owned or controlled, directly or indirectly, by a financial holding company under any other provision of the Federal banking laws that imposes 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 ownership or control of the shares, assets or ownership interests under such other provision of law. For purposes of this paragraph (b)(3), a financial holding company includes a depository institution controlled by the financial holding company and any subsidiary of such a depository institution.

(4) *Approval required to hold investments held in excess of applicable time limit.* A financial holding company may, in extraordinary circumstances, seek Board approval to own, control or hold shares, assets or ownership interests of a company under this subpart for a period that exceeds the applicable period specified in paragraph (b)(1) of this section. A request for approval must:

(i) Be submitted to the Board no later than 1 year prior to the expiration of the applicable time period;

(ii) Provide the reasons for the request, including information that addresses the factors in paragraph (b)(5) of this section; and

(iii) Explain the financial holding company's plan for divesting the shares, assets or ownership interests.

(5) *Factors governing Board determinations.* In reviewing any proposal under paragraph (b)(4) of this section, the Board may consider all the facts and circumstances related to the investment, including:

(i) The cost to the financial holding company of disposing of the investment within the applicable period;

(ii) The total exposure of the financial holding company to the company and

the risks that disposing of the investment may pose to the financial holding company;

(iii) Market conditions; and

(iv) The extent and history of involvement by the financial holding company in the management and operations of the company.

(6) *Restrictions applicable to investments held beyond applicable period.* A financial holding company that directly or indirectly owns, controls or holds any share, asset or ownership interest of a company under this subpart for a total period that exceeds the applicable period specified in paragraph (b)(1) of this section must:

(i) Deduct an amount equal to 100 percent of the carrying value of the financial holding company's interest in the share, asset or ownership interest from the Tier 1 capital of the holding company and exclude all unrealized gains on the share, asset or ownership interest from its Tier 2 capital;

(ii) Not enter into any additional transactions, contractual arrangements or other relationships with the company or extend any additional credit to the company without Board approval; and

(iii) Abide by any other restrictions that the Board may impose in connection with granting approval under paragraph (b)(4) of this section.

(c) *What is a private equity fund?* (1) *Definition of a private equity fund.* For purposes of this subpart, a "private equity fund" is any company that:

(i) Is formed for the purpose of and is engaged exclusively in the business of investing in shares, assets, and ownership interests of companies for resale or other disposition;

(ii) Is not an operating company;

(iii) Issues equity ownership interests to at least 10 investors that are not affiliated with, and are not officers, directors, employees or principal shareholders of the financial holding company;

(iv) No more than 25 percent of the total equity of which is held, owned or controlled, directly or indirectly, by the financial holding company and its directors, officers, employees and principal shareholders;

(v) That has an initial term of not more than 12 years, which term may be extended for an additional three 1-year periods with the approval of persons holding a majority of the equity of the fund;

(vi) Establishes a plan for the resale or disposition of its investments, and holds, owns or controls investments only for a reasonable period of time consistent with making merchant banking investments;

(vii) Maintains policies on diversification of fund investments; and

(viii) Is not formed or operated for the purpose of making investments inconsistent with the authority granted under section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) or evading the limitations contained in this subpart on merchant banking investments.

(2) *What form may a private equity fund take?* A private equity fund may be a corporation, partnership, limited liability company or other type of company that issues ownership interests in any form.

(3) *May a private equity fund manage a portfolio company?* A private equity fund may not routinely manage or operate a portfolio company except as permitted by this subpart.

§ 225.173 What aggregate limits apply to merchant banking investments?

(a) *In general.* A financial holding company may not, without Board approval, directly or indirectly acquire any additional shares, assets or ownership interests under this subpart or make any additional capital contribution to any company the shares, assets or ownership interests of which are held by it under this subpart if the aggregate carrying value of all merchant banking investments held by the financial holding company under this subpart exceeds:

(1) The lesser of 30 percent of the Tier 1 capital of the company or \$6 billion; or

(2) The lesser of 20 percent of the Tier 1 capital of the company or \$4 billion excluding interests in private equity funds.

(b) *Do these limits apply to interests held through a private equity fund?*

Paragraph (a) of this section does not prohibit any private equity fund that a financial holding company controls from acquiring shares, assets or ownership interests.

§ 225.174 What risk management, reporting and recordkeeping policies are required to make merchant banking investments?

(a) *What internal controls are necessary?* A financial holding company, including a private equity fund controlled by the financial holding company, that makes investments under this subpart must establish and maintain policies, procedures, and systems reasonably designed to:

(1) Monitor and adequately assess the value of each investment, the value of the aggregate portfolio, and the diversification of the portfolio;

(2) Identify and manage the market, credit, concentration and other risks

associated with merchant banking investments;

(3) Monitor and review the terms, amounts and types of transactions and relationships between the financial holding company (in the aggregate and separately by affiliate) and each company in which the financial holding company has an interest under this subpart to assess the risks and costs of the transactions and relationships, including whether each transaction or relationship is on market terms, and to assure compliance with any provisions of law, including any applicable fiduciary principles, governing those transactions and relationships;

(4) Ensure the maintenance of corporate separateness between the financial holding company and each company in which the financial holding company has an interest under this subpart, including policies, procedures and systems sufficient to protect the financial holding company and depository institutions controlled by the financial holding company from legal liability for the conduct of operations and for the financial obligations of each such company; and

(5) Ensure compliance with the provisions of this subpart governing merchant banking investments.

(b) *What records must be maintained?* A financial holding company must maintain, at a central location, records and supporting information that:

(1) Are sufficient to enable the Board to review the policies, procedures and systems described in paragraph (a) of this section;

(2) Detail the cost, carrying value, market value, and performance data for each investment made under this subpart, including investments made through private equity funds;

(3) Include copies of the financial statements of any company in which the financial holding company holds an interest under this subpart, including investments made through private equity funds, and any information and valuations provided to any co-investors in such companies;

(4) Document any transaction or relationship between the financial holding company and any company in which the financial holding company holds an interest under this subpart that is not on market terms; and

(5) Document any contingent fee or contingent interest in a private equity fund or relating to any other investment held under this subpart, including the carrying value and market value of such fee or interest and the amount of such fee or interest that has been recognized by the financial holding company as

income but that is contingent on future performance or asset valuations.

(c) *What periodic reports must be filed?* (1) *Annual reports regarding merchant banking investments.* A financial holding company must report annually to the appropriate Reserve Bank in such format and at such time as the Board may prescribe:

(i) For each interest that the financial holding company owns or controls under this subpart (other than an interest in or held through a private equity fund) and that it has owned or controlled for a period that totals longer than five years as of the reporting date:

(A) The identity of the company in which the interest is held, a description of the investment and, if available, a description of the other investors and their interests in the company;

(B) The historical cost of the investment;

(C) The market or other valuation of the investment as of the reporting date; and

(D) The schedule for sale or disposition of the investment;

(ii) For each interest that the financial holding company owns or controls under this subpart, including an interest in or held through a private equity fund, and that it has owned or controlled for a period that totals longer than eight years as of the reporting date:

(A) A detailed explanation of the financial holding company's plan and schedule for the sale or disposition of the investment; and

(B) The information required under paragraph (c)(1)(i) of this section;

(iii) Aggregate data describing the number, total historical cost, total carrying value and total market value for merchant banking investments, segregated by holding period (in 2 year increments), geographic distribution (national or regional, as appropriate), and industrial sector.

(2) *Quarterly reporting for all merchant banking investments.* A financial holding company must, within 60 days of the end of each calendar quarter and in the format prescribed by the Board, submit a report to the appropriate Reserve Bank of the total number, aggregate historical cost and aggregate current valuation of all investments held pursuant to this subpart.

(d) *Is notice required for the acquisition of companies?*

(1) *Fulfillment of statutory notice requirement.* Except as required in paragraph (d)(2) of this section, no post acquisition notice under section 4(k)(6) of the Bank Holding Company Act (12 U.S.C. 1843(k)(6)) is required by a financial holding company in

connection with an investment made under this subpart if the financial holding company has previously filed a notice under § 225.87 indicating that it had commenced activities under this subpart.

(2) *Notice of large individual investments.* A financial holding company must provide written notice to the Board within 30 days after acquiring more than 5 percent of the shares, assets or ownership interests of any company, including a private equity fund, at a total cost that exceeds the lesser of 5 percent of the Tier 1 capital of the company or \$200 million.

(3) *Content of notice.* A notice under paragraph (d)(2) of this section must set forth:

(i) The cost of the investment and method for funding the investment;

(ii) The percentage of Tier 1 capital that the investment represents;

(iii) A description of the company and the type of investment; and

(iv) An explanation of the risk management measures to be applied by the financial holding company to the investment.

§ 225.175 How do the statutory cross marketing and section 23A and 23B limitations apply to merchant banking investments?

(a) *Are cross marketing activities prohibited?* (1) *In general.* A depository institution, including a subsidiary of a depository institution, controlled by a financial holding company may not:

(i) Offer or market, directly or through any arrangement, any product or service of any company if more than 5 percent of the company's shares, assets or ownership interests are owned or controlled by the financial holding company pursuant to this subpart; or

(ii) Allow any product or service of the depository institution, including any product or service of a subsidiary of the depository institution, to be offered or marketed, directly or through any arrangement, by or through any company described in paragraph (a)(1)(i) of this section.

(2) *How are financial subsidiaries treated?* For purposes of paragraph (a)(1) of this section, a subsidiary of a depository institution does not include a financial subsidiary held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the Federal Deposit Insurance Act (12 U.S.C. 1831w).

(b) *When are companies held under section 4(k)(4)(H) affiliates under sections 23A and 23B?* (1) *Rebuttable presumption of control.* The following rebuttable presumption of control shall apply for purposes of sections 23A and

23B of the Federal Reserve Act (12 U.S.C. 371c, 371c-1): if a financial holding company holds any shares, assets or ownership interests of a company pursuant to this subpart, the company shall be presumed to be an affiliate of any member bank that is affiliated with the financial holding company if such financial holding company, directly or indirectly, owns or controls 15 percent or more of the equity capital of the company.

(2) *Request to rebut presumption.* A financial holding company may rebut this presumption by providing information acceptable to the Board demonstrating that the financial holding company does not control the company.

(3) *Convertible instruments.* For purposes of paragraph (b)(1) of this section, equity capital includes options, warrants and any other instrument convertible into equity capital.

(4) *Application of presumption to private equity funds.* A financial holding company will not be presumed to own or control the equity capital of a company for purposes of paragraph (b)(1) of this section solely by virtue of an investment made by the financial holding company in a private equity fund that owns or controls the equity capital of the company unless the financial holding company controls or has sponsored and advises the private equity fund.

(5) *Application of sections 23A and 23B to U.S. branches and agencies of foreign banks.* Sections 23A and 23B of the Federal Reserve Act shall apply to all covered transactions between each U.S. branch and agency of a foreign bank that acquires or controls, or that is affiliated with a company that acquires or controls, merchant banking investments and—

(i) Any portfolio company that the foreign bank or affiliated company controls or is presumed to control under paragraph (b)(1) of this section; and

(ii) Any company that the foreign bank or affiliated company controls or is presumed to control under paragraph (b)(1) of this section if the company is engaged in acquiring or controlling merchant banking investments.

By order of the Board of Governors of the Federal Reserve System, March 17, 2000.

Robert deV. Frierson,

Associate Secretary of the Board.

Department of the Treasury

12 CFR Chapter XV

Authority and Issuance

For the reasons set forth in the preamble, the Department of the Treasury adds part 1500 to subchapter

A of chapter XV of Title 12 of the Code of Federal Regulations to read as follows:

PART 1500—MERCHANT BANKING INVESTMENTS

Sec.

- 1500.1 How are terms defined for purposes of this part?
- 1500.2 What investments are permitted under this part and who may make them?
- 1500.3 What are the limitations on managing or operating a portfolio company held as a merchant banking investment?
- 1500.4 What are the holding periods permitted for merchant banking investments?
- 1500.5 What aggregate limits apply to merchant banking investments?
- 1500.6 What risk management, reporting and record keeping policies are required to make merchant banking investments?
- 1500.7 How do the statutory cross marketing and sections 23A and 23B limitations apply to merchant banking investments?

Authority: 12 U.S.C. 1843(k)(4)(7).

§ 1500.1—How are terms defined for purposes of this part?

Unless otherwise provided in this part, all terms used in this part have the meanings given such terms in 12 CFR Part 225 (Regulation Y of the Board of Governors of the Federal Reserve System Board).

§ 1500.2—What investments are permitted under this part and who may make them?

(a) *What investments are permitted under this part?* Section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) and this part authorize 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, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for a financial holding company under section 4 of the Bank Holding Company Act. For purposes of this part, shares, assets or ownership interests acquired or controlled under this part are referred to as “merchant banking investments.” A financial holding company may not directly or indirectly acquire or control any merchant banking investment except in compliance with the requirements of this part.

(b) *Must the investment be a bona fide merchant banking investment?* The acquisition or control of shares, assets or ownership interests under this part is not permitted unless it is part of a bona fide underwriting or merchant or investment banking activity.

(c) *What types of ownership interests may be acquired?* Shares, assets or ownership interests of a company or other entity include any debt or equity security, warrant, option, partnership interest, trust certificate or other instrument representing an ownership interest in the company or entity, whether voting or nonvoting.

(d) *Where in a financial holding company may merchant banking investments be made?* A financial holding company and any subsidiary (other than a depository institution or subsidiary of a depository institution) may acquire or control merchant banking investments. A financial holding company and its subsidiaries may not acquire or control merchant banking investments on behalf of a depository institution or subsidiary of a depository institution.

(e) *May assets other than shares be held directly?* A financial holding company may not under this part acquire or control assets, other than shares or other ownership interests in a company, unless:

- (1) The assets are held within or promptly transferred to a portfolio company;
- (2) The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership or limited liability organization and operation that are separate from the financial holding company and that meet the requirements of 12 CFR 225.174(a)(4) for limiting the legal liability of the financial holding company; and
- (3) The portfolio company has management that is separate from the financial holding company to the extent required by § 1500.3.

(f) *What type of affiliate is required for a financial holding company to make merchant banking investments?* A financial holding company may not acquire or control merchant banking investments under this part unless the financial holding company qualifies under at least one of the following:

- (1) *Securities affiliate.* The financial holding company controls a company that is registered with the Securities and Exchange Commission as a broker or dealer under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*); or
- (2) *Insurance affiliate with an investment adviser affiliate.* The financial holding company controls:
 - (i) An insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance), or providing and issuing annuities; and
 - (ii) A company that:

(A) Is registered with the Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 *et seq.*); and

(B) Provides investment advice to an insurance company.

(g) *What do references to a financial holding company include?* The term “financial holding company” as used in this part means the financial holding company and each of its subsidiaries, but, except for § 1500.3, does not include a depository institution or subsidiary of a depository institution. The term includes a private equity fund controlled by the financial holding company, but does not include any portfolio company controlled by the financial holding company.

(h) *What do references to a depository institution include?* For purposes of this part, the term “depository institution” includes a U.S. branch or agency of a foreign bank that acquires or controls, or is affiliated with a company that acquires or controls, merchant banking investments under this part.

(i) *What is a portfolio company?* A portfolio company is any company or entity:

- (1) That is engaged in any activity not authorized for a financial holding company under section 4 of the Bank Holding Company Act; and
- (2) The shares, assets or ownership interests of which are held, owned or controlled directly or indirectly by the financial holding company pursuant to this part.

§ 1500.3 What are the limitations on managing or operating a portfolio company held as a merchant banking investment?

(a) *May a financial holding company routinely manage or operate a portfolio company?* Except as provided in paragraph (d) of this section, a financial holding company may not routinely manage or operate any portfolio company in which it has a direct or indirect interest and any portfolio company held by any company (including a private equity fund) in which the financial holding company has an ownership interest under this part.

(b) *What does it mean to routinely manage or operate a company?* A financial holding company routinely manages or operates a portfolio company if:

- (1) Any director, officer, employee or agent of the financial holding company serves as or has the responsibilities of an officer or employee of the portfolio company;
- (2) Any officer or employee of the portfolio company is supervised by any

director, officer, employee or agent of the financial holding company (other than in that individual's capacity as a director of the portfolio company);

(3) Any covenant or other contractual arrangement exists between the financial holding company and the portfolio company that would restrict the portfolio company's ability to make routine business decisions, such as entering transactions in the ordinary course of business or hiring employees below the rank of the five highest ranking executive officers;

(4) Any director, officer, employee or agent of the financial holding company, whether in the capacity of a director of the portfolio company, adviser to the portfolio company, or otherwise, participates in:

(i) The day-to-day operations of the portfolio company, or

(ii) Management decisions made in the ordinary course of business of the portfolio company other than decisions in which a director of a company customarily participates in that individual's capacity as a director; or

(5) Any other arrangement or practice exists by which the financial holding company routinely manages or operates the portfolio company.

(c) *What arrangements do not involve routinely managing or operating a company?* (1) *Director representation at portfolio companies.* A financial holding company may select any or all of the directors of a portfolio company or have one or more directors, officers, employees or agents serve as directors of a portfolio company if:

(i) The portfolio company employs officers and employees responsible for routinely managing and operating the company; and

(ii) The financial holding company does not routinely manage or operate the portfolio company as described in paragraph (b) of this section.

(2) *Covenants or other provisions regarding extraordinary events.* A financial holding company may, by virtue of covenants or other written agreements with a portfolio company, require the portfolio company to consult with or obtain the approval of the financial holding company to take actions outside of the ordinary course of the business of the portfolio company, including:

(i) The acquisition of control or significant assets of other companies;

(ii) Significant changes to the business plan of the portfolio company;

(iii) The redemption, authorization or issuance of any shares of capital stock (including options, warrants or convertible shares) of the portfolio company; and

(iv) The sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution or sale of substantially all of the assets of the portfolio company or any of its significant subsidiaries.

(d) *When may a financial holding company manage or operate a portfolio company?* (1) *Special circumstances required.* A financial holding company may routinely manage or operate a portfolio company only:

(i) When intervention is necessary to address a material risk to the value or operation of the portfolio company, such as a significant operating loss or loss of senior management; and

(ii) For the period of time as may be necessary to address the cause of involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return upon the resale or disposition of the investment.

(2) *Approval required for extended involvement.* A financial holding company may not routinely manage or operate a portfolio company for a period greater than six months without prior approval of the Board.

(3) *Documentation required.* A financial holding company must maintain and make available to the Board a written record describing its involvement in the management or operation of a portfolio company and the reasons therefor.

(e) *May a depository institution or its subsidiary manage or operate a portfolio company?* (1) *In general.* A depository institution or subsidiary of a depository institution may not under any circumstances manage or operate a portfolio company in which an affiliated company owns or controls an interest under this part.

(2) *Exceptions.* Paragraph (e)(1) of this section does not prohibit—

(i) A director, officer or employee of a depository institution or subsidiary of a depository institution from serving as a director of a portfolio company in accordance with the limitations set forth in this section; or

(ii) A financial subsidiary held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46(a) of the Federal Deposit Insurance Act (12 U.S.C. 1831w) from taking actions in accordance with the limitations set forth in this section.

§ 1500.4 What are the holding periods permitted for merchant banking investments?

(a) *Must investments be made for resale?* A financial holding company may own or control shares, assets and ownership interests pursuant to this

part only for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the financial holding company's merchant banking investment activities.

(b) *What period of time is generally permitted for holding merchant banking investments?* (1) *In general.* A financial holding company may not, directly or indirectly, own, control or hold any share, asset or ownership interest pursuant to this part for a period that exceeds 10 years, except that an investment in or held through a private equity fund may be held for the duration of the fund.

(2) *Ownership interests acquired from or transferred to companies held under this part.* For purposes of paragraph (b)(1) of this section, any interest in shares, assets or ownership interests—

(i) Acquired by a financial holding company from a company (including a private equity fund) in which the financial holding company held an interest under this part will be considered to have been acquired by the financial holding company on the date that the share, asset or ownership interest was acquired by the company; and

(ii) Acquired by a company (including a private equity fund) from a financial holding company will be considered to have been acquired by the company on the date that the share, asset or ownership interest was acquired by the financial holding company if—

(A) The financial holding company held the share, asset, or ownership interest under this part; and

(B) The financial holding company holds an interest in the acquiring company under this part.

(3) *Interests previously held by a financial holding company under limited authority.* For purposes of paragraph (b)(1) of this section, any shares, assets, or ownership interests previously owned or controlled, directly or indirectly, by a financial holding company under any other provision of the Federal banking laws that imposes a limited holding period will be considered to have been acquired by the financial holding company under this part on the date the financial holding company first acquired ownership or control of the shares, assets or ownership interests under such other provision of law. For purposes of this paragraph (b)(3), a financial holding company includes a depository institution controlled by the financial holding company and any subsidiary of such a depository institution.

(4) *Approval required to hold investments held in excess of applicable*

time limit. A financial holding company may, in extraordinary circumstances, seek Board approval to own, control or hold shares, assets or ownership interests of a company under this part for a period that exceeds the applicable period specified in paragraph (b)(1) of this section. A request for approval must:

(i) Be submitted to the Board no later than 1 year prior to the expiration of the applicable time period;

(ii) Provide the reasons for the request, including information that addresses the factors in paragraph (b)(5) of this section; and

(iii) Explain the financial holding company's plan for divesting the shares, assets or ownership interests.

(5) *Factors governing Board determinations.* In reviewing any proposal under paragraph (b)(4) of this section, the Board may consider all the facts and circumstances related to the investment, including:

(i) The cost to the financial holding company of disposing of the investment within the applicable period;

(ii) The total exposure of the financial holding company to the company and the risks that disposing of the investment may pose to the financial holding company;

(iii) Market conditions; and

(iv) The extent and history of involvement by the financial holding company in the management and operations of the company.

(6) *Restrictions applicable to investments held beyond applicable period.* A financial holding company that directly or indirectly owns, controls or holds any share, asset or ownership interest of a company under this part for a total period that exceeds the applicable period specified in paragraph (b)(1) of this section must:

(i) Deduct an amount equal to 100 percent of the carrying value of the financial holding company's interest in the share, asset or ownership interest from the Tier 1 capital of the holding company and exclude all unrealized gains on the share, asset or ownership interest from its Tier 2 capital;

(ii) Not enter into any additional transactions, contractual arrangements or other relationships with the company

or extend any additional credit to the company without Board approval; and

(iii) Abide by any other restrictions that the Board may impose in connection with granting approval under paragraph (4).

(c) *What is a private equity fund?* (1) *Definition of a private equity fund.* For purposes of this part, a "private equity fund" is any company that:

(i) Is formed for the purpose of and is engaged exclusively in the business of investing in shares, assets, and ownership interests of companies for resale or other disposition;

(ii) Is not an operating company;

(iii) Issues equity ownership interests to at least 10 investors that are not affiliated with, and are not officers, directors, employees or principal shareholders of the financial holding company;

(iv) No more than 25 percent of the total equity of which is held, owned or controlled, directly or indirectly, by the financial holding company and its directors, officers, employees and principal shareholders;

(v) That has an initial term of not more than 12 years, which term may be extended for an additional three 1-year periods with the approval of persons holding a majority of the equity of the fund;

(vi) Establishes a plan for the resale or disposition of its investments, and holds, owns or controls investments only for a reasonable period of time consistent with making merchant banking investments;

(vii) Maintains policies on diversification of fund investments; and

(viii) Is not formed or operated for the purpose of making investments inconsistent with the authority granted under section 4(k)(4)(H) of the Bank Holding Company Act or evading the limitations contained in this part on merchant banking investments.

(2) *What form may a private equity fund take?* A private equity fund may be a corporation, partnership, limited liability company or other type of company that issues ownership interests in any form.

(3) *May a private equity fund manage a portfolio company?* A private equity fund may not routinely manage or

operate a portfolio company except as permitted by this part.

§ 1500.5 What aggregate limits apply to merchant banking investments?

(a) *In general.* A financial holding company may not, without Board approval, directly or indirectly acquire any additional shares, assets or ownership interests under this part or make any additional capital contribution to any company the shares, assets or ownership interests of which are held by it under this part if the aggregate carrying value of all merchant banking investments held by the financial holding company under this part exceeds:

(1) The lesser of 30 percent of the Tier 1 capital of the company or \$6 billion; or

(2) The lesser of 20 percent of the Tier 1 capital of the company or \$4 billion excluding interests in private equity funds.

(b) *Do these limits apply to interests held through a private equity fund?*

Paragraph (a) of this section does not prohibit any private equity fund that a financial holding company controls from acquiring shares, assets or ownership interests.

§ 1500.6 What risk management, reporting and recordkeeping policies are required to make merchant banking investments?

Certain risk management, reporting and recordkeeping requirements for merchant banking investments are set forth in the Board's Regulation Y, 12 CFR 225.174.

§ 1500.7 How do the statutory cross marketing and sections 23A and 23B limitations apply to merchant banking investments?

Certain cross-marketing limitations and limitations under sections 23A and 23B of the Federal Reserve Act applicable to merchant banking investment are set forth in the Board's Regulation Y, 12 CFR 225.175.

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