Testimony of John P. Whaley

On Behalf of the ABA Securities Association

Before

The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

And

The Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services
United States House of Representatives

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Chairmen Baker and Bachus, Representatives Kanjorski and Waters, distinguished members of the subcommittees, my name is John P. Whaley. I am a partner of Norwest Equity Partners and Norwest Venture Partners, merchant banking firms based in Minneapolis, Minnesota, and Palo Alto, California, respectively. Norwest Venture Partners makes equity investments in early stage and emerging growth businesses focused on information technology related industries. Norwest Equity Partners invests in management-led buyouts of more mature businesses. Together, these firms comprise the private equity investment business of Wells Fargo & Co., a $272 billion financial holding company based in San Francisco, California.

I appear here today on behalf of ABASA, the ABA Securities Association. ABASA is a separately chartered trade association subsidiary of the American Bankers Association ("ABA"), formed in 1995 to develop policy and provide representation for those bank and financial holding companies involved in, among other things, merchant banking and investment banking activities. My testimony today also reflects the views of the ABA.[1]

I commend you, Messrs. Chairmen, for holding this hearing to focus on capital markets developments after passage of the Gramm-Leach-Bliley Act ("Act"), particularly the merchant banking rules issued during the last quarter by the Board of Governors of the Federal Reserve System ("Board") and the Department of the Treasury ("Treasury") and the re-proposed capital rule issued by the Board, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC).[2] Many of ABASA's members regard the authority to engage in expanded merchant banking activities as the single most important new power granted by the Act. As a result, ABASA has a strong interest in ensuring that its members are able to engage in merchant banking activities to the full extent allowed under the law.

As the Subcommittees are well aware, ABASA strongly opposed the original capital proposal issued by the Board, as well as the interim merchant banking rule issued by the Board and Treasury, in March of 2000.[3] Indeed, during the 106th Congress, ABASA testified before the House Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises concerning its opposition to the proposed rules.

Since that time, the Board and Treasury have revised the proposed interim rules

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[1] ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

[2] Final merchant banking rules adopted by both the Board and the Treasury (Docket No. R-1065, 66 Federal Register 8466 (January 31, 2001)); Re-proposed capital rule issued by the Board, OCC and FDIC (Docket No. R-1097, 66 Federal Register 10212 (February 14, 2001)).

[3] See Docket Nos. R-1065 and R-1067, 65 Federal Register 16460, 16480 (March 28, 2000).

and adopted final rules, effective February 15, 2001. In addition, the Board, along with the OCC and the FDIC, has issued a revised capital proposal, with comments due on April 16, 2001.

As more fully expressed below, ABASA is pleased that the regulators have addressed many of its concerns and comments, and that additional flexibility has been incorporated in many instances. We are particularly pleased that the 50 percent capital charge and the restrictions placed on merchant banking activities conducted through private equity funds have been modified substantially. While ABASA continues to believe that a supervisory approach is the most appropriate method for addressing any special capital requirements for merchant banking activities, we are most concerned about, and continue to be opposed to, assessment of a special capital charge for equity investment activities authorized ***prior*** to enactment of the Gramm-Leach-Bliley Act.[4]

In addition, Messrs. Chairmen, ABASA seeks your support in sponsoring legislation that would amend the cross-marketing prohibitions imposed by the Gramm-Leach-Bliley Act on merchant banking activities. Under current law, the cross-marketing prohibitions unfairly disadvantage those FHCs not affiliated with insurance underwriting firms that seek to engage in merchant banking activities. ABASA strongly urges revisions to the Act to allow all FHCs to engage in such limited cross-marketing activities.

[4] It should be noted that in addition to applying to merchant banking investments, the capital charge would apply to non-financial equity investments made: (1) pursuant to section 4(c)(6) and 4(c)(7) of the Bank Holding Company Act ("BHCA"); (2) overseas, pursuant to the Board's Regulation K; (3) through Small Business Investment Companies (or "SBICs"); or (4) by state non-member banks pursuant to section 24 of the Federal Deposit Insurance Act ("FDIA").

Special Capital Charge

The proposed rule would adopt a three-tier or sliding scale approach for assessing capital against equity investments made by FHCs and bank holding companies ("BHCs"). The capital charge would be in addition to the capital otherwise required to be held under bank holding company capital requirements. This separate capital charge would take the form of a deduction from the organization's Tier 1 capital. The size of the deduction would increase as the equity investment portfolio increased relative to the organization's Tier 1 capital, as described below.

Specifically, if equity investments in nonfinancial companies make up less than 15 percent of an organization's Tier 1 capital, an 8 percent Tier 1 capital charge would be assessed against all such equity investments (except, as noted below, those made through small business investment companies ("SBICs")).

The second tier provides that if equity investments in nonfinancial companies make up 15 percent or more but less than 25 percent of an organization's Tier 1 capital, a 12 percent capital charge would apply to the amount of such investments exceeding the 15 percent threshold.

Under the third tier, a 25 percent capital charge would apply to the amount of equity investments in nonfinancial companies that equal or exceed 25 percent of an organization's Tier 1 capital.

In addition to the new, merchant banking equity investments that may be made under Gramm-Leach-Bliley, there are four other pre-Gramm-Leach-Bliley types of banking organization equity investments in nonfinancial companies that also must be counted in determining whether the 15 percent and 25 percent thresholds have been exceeded:

1. Equity investments made through SBICs;

2. Non-controlling equity investments made under sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act;

3. Portfolio equity investments made under Regulation K; and

4. Most equity investments by state banks under section 24 of the Federal Deposit Insurance Act.

Although SBIC equity investments count towards the aggregate 15 percent and 25 percent calculations, no capital charge or deduction is applied to any such SBIC investment unless the total amount of such SBIC investment by itself exceeds the 15 percent threshold. To the extent that the separate 15 percent SBIC investment threshold is exceeded, such "excess" SBIC equity investments are subject to the aggregate capital charge.

As noted above, the capital deduction would be applied on a marginal basis. For example, if an organization's equity investments in nonfinancial companies equaled 27 percent of that organization's Tier 1 capital, 8 percent of the carrying value of the investments would be deducted for those investments that represent less than 15 percent of Tier 1 capital (other than SBIC investments). For those investments that represent between 15 and 24.99 percent of Tier 1 capital, a 12 percent capital deduction would apply (other than to SBIC investments, except to the extent that such SBIC investments by themselves exceeded the 15 percent threshold). For those investments that represent 25 percent or more of Tier 1 capital, a 25 percent capital deduction would apply (other than to SBIC investments, except to the extent that such SBIC investments by themselves exceeded the 15 percent threshold).

ABASA is pleased that the Board, with the assistance of the OCC and the FDIC, significantly reduced the 50 percent blanket capital charge originally sought to be imposed on all equity investment activities. While ABASA still maintains that the optimum method for dealing with nonfinancial equity investments would be to adopt a supervisory approach as we originally advocated in our testimony to the Congress and in our comments to the Board,[5] we recognize that a special capital charge ranging from 8 to 25 percent of Tier 1 capital is a significant improvement over "the one size fits all" 50 percent capital charge originally proposed.

We are particularly pleased that the Board considered our arguments against "the one-size-fits all approach." The newly proposed sliding scale approach addresses, in large part, many of our concerns by assessing capital according to the level of nonfinancial equity investments made by an organization. Thus, as the level of such investments increases, so too, would the required Tier 1 capital deduction.

We remain concerned, however, that any special capital charge assessed against FHCs engaged in merchant banking activities will further exacerbate the inequities between FHCs and non-FHCs engaged in merchant banking activities. The legislative history describing the merchant banking provisions of the Gramm-Leach-Bliley Act indicates that Congress intended that those investment banking firms affiliated with securities firms and insurance companies that opt to become FHCs should be permitted to continue to engage in merchant banking activities in substantially the same manner as had always been permitted.[6] Conversely, Congress also intended that bank and financial

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[5] A supervisory approach would require FHCs to meet appropriate qualitative standards for managing merchant banking risk in order to qualify for the supervisory approach. In assessing where an FHC is appropriately managing risk under this approach, the regulators would look at all relevant facts and circumstances, including internal capital allocation models, valuation policies, reporting systems, equity investment risk management policies, and so forth. An FHC's internal capital allocation model could be used to measure and "backtest" capital adequacy with respect to merchant banking investments in a manner that could be readily monitored and validated by the regulators. Significant failures of the model could result in additional capital requirements for merchant banking investments, on a case-by-case basis.

[6] House Rep. No. 106-74, 106th Cong., 1st Sess. at 123; S. Rep. No. 106-44, 106th Cong., 1st Sess. at 9.

holding companies should not be placed at a competitive disadvantage relative to investment banking firms not affiliated with any depository institution, but should be allowed to engage in merchant banking activities to the same extent as those other firms.[7]

Despite Congress' stated intentions, the newly proposed special capital charge against merchant banking activities, even as reduced under the revised proposal, would preclude FHCs from engaging in merchant banking activities on the same terms and conditions as their non-bank affiliated competitors. These provisions also might discourage securities and insurance firms from becoming FHCs, because the price, in terms of limits on merchant banking activities, may be too steep. The result: financial holding companies will be precluded from engaging in merchant banking activities on the same terms and conditions as their non-bank affiliated competitors. If they choose to engage in merchant banking it will be with a capital charge not borne by their non-bank competitors.

Most importantly, ABASA continues to oppose any assessment of a special capital charge on non-merchant banking equity investments, which have been permissible for banking organizations for many years preceding the Gramm-Leach-Bliley Act. The banking industry has a long history of engaging in such equity investment activities through SBICs,[8] under Regulation K,[9] and under the authority of sections 4(c)(6) and

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[7] Id.

[8] Since 1958, commercial banks have, through their SBIC corporations, provided equity capital, long-term loans and management assistance to new and established small business firms. Bank-owned or bank-affiliated SBICs generally provide the largest proportion of financed dollars to small businesses. For 21 of the last 22 years, such SBICs have made a profit on their venture capital investments, averaging an annual rate of return of 13%.

4(c)(7) of the Bank Holding Company Act and Section 24 of the Federal Deposit Insurance Act.[10] To date, those activities have produced strong returns with minimal losses and have taken place over a relatively long period of time, involving both up and down markets. There is simply no evidence that additional capital is warranted for equity investments authorized for banking organizations ***prior*** to passage of the Gramm-Leach-Bliley Act. At the very least, investments through SBICs should be excluded from both the activity-level calculation and special capital charge.[11]

Should the regulators insist on going forward with their proposal to assess capital against merchant banking activities authorized for banking organizations prior to passage of the Gramm-Leach-Bliley Act, ABASA would strongly encourage the regulators to grandfather all equity investments made prior to March 13, 2000. Without such a determination, many of the investments made previously will be rendered uneconomic – not because of any change in inherent worth but solely because of an unanticipated change in regulatory treatment that results in greater unexpected cost.[12]

Moreover, grandfathering these investments avoids the burdens associated with implementing a phase-in of the special capital charge over a period of time for those equity investments made prior to March 13, 2000. As the proposal notes, these

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[9] Many banking organizations engage in equity investment activities abroad through a variety of vehicles. Limits on these activities include limiting the investment to no more than 40 percent of the equity of a company, with no more than 20 percent consisting of voting equity.

[10] Bank holding companies may make limited, non-controlling equity investments under authority of Sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act. In addition, state nonmember banks may, under certain circumstances, engage in equity investment activities under Section 24 of the Federal Deposit Insurance Act.

[11] The agencies have suggested that even if equity investments made prior to March 13, 2000 are grandfathered, the adjusted carrying value of the organization's investment portfolio made in grandfathered investments will nevertheless be used to determine the appropriate marginal capital charge on any investments not grandfathered.

investments involve only modest amounts at most banking organizations and will be liquidated over time. Modest investments liquidating over time would tend to argue against a phase-in of capital charges.[13]

Private Equity Funds

As the Subcommittees are aware, the new type of merchant banking equity investment may be made through pooled funds or directly in portfolio companies. The interim rule seemed to recognize that investments made through a specially-defined type of pooled fund, "a private equity fund," in which an FHC, by definition, may only be a minority investor should have fewer restrictions than investments made directly.

ABASA concurred with the Board and Treasury that merchant banking equity investments through private equity funds should have fewer restrictions than those made directly because fund investments inherently raise fewer regulatory concerns than do direct investments in portfolio companies. Proportionally less of the FHC's capital is at risk and majority participation in the private equity fund by unaffiliated investors imposes significant market discipline on investment decisions. The unaffiliated investor participation also helps ensure that the FHC's investment is made for bona fide investment purposes, rather than to allow the FHC to engage in prohibited commercial activities.

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[13] While the definition of "nonfinancial equity investment" appears on its fact to capture investments made by FHCs under the "complementary" authority of Section 4(k) of the Gramm-Leach-Bliley Act, ABASA assumes that the special capital charge will only apply to equity investments authorized under either section 4(k)(4)(H) of the BHCA, section 4(c)(6) or 4(c)(7) of the BHCA, section 302(b) of the Small Business Investment Act ("SBIA"), Regulation K, or section 24 of the FDIA (other than section 24(f)). To read this proposal otherwise would require the special capital charge to be assessed against any FHC investment in data storage and general data processing companies and electronic information portal services permitted

Having recognized these legitimate reasons for less restrictive treatment, the interim rule needlessly imposed many of the same burdensome restrictions on portfolio investments made by a private equity fund in which an FHC has invested than it imposed on direct portfolio investments made by an FHC. That is, the rule's restrictions applied to the FHC's investment in the private equity fund itself, *and* then also "looked through" the equity fund to the portfolio investments made by the private equity fund and imposed many of the same restrictions on the fund's investments.

ABASA strongly objected to these "look through" provisions. The restrictions needlessly deterred FHCs from investing in private equity funds, and created a significant disincentive to the inclusion of FHC investors in many private equity funds offered by non-FHCs. ABASA believed the Board and Treasury could not have intended that result and commented extensively on that aspect of the interim rule.

We are pleased that the final rules applicable to private equity funds have been simplified and clarified in ways that address many of ABASA's concerns. Significantly, the restrictions on direct portfolio investments will no longer be applied on a "look through" basis to private equity fund investments unless the FHC controls the private equity fund. For example, where an FHC does not control the private equity fund, the restriction on routine management[14] will not apply to the private equity fund's investment in a portfolio company.

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under the complementary authority of Section 4(k)(1)(B). Such an assessment could negatively affect the ability of FHCs to engage in e-commerce. ABASA would oppose such a reading of the proposal.

[14] Both the Gramm-Leach-Bliley Act and the final regulations prohibit the routine management or operation of a portfolio company "except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition."

In fact, the only “look through” provision remaining in the final rule for non-controlling investments in a private equity fund involves the length of time such a fund may hold an investment. Specifically, investments in private equity funds and the fund’s own investments in portfolio companies may be held for only15 years, even if the FHC’s investment in the fund is non-controlling. While this 15-year holding period is longer than the 10-year holding period applicable to direct merchant banking investments in portfolio companies, ABASA continues to maintain that it is unnecessary to require any holding period limit on investments made by a private equity fund that is not controlled by an FHC.

Another significant revision to the private equity fund provisions addressed an ABASA concern involving the issue of control. The original proposal lacked a clear standard for determining when “control” of a private equity fund existed. “Control” is an important concept with respect to private equity funds as it has significant ramifications for both the fund’s operations and the FHC investor (and the application of the “look through” restrictions). For example, if an FHC “controls” a private equity fund, the FHC is prohibited from routinely managing a portfolio company in which the private equity fund has invested. In addition, as discussed below, an FHC is prohibited from cross-marketing its subsidiary banks’ services through portfolio companies held by a private equity fund controlled by the FHC.

The final rule provides that an FHC will be deemed to control a private equity fund if the financial holding company, including any director, officer, employee or principal shareholder of the FHC:

- Serves as general partner, managing member, or trustee of the private equity fund;

- Owns or controls 25 percent or more of any class of voting shares or similar interest in the private equity fund;

- Selects, controls, or constitutes a majority of the directors, trustees, or management of the private equity fund; or

- Owns or controls more than 5 percent of the voting shares of the private equity fund and at the same time acts as the private equity fund's investment adviser.

While the Board has clarified its definition of control through these four conclusive presumptions, we find the attribution rules related to the control determination quite troublesome. Specifically, ownership of shares of a fund by an officer or employee of a holding company is equated with ownership of shares by the holding company itself. Such an attribution of ownership of shares to the FHC goes beyond any attribution rules previously set forth by the Board in its Regulation Y. We also continue to maintain that general partnership, in and of itself, should not be considered "control".

Other significant revisions to the final rules applicable to private equity funds involve cross-marketing activities. Specifically, the final rule now makes clear that FHCs may cross-market interests in private equity funds to high net worth investors. FHCs also can cross-market the services of its subsidiary banks through portfolio companies held by a private equity fund so long as the FHC does not control the private equity fund.

Despite the easing of these cross-marketing restrictions contained in the final rule, more relief is needed. However, such relief requires legislation.

Other Provisions of the Final Rule

The final rule adopted by the Board and Treasury was significantly improved in other respects, providing additional flexibility in a number of areas. I would like to outline a few of these improvements.

Aggregate Investment Limits. The final rule removed the fixed dollar amount caps on the rule's aggregate investment limits. ABASA had objected strenuously to the aggregate investment limits, particularly the fixed dollar caps. Further, and most importantly, the final rule specifically provides that the aggregate investment limitations contained in the final rule will sunset automatically once the capital rules for nonfinancial equity investments are adopted.

Holding Periods. Additional flexibility was also provided with respect to the rules on holding periods. Specific holding periods continue to apply -- ten years for direct investments in portfolio companies and fifteen years for investments made through qualifying private equity funds. However, extensions now are permitted if Board approval is obtained up to 90 days before the end of the holding period. This 90 day pre-approval requirement is a significant improvement over the one year pre-approval requirement in the interim rule. Further, the disincentives to obtaining an extension have been pared back from those in the interim rule. All disincentives were eliminated save one: the capital charge requirement, which itself was pared back to require that the FHC hold capital against the investment in an amount set by the Board that must be above the highest capital charge applicable to the requesting FHC under the capital rules, but in no event less than 25% of the adjusted carrying value of the investment.

Routine Management. The rules on what constitutes "routine management" also were improved with additional flexibility provided here as well. Rather than an absolute bar on all officer and employee interlocks, the final rule establishes a rebuttable presumption that routine management exists where there are officer or employee interlocks. While routine management continues to be permitted only for a limited period of time, here, as well, additional flexibility was provided. Rather than obtain Board approval to routinely manage a portfolio company for more than six months as required under the interim rule, the final rule requires only written notice to the Board when routine management will exceed nine months.

Affiliate Transactions. For purposes of affiliate transaction limitations, the Gramm-Leach-Bliley Act establishes a rebuttable presumption of control when an FHC owns or controls more than 15 percent of the equity of a portfolio company. In its comment letter to the Board and Treasury, ABASA requested that the rule establish explicit safe harbors from this affiliate transaction rebuttable presumption. The final rule now has three specific safe harbors that establish an automatic rebuttal of the presumption, without the necessity for Board approval or notice.

Legislative Changes are Necessary to Level the Playing Field

Under the Gramm-Leach-Bliley Act, an FHC is permitted to engage in merchant banking equity investment activities if, among other things, it is affiliated with either a securities firm or an insurance underwriting firm. Presumably, the theory behind these requirements is that affiliation with either of these firms evidences some degree of sophistication with the financial markets.

The Gramm-Leach-Bliley Act generally imposes cross-marketing restrictions on FHCs engaged in merchant banking activities. The Act prohibits a depository institution controlled by an FHC from marketing any product or service of a company in which the FHC has made a merchant banking investment. The reverse is also true: the company in which the FHC has invested may not market the products and services of the FHC's affiliated depository institution to its customers.

A carve-out from this prohibition is provided, however, for merchant banking investments made by insurance companies owned by an FHC. Thus, insurance underwriting firms that affiliate with depository institutions are able to cross-market, through Internet websites or through statement stuffers, depository institution products to or through the company in which they have made a merchant banking investment. Products and services offered by the company in which the insurance underwriting firm has invested also may be marketed through Internet websites or statement stuffers via the depository institution that is affiliated with the insurance underwriting firm. Nearly all of ABASA's members are FHCs that may make merchant banking investments because of their affiliation with securities firms, while very few own insurance companies that could engage in the type of insurance company merchant banking permitted by Gramm-Leach-Bliley. As a result, our FHC members could not take advantage of the website/statement-stuffer exception, while other FHCs with insurance company merchant banking operations would be permitted to do so. There is simply no rational or public policy reason for this plain competitive inequity. The ability to cross-market through Internet websites is important to banks. Current business practices often require an FHC to invest in an Internet firm in order for its banks' products to be posted on or linked to that firm's website. The new merchant banking authority granted to FHCs would appear to preclude such an investment unless done through an insurance company owned by the FHC.

Some banking organizations have avoided this problem to a limited degree by investing in Internet firms through SBICs. The Board is also considering adding Internet activities to the list of "complementary" activities permitted under Section 4(k) of the BHCA.[15] These solutions are of limited use, however, and are clearly not a permanent solution. Consequently, ABASA urges the Congress to expand the website/statement stuffer carve-out currently applicable to merchant banking activities engaged in by insurance company subsidiaries of FHCs to all FHCs engaged in merchant banking activities -- ownership of an insurance company should not be a condition for such sensible cross-marketing relief.

Conclusion

In conclusion, ABASA appreciates the opportunity to once again share with you our views regarding the rules and their impact on merchant banking – an activity that is of fundamental importance to the financial services industry, corporate America and consumers.

[15] See Docket No. R-1092, 65 Federal Register 80384 (December 21, 2000).