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**Viewpoints: Interim Fed Rule Improperly Restricts Merchant Banking**

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The Federal Reserve Board has issued a controversial interim rule that would permit most financial holding companies to make controlling merchant banking investments in portfolio companies, provided they are not made through a bank or a bank's subsidiary.

The rule is overly restrictive and in some ways inconsistent when compared with other regulatory options available.

The investments must not be "strategic" in nature, and therefore must have a good-faith relationship to an underwriting, investment banking, merchant banking role. (This prohibits a financial holding company from placing tellers in hamburger joints it owns as a merchant banking investment.)

An important issue is how much has to be disclosed to investors in the offering memorandum of funds promoted by the financial holding company. For example, investment limitations, holding periods, risk of Fed intervention, and the portfolio diversification requirements are all things an investor would like to know.

These rules also do not level the playing field adequately between the regulated and unregulated merchant banking institutions. For example, though loopholes exist, the interim rule prohibits cross-marketing between a depository institution and the portfolio companies, and restricts transactions between an insured bank and certain portfolio companies. It also bars a financial holding company from routinely managing or operating a portfolio investment (such as hiring employees below the rank of the five highest-ranking executive officers or participating in day-to-day management).

Competitors do not have the same restrictions, and proper financial monitoring of a portfolio investment without strategic control might require a financial holding company to intervene to appoint a head of a division, make recommendations regarding management, and have a larger presence on the board.

The Fed's quantitative restriction on merchant banking investments is extremely harmful to competition. Aggregate merchant banking investments are limited to the lesser of 30% of Tier 1 Capital or $6 billion and lesser of 20% of Tier 1 Capital or $4 billion after excluding investments made in qualifying private equity funds.

Another proposed restriction is a capital hit for merchant banking investments, which may exceed the Fed's authority. The Fed wants 50% of all merchant banking investments to be deducted from a financial holding company's consolidated core capital. That is inconsistent with what investment bankers do, fails to account for risk accurately, and ignores the ability of a financial holding company to use a more sensitive risk-based model.

The interim rule also imposes a maximum 10-year holding period unless an investment is held through a private equity fund, in which case it may be held for a maximum of 15 years subject to extension, but with adverse capital treatment. To qualify, a private equity fund must:

* Be engaged in the resale or other disposition of companies.
* Have a limited term.
* Have a plan for the disposition of its investments.
* Control investments only for a reasonable period of time.
* Not be formed for a strategic purpose.
* Maintain policies on diversification and fund investments.
* Have at least 10 other investors.

One problem is disclosure - investors in a "private equity fund" should know about these possible restrictions on the funds' investment authority and - because of these limitations - might not wish to invest in funds sponsored by banking organizations. Moreover, the limitations do not take into account the feasibility needed to realize fully on an investment, and investment banks are not subject to these limits.

The interim rule imposes record keeping and reporting requirements based on, among other things: costs, value, geographic distribution and industrial sector, risk management practices, and corporate separateness procedures. These restrictions, of course, could invite Fed scrutiny and intervention. The problem with this is again the risk an investor in a fund might suffer because the Fed either takes a position on an investment contrary to their interest or forces a financial holding company to restructure or divest it - again a restriction that nonregulated merchant banking firms or funds do not confront.

Owning a real estate development company is a permissible part of a diversified portfolio of merchant banking investments, but the Fed should clarify what "diversified" means and should allow real estate investment and less-risky activities like real estate brokerage, development, and management.

For a variety of reasons, a financial holding company might choose instead to make investments under the other options permitted to bank holding companies. For example, merchant banking investments are permitted under the Fed's Regulation Y, which allows generally passive noncontrolling investments in portfolio companies amounting to less than 5% of the voting shares of the portfolio company or 25% of the nonvoting equity of such a company.

Small Business Investment Corporations are another option; investments are limited to 49% of a firm with tangible net worth below $18 million and average net income after federal income taxes (excluding carry-over losses) below $6 million, unless control is necessary for realizing on the value of an investment divestiture plan is filed.

Moreover, a financial holding company may use a fund that it does not control. Such funds are "advised" by the financial holding company, but an independent board meets frequently and may terminate the fund advisor.

***Mr. Lustgarten is a partner with the law firm Schulte Roth & Zabel in New York.***

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