CREDIT SUISSE | FIRST BOSTON

TESTIMONY OF PETER A. GRAUER

On behalf of

Credit Suisse First Boston
The Financial Service Roundtable
The Securities Industry Association

Hearings on Merchant Banking Activities
House Committee on Financial Services
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Introduction

Good morning Mr. Chairman. I want to thank you for holding these hearings today and allowing me to appear before the Committee. I am presenting testimony today on behalf of Credit Suisse First Boston ("CSFB"),[1] as well as The Financial Services Roundtable and the Securities Industry Association ("SIA").

My name is Peter Grauer and I am a Managing Director in CSFB's Private Equity[2] Group. I joined CSFB in November 2000 when the Firm merged with Donaldson, Lufkin & Jenrette ("DLJ"). This was my second tour at DLJ. Prior to this, I ran a merchant banking boutique, Grauer & Wheat, Inc., for three years. I began my private equity career at DLJ in 1980 as a Vice-President in DLJ's Venture Capital arm. In 1985, I moved to DLJ's Merchant Banking group as a Managing Director and in 1995, I became the founding partner of DLJ Investment Partners, a private equity fund that invests in mezzanine securities. Prior to DLJ, I spent eleven years at Citibank, N.A., concluding my career as a Vice President and senior credit officer. In sum, I have spent over twenty years in the merchant banking business of which only for the past five months have my activities come under the regulation of the Bank Holding Company Act

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[1] CSFB is a leading global investment and commercial banking firm serving institutional, corporate, government and individual clients. CSFB's businesses include securities underwriting, sales and trading, investment and merchant banking, financial advisory services, investment research, venture capital, correspondent brokerage services and online brokerage services. It operates in over 76 locations across more than 37 countries and 6 continents, and has some 28,000 staff worldwide (including over 16,000 in the United States). CSFB is a business unit of the Zurich based Credit Suisse Group ("CSG"), a leading global financial services company.

[2] Consistent with industry practice, the terms "merchant banking" and "private equity" are used interchangeably throughout the testimony.

with the CSFB merger. Based on this history, I believe that I can present a unique perspective to the Committee on what constitutes traditional merchant banking practices and whether the Joint Rules we are discussing today permit these practices to continue.

As you may know, in March 2000, CSG and CSFB were each designated as financial holding companies ("FHCs") pursuant to the Gramm-Leach-Bliley Act ("GLBA"). CSFB Private Equity ("CSFB-PE") is a subsidiary of CSFB and, accordingly, is now subject to the Rules on Merchant Banking jointly promulgated by the Federal Reserve and Treasury in January of this year ("Joint Rules"). As a result, we have completed a full review of these Rules in the context of their application to a preexisting merchant banking operation that has a wealth of experience in the making and management of merchant banking investments of all types, and through all types of vehicles.

CSFB commends the Federal Reserve and Treasury for the significant improvements that the Joint Rules reflect from the original Interim Merchant Banking Rules put out in March 2000. The Joint Rules in their current form respond much more accurately than the Interim Rules to the economic and practical realities of a merchant banking operation. We appreciate the Federal Reserve and Treasury's willingness to be open-minded and work with the industry to improve these Rules. In the same spirit, we look forward to further refining the Rules as the Agencies gain greater expertise in private equity activities.

While we recognize how far the Agencies have come, unfortunately, we still believe that, considered on a whole, the Joint Rules present an unnecessarily burdensome array of restrictions that are neither mandated by safety and soundness concerns, nor in keeping with the language or spirit of the GLBA. There are a number of provisions of the Joint Rules that still do not fully reflect the manner in which private equity investors such as CSFB-PE conduct their businesses. We urge that the Federal Reserve and Treasury work cooperatively with Congress and industry participants to address these issues.

We believe that, more than any other provisions of the GLBA, the merchant banking restrictions have impeded non-bank financial firms from becoming financial holding companies. In evaluating the new Joint Rules, it is important to note that neither our competitors in the traditional securities industry, nor our competitors in the provision of venture capital and the making and management of private equity investments (e.g., Kohlberg Kravis & Roberts; Thomas H. Lee; The Texas Pacific Group; AIG; The Blackstone Group; Hicks, Muse, Tate & Furst), seem to have overcome their aversion to FHC status under the GLBA. To us, this is the acid, market test on whether the Joint Rules have enabled or impeded a two-way street between the investment and commercial banking industries. In our view, the unwillingness of major private equity market participants to elect FHC status -- including securities firms which were in the forefront of advocating enactment of the GLBA -- serves to underscore the continuing difficulties which the Joint Rules raise and presents the real possibility that FHCs may be operating at a significant disadvantage in the marketplace.

Today, I would like to raise certain items under the Joint Rules for the Committee's further review. I believe that resolution of these issues could go a long way to building an effective two way street consistent with Congressional intent under the GLBA.[3]

[3]The House Report provided, "[T]he Committee intends section 6(c)(3)(H) to permit investment banking firms to continue to conduct their principal investing in substantially the same manner as at present. The Board shall take into account that investment banking firms affiliated with depository institutions should be able to compete on an equal basis for principal investments with firms unaffiliated with any depository institutions so that the effectiveness of these organizations in their investment banking activities is not compromised." (H. Rep. 106-74, part 1, p.123 (1999))

Background.

By way of background, CSFB-PE is a combination of CSFB's pre-existing private equity activities merged with the activities of DLJ Merchant Banking Partners. The combined entity, CSFB-PE, is the sponsor of merchant banking, venture capital[4], "funds of funds"[5], mezzanine[6], real estate[7] and other private investment funds[8] with aggregate committed capital in excess of $22 billion, resulting in the world's largest manager of merchant banking assets. CSFB-PE's merchant banking activities have long been a strategic core business, reflecting over 30 years experience in the venture capital business.[9] CSFB-PE's leveraged corporate private equity funds (which invest directly in large private equity opportunities) have made more than 100 investments with an average transaction value of $475 million across a broad range of industries (including retailing, railroads, healthcare, telecommunications and industrial manufacturing), generating a 15-year compound annual internal rate of return in excess of 80%. This does not include smaller venture capital transactions or investments in third party funds, mezzanine securities or other types of assets. CSFB-PE's investor base includes a broad spectrum of the largest corporate pension funds, insurance companies, high net worth individuals and

[4] A "venture capital" fund is a pool of capital used to make equity investments in companies with growth potential. The proceeds of the financing are used to start or expand a company.
[5] A "fund of funds" is a pool of capital that, instead of being used to make direct investments in companies, is distributed among a number of other funds managers, which in turn invest the capital directly.
[6] A "mezzanine" fund offers subordinated debt financing to companies (the level of financing that is subordinated to the senior debt but is senior to equity). Mezzanine financing shares characteristics of both debt and equity financing.
[7] A "real estate" fund is pool of capital that invests in real property interests.
[8] A "private investment" fund refers generally to any pool of capital used to make equity investments in private companies.
[9] This includes DLJ Merchant Banking Partners.

endowments. CSFB-PE is also often a minority co-investor alongside other leading private equity buy-out funds.

Federal Reserve/ Treasury Joint Rules.

While we were pleased at many of the modifications made by the Federal Reserve and Treasury in promulgating their final Joint Rules on merchant banking, we remain concerned that the Rules fail to capture the realities of the current marketplace for private equity investing. In our view, the merchant banking provisions of the GLBA are essential components of that landmark legislation and any regulatory implementation of those provisions that undercuts the Congressional intent and focus of that legislation should be scrutinized with great care.

It is important to start from the premise -- which is entirely borne out by CSFB-PE's experience -- that active merchant banking, properly managed, poses no greater risks to FHCs than many other activities that regulated financial institutions are permitted to engage in *without* restrictions (e.g., bank loans to debtor corporations). Moreover, merchant banking has provided a dynamic and growing source of capital funding for large and small business operations -- both "old economy" and "new" -- throughout the United States. Our historical returns further illustrate that merchant banking is a consistently profitable activity over a period of many years, including periods when the economy as a whole and many financial institutions have not performed well. Indeed, merchant banking investments (unlike publicly traded equity securities) are not directly subject to the short-term volatility of the financial markets, in which an earnings shortfall of a few pennies per share can cause a security to lose 25-40% of its value. Moreover, the conduct of merchant banking activities has not led in any way to a breakdown or weakening of the separation of banking and commerce which the GLBA preserves as a hallmark of the U.S. financial system.

In this context, I would like to start today by discussing some particularly nettlesome aspects of the Joint Rules that cause us practical difficulties and do not reflect established industry practice. I will then move briefly to an overview of broader industry concerns.

Specific problem areas under the Rules that we would like to highlight today and that we find raise operational difficulties are largely twofold. First, the restrictions on "routine management or operation" of a portfolio company remain highly problematic and raise particular difficulties for minority investors.[10] Second, the aggregate limit on a FHCs merchant banking investments continues to cause operational difficulty, particularly since the Joint Rules base this limitation on the "carrying value"[11] of these investments, rather than the dollars committed. In my view, these restrictions significantly diminish an important business opportunity for FHCs, and undercut the intent of Congress, *without* adding in any material way to the regulatory goals referred to in the Joint Rules.

Routine Management/ Restrictions on Minority Investors.

CSFB-PE is a growth-oriented investor that has traditionally taken an active role in assembling strong management teams for portfolio companies[12] and working with portfolio

[10] A "minority investor" is a shareholder that owns a small percentage of the equity of a company, and as a result, does not have the ability to control the company's management or board of directors.
[11] The "carrying value" of an investment is the value of the investment as reflected on the holder's balance sheet.
[12] A "portfolio company" is any company – whether a corporation, partnership, limited liability company or other business entity – in which a private equity investor or fund invests and which therefore constitutes part of such investor's or fund's "portfolio".

companies to develop strategic value-creation plans that benefit their investors. It is our philosophy to be an actively involved shareholder with long-term (as opposed to short-term) corporate goals, bringing to our investments all available resources and expertise. In that context, for example, since 1992, CSFB-PE has provided direct assistance to portfolio companies in making more than 30 acquisitions. Further, to provide ongoing guidance and monitor results, representatives of CSFB-PE have served on the boards of many portfolio companies. In conducting our merchant banking operations, we believe that the ability, if necessary, to change the strategic direction of a portfolio company, to change management, to determine how and when to refinance a portfolio company and to control the timing and manner of exit from the investment are each critically important risk-mitigating factors that should be fully preserved under the applicable Rules.

In general, the Joint Rules' restrictions on "routine management or operation" of a portfolio company appear to presume that an investment can be generally protected from bad or improper management through control of a portfolio company's board of directors. However, where -- as is frequently the case -- CSFB-PE only takes a minority position in a portfolio company, CSFB-PE would not have the ability to control the portfolio company's board of directors. In this case, the need for additional contractual and operational protections becomes significantly greater than in the majority-investment context. Traditionally, these protections are obtained through covenants for the benefit of minority investors (which may or may not be represented on the board) that dictate prudent business practices or controls for the portfolio company. The Joint Rules' prohibition on the use of many of these traditional covenants by FHC-affiliated funds would increase the risk associated with a minority investment and cause FHC minority investors to lose an important tool to protect the value of their investments. It may also create an artificial and perverse bias in favor of majority investments.

Based on our experience at CSFB-PE, I would strongly recommend that the Federal Reserve and Treasury revise the Joint Rules to permit FHCs making minority investments to retain the right to utilize a wide range of restrictive covenants for the express purpose of reducing the level of risk to investors. These covenants are intended to ensure prudent management and operating practices and to channel portfolio company business decisions in a cost-effective and revenue-enhancing manner.

While we recognize that the Joint Rules do provide limited examples of covenants that, if granted to a FHC, would not be considered to be "routine management or operation," the regulatory list is limited and incomplete. In my view this list relates fundamentally to what I would consider to be "extraordinary corporate events." The approved list does not go far enough to protect a merchant banking investment, particularly a minority investment that may most need the protection. In fact, the Rules ignore the reality that "ordinary" poor management (particularly in the absence of proper operating and management controls) will diminish value much more quickly than any "extraordinary event" where intervention would be permissible under the Joint Rules.

I believe that the current restrictions on "routine management or operation" of a portfolio company are unnecessary and could result in a significant handicap to our business as asset managers.[**] But even assuming that the prohibition on "routine management or operations" is desirable, there is a broad continuum between "routine management or operations" and approval of extraordinary corporate events. Accordingly, I believe that a far broader range of events and

[**] I should, of course, make it clear that CSFB-PE fully intends to conduct its merchant banking operations in such a way as to comply with the Joint Rules as in effect at the time.

business developments should expressly be subject to a private equity investor's approval without such approval being deemed illegal participation in "routine management or operations". Examples of such events and developments should expressly include:

- All matters affecting the financing of a portfolio company, whether or not in the ordinary course of business.
- All matters affecting the regulatory, tax or liability status of a portfolio company or its equity holders.
- Approval of capital expenditures and major expense items.
- Policies regarding the hiring, firing or setting or changing the compensation of non-executive employees (including incentive plans).
- Any transactions with affiliates or related persons (to ensure such transactions are on arms' length basis to protect investors from the wasting of corporate assets by others).
- Negative covenants relating to any material operations, including, in particular, financial covenants.
- The creation of any subsidiary, partnership or joint venture to conduct any part of a portfolio company's business.

While the Joint Rules have left the door open that these items may be acceptable on some type of case-by-case basis, the fact is that market circumstances will not wait for regulators to make those determinations. If a FHC is forced to consult its regulator to determine whether it can be involved in a transaction, a non-FHC can step up and immediately commit to a deal with such terms. The rights described above are typical of those that private equity funds routinely seek in connection with a minority equity investment in a portfolio company. Indeed, most of them are little different from the covenants that a lender would normally require.[13] In private

[13] It appears to us that limiting minority rights generally runs counter to accepted industry conventions. Since an equity investment by its nature means that the equity holder is subject to the prior satisfaction of debt in a bankruptcy, many practitioners are questioning why lenders may negotiate covenants related to operational matters, whereas under the Joint Rules the equity holder, which has more risk, is more limited in its ability to do so.

equity investing, these rights would normally be evidenced by covenants contained in a shareholder's agreement or similar contract among the portfolio company, the investor and the other shareholders of the portfolio company. In a minority investment context, the foregoing approval rights are absolutely critical to investor protection. These covenants (particularly financial covenants) would never be considered "routine management" and, as I mentioned earlier, majority investments (where the FHC controls the portfolio company's board of directors) inherently have these protections built in.[14]

Let me stress that the type of covenants we are describing are critical to preserving the capital of our client-investors. CSFB-PE's client-investors are mainly comprised of third party institutional and public and private pension plans as well as high net worth individuals.[15] CSFB-PE manages its portfolio in a manner that seeks to maximize the return to our client-investors and mitigate against losses. We have designed our shareholder covenants to achieve that goal and have specifically represented our policies to investors in offering memoranda. We believe that the types of restrictive covenants described above are vital to protecting the interests of our client-investors.

Finally, apart from the issues facing minority investors, we believe that the prohibition on any officer or employee interlock between a FHC and a portfolio company at the "executive

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[14]Further, it should also be noted that minority investments are often made in syndicated deals where the lead investor offers a "strip" of a deal it has already negotiated with a portfolio company. In this event, it is conceivable that a FHC could be in an awkward position of asking for lesser rights where the terms include substantial protections that stray into what the Rules call "routine management", or requesting substantial structural changes in order to convert its control rights into board representation. One can imagine that if the deal is good enough, there will be plenty of non-FHC players ready to participate without such complications.

[15] Indeed, the typical aggregate investment by CSFB itself in a particular fund sponsored by CSFB-PE is normally in the range of only approximately 12%.

officer" level raises particular difficulties in a number of circumstances. From time to time it has been important for a CSFB-PE entity to provide its direct expertise to a portfolio company in a variety of different contexts.[16] Certain situations -- such as an investment in an earlier stage company or one at a critical juncture in its development -- can require full-time senior assistance in building or restructuring a management team. Investors count on our ability to provide this assistance (especially in times of distress) when choosing to invest in our funds. In some (indeed, many) instances, senior officer involvement can be considered very analogous to a "management consulting" role, that the Joint Rules expressly contemplate would be permissible in the merchant banking context. There is no reason, in my judgment, why the same flexibility should not be brought to bear in respect to appropriate senior officer interlocks, and such flexibility would be entirely consistent with the way in which non-FHC merchant banking/private equity operations are currently conducted.

Aggregate Investment Limits/Carrying Value.

The aggregate percent of capital-based investment limits impact under the Joint Rules raise difficult issues for CSFB-PE. While we are pleased that the Joint Rules now anticipate that these investment limits will ultimately "sunset," we do not believe that market circumstances justify or support the imposition of these caps in any manner. Most fundamentally, since performance-related evidence shows that merchant banking activities conducted by firms with substantial experience do <u>not</u> pose significant risk to a FHC, I believe that a separate restriction on the volume of merchant banking investments is entirely inappropriate. I respectfully submit that the

[16] This is wholly apart from a determination that "intervention" might be necessary to address a material risk to the value or operation of a portfolio company.

standard capital rules required of a FHC (i.e., all subsidiary banks must be "well-capitalized") should in themselves provide the basis for any appropriate limitation on the volume of merchant banking investments.[17]

If such a limit is nonetheless maintained, CSFB-PE respectfully submits that compliance with the quantitative limit should be based on the "cost" of our investments --which is a fixed amount that facilitates planning of our investments in compliance with an objective standard. Since, under the Joint Rules, the applicable limits are determined by reference to "carrying value" the limits will vary at any given time. This is because we only carry investments on our books at cost until there has been a significant valuation event (such as a public offering or a permanent impairment in value). Therefore, while we can apply the mathematical formula stated in the Joint Rules at any "snapshot in time" to determine compliance with the applicable investment limit at that time, since the limits are tied to "carrying value" we are unable to predict the high end of the value that any of our investments will achieve, particularly in light of the volatility of the equity markets after our portfolio companies go public. In other words, the Joint Rules have the perverse effect of negatively impacting a FHC and its investors for superior performance, since more merchant banking capacity is absorbed by an investment that is successful (i.e., has a greater "carrying value") than one that fails.

I would also respectfully suggest that if quantitative limits are maintained, FHCs should be permitted to exclude from such limits the value of any portfolio company investment in the form of a publicly traded equity securities registered under the federal securities laws or otherwise

[17] It seems particularly inappropriate and overreaching for a non-U.S. entity like CSFB to be subject to an artificial U.S. mandated volume limit that is separate and apart from those limits mandated by its home country regulator, particularly since the Federal Reserve has acknowledged that CSFB's regulators provide comprehensive consolidated supervision & regulation of CSFB as well as its subsidiaries.

tradable under those laws without registration. While merchant banking funds make privately negotiated investments, the securities that make up the investment may at some point become publicly tradable as a result of a public offering. At that point in the cycle of ownership, the fund as a holder of such securities would be entitled to the broad protections offered by the regulatory and reporting requirements of the securities laws and the investment would not be distinguishable from any other position in publicly traded securities. In other words, once a portfolio company goes public and the position is more liquid, I do not think such position should be counted as a merchant banking investment for purposes of the aggregate investment limits.

Additional Industry Concerns.

Beyond the specific issues I have identified above, I wanted to describe a few additional industry concerns.

First, related to the holding periods for private equity investments,[18] the amendments reflected in the Joint Rules should reduce, but will not eliminate, the "fire sale" mentality created by GLBA's holding period limitations. A simple look at the market circumstances over the past few weeks demonstrates why forced sales and formally limited holding periods could be problematic from an investment as well as a safety and soundness viewpoint. Private equity is the ultimate "buy and hold" experience and the resilience of profitability related to merchant banking activities comes from the ability to develop companies over a substantial time period

[18] The Joint Rules limit investments in portfolio companies to 10 years (without prior Federal Reserve approval), and to 15 years for investments in so-called private equity funds.

waiting for the appropriate market windows. It seems particularly inappropriate to require prior Federal Reserve staff review of every proposed merchant banking investment holding which exceeds the regulatory maximum and to impose a capital charge for longer term investments. Requiring such a process will only provide an unfair degree of leverage to portfolio companies in dealing with their venture capital/merchant banking investors if such companies know that a troublesome (i.e., prudent, value-oriented) investor could be forced to dispose of its interest[19] or suffer adverse regulatory consequences. We submit that any abuses associated with holding investments beyond some regulatory benchmark be addressed through the normal supervisory/examination process.

Second, many in the industry view the cross marketing prohibition between a portfolio company and a U.S. depository institution or U.S. branch or agency of a foreign bank as unnecessary as well as inconsistent with market practices. At a minimum, we would recommend modifying GLBA's cross-marketing restrictions to give private equity investments the same types of flexibility given to the investments of insurance companies.

Third, the financial industry is currently reviewing new proposals related to risk based capital standards being circulated by the Basel Committee on Bank Supervision. It would appear that the merchant banking capital standards proposed by the Federal Reserve and Treasury are inconsistent with the new Basel approach and, indeed, have no basis whatsoever in the GLBA itself. While these U.S. standards do not apply directly to CSFB-PE since due to our foreign bank affiliation the Swiss regulators set our capital requirements, we also have to deal with capital charges on certain merchant banking investments that are higher than international

[19] Such an event may require negotiating the consent of the portfolio company or other investors and cause the merchant banking investor to be at a severe disadvantage.

requirements. We generally believe that the U.S. regulators (as well as the Swiss) should adopt standards consistent with Basel without burdensome additional charges for merchant banking or other activities. Uniform cross-border capital requirements will only improve the efficiency of the global financial industry.

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In closing, I very much appreciate the opportunity to raise these points with you, as a senior officer of an entity that, until recently, functioned outside the GLBA framework. I can appreciate - perhaps more than most - the significant and potentially harmful impact of the imposition of rules and limitations which, for all of their good and well-appreciated intention, simply do not "translate" well to the actual operations of a merchant banking/private equity business. While again we greatly appreciate the efforts of the Federal Reserve and Treasury staffs to improve the Joint Rules, we still believe that even in their current form they give significant advantages to our non-FHC competitors. We do not believe that this was the Congressional intent behind GLBA and we look forward to a further dialogue with Congress and the regulators to remedy this situation. I would, of course, be pleased to discuss these matters with you and answer any questions.

Thank you for your consideration.