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**Comment: Fed's Reins on Venture Capital Activities Too Tight**

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While Congress and the regulators contemplate financial reform, private equity and venture capital remain overly restricted.

The Federal Reserve Board's rules severely restrict private equity and venture capital investments as well as venture capital and private equity funds.

As a result, bank holding companies may not acquire broker-dealers or asset management firms, nor conduct basic financial services activities allowed to their investment bank and asset management competitors.

However, regulators allow holding companies to fund risky securities and mutual fund activities, provided certain conditions are met. Among these activities: buying assets from the money market funds they advise and investing in and lending to mutual funds they advise. The same should apply to the private equity and venture capital fund area.

Generally, bank holding companies may not have a controlling influence over nonfinancial services companies. Control is defined as:

Direct or indirect ownership, control or power to vote 25% or more of any class of voting securities of another company;

Control in any manner over the election of a majority of the directors of a company; or

A determination by the Fed that a company has the power to exercise, directly or indirectly, a controlling influence over the management policies of another company.

The Fed views a number of relationships between a bank holding company and another company to determine whether control of the nonbanking company exists. Among the factors: interlocks, similar names, cross-marketing, support, financing, and restrictive arrangements. The Fed also views a bank holding company as controlling another company if the holding company owns 25% or more of the nonvoting equity of the target on the grounds that in such a case the holding company has an incentive to control the target.

Most lawyers agree that the rules and guidelines for investment in nonfinancial services companies were never statutorily mandated and were unnecessary to achieve the policy objectives of the law.

These rules regulate "potential" motives, while substantial loans to companies with the usual financial ratio tests and restrictive covenants do not raise a control situation.

In making a venture capital investment, a bank performs the same analysis as for a loan-evaluating financial statements, the overall economic environment, and opportunities for future growth. In lending to start-up companies, restrictive, controlling covenants are commonplace, so equity investments should not be perceived as providing any more control.

Bank holding companies typically make venture capital investment by setting up small-business investment companies, special-purpose entities that provide capital to small businesses.

This allows them to provide funding and financial expertise to assist the growth of a start-up company and then exit when the company's potential is realized-without controlling the company.

SBICs are exempt from many U.S. banking laws and, as a result, may acquire up to 50% of the equity of eligible companies or more through certain loopholes.

There are several steps the bank regulators can take to level the playing field in the private equity and venture capital arena.

The antiquated, nonsensical control specifications must be revamped.

First, for both funds and direct investment, the Fed could interpret the Bank Holding Company Act to permit equity investments that do not result in "strategic control" as a financing activity that is closely related to banking.

Bank holding companies must be allowed to segregate their equity investment and fund activities so that they are allowed to invest, monitor, and manage investment properly, but do not strategically control the portfolio companies.

The Fed needs to ensure that banks would not control the portfolio companies. It could do this by (a) imposing the same limitations on transactions with affiliates, (b) restricting venture capital managers from involvement in the bank's senior management, (c) restricting cross- marketing with the portfolio company, and (d) prohibiting bank employees outside of the venture capital group from controlling or influencing the strategic or day-to-day decision-making and dividend policies of the portfolio company.

Second, the 25% total equity rule must be abandoned. Commercial banks should be able to invest in the equity of companies as investment bankers do.

Equity investments do not actually provide more control compared with lending to start-up companies, due to commonplace controlling covenants.

Third, if a bank holding company invests in a company, the employees of the company will contribute their labor or "sweat equity." If the Fed wants to limit the percentage of a target's total equity, that total equity should include sweat equity.

The Fed has never made it clear whether total equity is based on capital contribution, liquidation, or profit percentage. The Fed has mysteriously also said that sometimes equity includes debt, if the holding company also owns some equity.

Fourth, the Fed should acknowledge that private equity and venture capital funds are merely an alternative asset management vehicle within a bank's advisory and fiduciary powers and not a means for controlling a portfolio investment.

Domestic investment funds are typically structured as limited partnerships, with income and gains and losses passing directly to investors with no entity-level income taxation.

The general partner of the fund is commonly an entity formed by the investment manager and may make a capital contribution to the fund. The general partner receives a return on investment at the same rate as the limited partners, with preferential capital gains treatment.

Looking at the tax implications within these types of relationships, the capital gains treatment received essentially requires the bank to be the general partner or a special limited partner with a third party taking over control of the fund, in order to be compensated in the same manner as other venture capital fund managers.

The rules and guidelines, described above, then apply to the holding company as general partner, essentially choking the investment potential. The Fed's "control" restrictions inhibit holding companies' ability to meet tax objectives, but presume that control is sought to benefit the bank's strategic purposes.

Fifth, the Fed should remove the restrictions on (a) extensions of credits by a holding company to funds, their investors or portfolio companies, (b) providing advice in connection with such funds, and on (c) leveraging of distressed debt funds. These restrictions are superfluous.

The arena of private equity and venture capital must be freed up to encourage future activity and growth. It is crucial that it not be overlooked during this time of significant regulatory changes in the banking industry.

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