TESTIMONY OF
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BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS OF THE COMMITTEE ON BANKING AND FINANCIAL SERVICES UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON CAPITAL MARKETS AND THE NEW ECONOMY

JUNE 7, 2000

Chairman Baker and Members of the Subcommittee, I am Marc Lackritz, President of the Securities Industry Association ("SIA"). I appreciate the opportunity to appear before you today to present SIA's views on the merchant banking rules issued by the Federal Reserve Board ("Fed") and Treasury Department ("Treasury").

SIA commends Chairman Baker and the Subcommittee for holding these important hearings. SIA has great respect for the Fed and Treasury and their dedicated staffs, but these rules have serious ill effects that could not have been intended. We are optimistic that these hearings will serve to encourage the agencies to develop and adopt merchant banking rules that do not have such adverse consequences; that foster rather than hinder the flow of capital to small and mid-sized companies; and that permit full, fair and effective competition in the capital markets by all of the participants in an integrated financial services industry. SIA looks forward to working with the Members of the Subcommittee, their staff, and the Fed and Treasury to achieve these results.

SIA brings together the shared interests of more than 740 securities firms, investment banks, broker-dealers and mutual fund companies that operate throughout the United States and North America. SIA member firms are active participants in U.S. and foreign securities and capital markets and in all phases of corporate and public finance. SIA believes that its membership and focus enable it to offer the Subcommittee a unique perspective: SIA would like to give the Subcommittee the securities industry's view of the merchant banking rules.

The securities industry believes that these rules -- and, in particular, the 50-percent capital charge on merchant banking investments, the total cap on merchant banking activity and the maximum holding period for venture capital investments -- will have a significantly adverse effect on the ability of securities firms within financial holding companies ("FHCs") to make merchant banking and other permissible investments on the same scale and to the same extent as securities firms that are not part of a FHC family. Because merchant banking is such an important part of the business of many securities firms, the existence of these rules will deter many firms from partnering with banks and becoming FHCs.

I. General Concerns with the Fed's and Treasury's Merchant Banking Rules

One of the most historic and important aspects of the Gramm-Leach-Bliley Act ("GLB Act") was the establishment of a "two-way street" in the financial services industry. That "two-way street" was designed to enable securities firms and banks to affiliate freely with each other and to ensure that securities firms, once they become partners with banks, are not artificially restricted in their activities.

To advance this "two-way street," and in recognition of the essential role that merchant banking plays in modern finance, Congress expressly authorized securities firms affiliated with FHCs to engage fully in the business of merchant banking. In fact, Congress emphasized that securities firms that affiliate with FHCs are to be permitted to continue their merchant banking activities in substantially the same manner as at present. Congress also placed specific statutory restrictions on the merchant banking activities of securities firms that affiliate with FHCs to safeguard against the potential risks that poorly run merchant banking programs could pose to those FHCs.

SIA believes that the Fed's and Treasury's merchant banking rules impose restrictions and limitations on merchant banking activities that go well beyond what Congress authorized in the GLB Act and that destroy the "two-way street" that is at the very core of the Act. For example, the 50-percent capital charge and the aggregate investment limit on merchant banking investments are artificial restrictions that are nowhere found in the GLB Act. These restrictions, which are not consistent with industry practice, were never contemplated by Congress in its extensive deliberations on the merchant banking powers of FHCs. Other aspects of the rules -- such as the rigid maximum holding period on merchant banking investments -- are plainly at odds with the more flexible approach that Congress specifically directed the Fed and Treasury to take.

These limits on merchant banking activities are entirely foreign to securities firms that are unaffiliated with banks. Consequently, these limits place securities firms that are part of FHC families at a competitive disadvantage by artificially restricting their merchant banking investments and by making it prohibitively more expensive for them to provide venture capital to entrepreneurs and growing companies. For this reason, many securities firms will be discouraged, and some effectively barred, from acquiring banks and becoming FHCs. This outcome is plainly at odds with what Congress intended when it authorized full merchant banking powers for securities firms affiliated with FHCs. In short, rather than opening the "two-way street," the merchant banking rules recreate the very sorts of roadblocks to an efficient and integrated financial services industry that the Members of this Subcommittee and others in Congress worked so hard to eliminate with the repeal of Glass-Steagall and the enactment of the GLB Act.

In fairness, the Fed and Treasury may not have comprehended the ill effects of their rulemaking. The preamble to the merchant banking rules indicates that, based on informal interviews with securities and banking firms, the Fed and Treasury thought that their rules largely formalized existing industry practice. Unfortunately, this is far from the case. Let me be clear on this point: the merchant banking rules are simply *not* in accord with prevailing securities industry practice.

SIA's experience is that merchant banking practices are far more diverse than the Fed and Treasury have recognized and that, as a consequence, the rules do not accurately reflect those varied and prudent practices. To cite but one example, the Fed has proposed a uniform 50-percent capital charge on all merchant banking investments because it believes that securities firms and others typically maintain higher internal capital positions to support their merchant banking activities. SIA's experience is that while some securities firms do indeed maintain higher capital levels for merchant banking positions, those levels vary significantly from firm to firm and, even within the same firm, from investment to investment depending on an array of factors. Thus, the securities industry's practices do not support or justify the application of a single 50-percent capital charge on all venture capital positions.

The Fed and Treasury also indicated in the rulemaking that they believe that the restrictions they have placed on merchant banking activities are warranted due to the risks posed by this business. The agencies neglect, however, the successful record of the financial services industry participating in the merchant banking business. In fact, it was Chairman Greenspan who noted in a speech only a few weeks ago that banking organizations (including those securities firms that are affiliated with bank holding companies) have engaged in merchant banking and other investment activities for several decades, through both bull and bear equity markets, without significant problems. This successful record was achieved precisely because firms have developed extensive internal controls and management information systems for making, managing and monitoring their venture capital investments. Such established, prudent and time-tested policies and systems should not be disturbed by new rules that inflict arbitrary limits on the amount firms may invest, on how long firms may hold their investments and how these investments may be counted against regulatory capital.

SIA recognizes that the Fed and Treasury have legitimate concerns about the potential conduct of merchant banking activities by some FHCs and that the agencies therefore bear a responsibility to foster the development of merchant banking practices by subsidiaries of FHCs that do not threaten the safety and soundness of financial institutions. Yet, the instant rules -- which treat all FHCs alike regardless of their expertise and experience with venture capital and merchant banking investments -- will have the perverse effect of actually increasing, rather than reducing, the risks of merchant banking activities. To explain, the capital charge and other aspects of the Fed's and Treasury's rules raise significantly the cost of making merchant banking investments; those increased costs, in turn, will pressure securities firms affiliated with FHCs to make riskier investments in search of potentially greater rates of return necessary to offset the new capital charge and other costs associated with these rules. In addition, by applying the capital charge and other restrictions across-the-board to all investments made by an institution, securities firms do not gain incentives to manage or monitor more carefully their portfolio investments -- no matter how conservative or risky an investment is, firms will be required to set aside the same capital charge.

SIA believes that the Fed's and Treasury's safety and soundness concerns can be better addressed through the Fed's ample supervisory authority over FHCs and with rules that specifically implement the statutory limits that Congress crafted in the GLB Act and that are, thus, far less intrusive and restrictive than what has been set forth in the current rulemaking. Such a course would allow the Fed to differentiate poorly managed firms from others and to focus their supervisory authority on those poorly managed firms; would encourage and reward institutions that develop sound internal merchant banking practices; and, perhaps most importantly, would be consistent (in a way that the current rulemaking is not) with the authority vested by Congress with the Fed and Treasury to adopt rules that promote the creation of a true "two-way street" in the financial services industry.

SIA has submitted a detailed comment letter to the Fed and Treasury urging them to reconsider various aspects of their merchant banking rules. A copy of that comment is attached to my testimony, and I will not repeat all of the points made in that letter here. Instead, I would like to touch on those parts of the merchant banking rules with which SIA has the greatest concerns.

II. The 50-Percent Capital Charge

For SIA, in several respects, the Fed's 50-percent capital charge is the most troublesome aspect of the merchant banking rulemaking. The capital charge increases by *eight-fold* the amount of capital required to be retained for merchant banking investments. To highlight this point, a simple example may be helpful. Let us say that a FHC with $500,000 of risk-based assets and a 6% Tier 1 capital ratio decides to make a merchant banking investment of $50,000. Under the current capital rules, that FHC would need to add $3,000 (6% of $50,000) of Tier 1 capital to maintain its current 6% Tier 1 capital level. Under the Fed's proposed rule, the FHC's risk-based assets would remain at $500,000 after its investment, but the FHC would need to deduct $25,000 (50% of its investment) from its Tier 1 capital. That means, in order for the FHC to maintain its 6% Tier 1 capital level, the $25,000 that was deducted would need to be replaced. This $25,000 replacement is over 8 times the $3,000 in additional capital required under the current rules.

In addition, the capital charge applies not only to new investments made pursuant to the GLB Act but also retroactively to pre-existing investments that have been made by bank holding companies under long-standing statutory authority. It is clear that the capital charge will increase the cost of merchant banking and other nonfinancial investments to securities firms that have partnered with banks and, thereby, disadvantage these institutions as compared to securities firms that are unaffiliated with banks, which are not required to hold excess capital in the fashion mandated by the Fed.

One of the Fed's principal defenses of the capital charge is that some securities firms, as part of their internal risk modeling, apply high capital charges to their equity investment activities. First, as noted above, SIA's own experience indicates that a 50-percent capital deduction is by no means universally applied. Second, even if it is correct that some securities firms do maintain higher capital levels for equity investments as part of their internal models, those internal models also apply lower capital charges to other assets, which the firms regard as comparatively safe. The Fed's approach does not leave room for such common, necessary and wise adjustments. SIA respectfully submits that it is inappropriate for the Fed to extract a single part of an *internal securities* capital model and to inject it out of context in an entirely different arena -- to mandate a *bank regulatory* capital requirement.

The Fed erroneously believes that the capital charge is of no practical significance because FHCs and bank holding companies will remain well capitalized even after application of the capital deduction on merchant banking investments. Thankfully, most institutions may not fall from well-capitalized status by imposition of this rule, but objections to the capital deduction are not a mere academic exercise. Institutions typically need to maintain higher internal capital to preserve a cushion above their regulatory capital requirements. That cushion serves a variety of purposes, including providing protection from unanticipated events. A mandatory increase in the required regulatory capital for merchant banking does *not* eliminate the need for institutions to maintain a cushion above their regulatory minimums. Thus, the proposed capital charge will require FHCs and bank holding companies to increase their capital levels, which will distort their earnings, stock prices and possibly debt ratings, and will be detrimental to the ability of securities firms affiliated with such FHCs and bank holding companies to supply venture capital to small and mid-sized businesses.

Despite these real business and economic consequences, consideration of some form of extraordinary capital treatment for merchant banking investments (albeit, treatment that is less draconian than the proposed 50-percent charge) might have been warranted if the Fed perceived some industry-wide problem with respect to merchant banking activities. Yet, the rulemaking does not indicate that the Fed has found any such issues or problems, and SIA submits that there are none. Instead, the Fed applies the charge as a preemptive measure to safeguard against the mere possibility of excessive risk by some institutions. SIA believes that it is wrong for the Fed to impose such a harsh charge on an entire industry without any evidence of inadequate practices or inappropriate internal controls, especially when the effect of this charge is to chill merchant banking investment activities, to undermine the statutory authority for FHCs to engage in merchant banking and to destroy the GLB Act's "two-way street."

The better approach to safeguard against the possibility of excessive risk is through the Fed's supervisory authority -- as umbrella regulator of FHCs. Specifically, the Fed could use flexible standards and rely on the very internal capital models that it cites in the rulemaking. Such an approach would require FHCs to maintain internal capital for equity investments but allow that capital level to vary according to such factors as the size and nature of the investments made; the size of the overall venture capital portfolio; and the extent of the securities firm's experience with merchant banking activities. Such a flexible approach would, indeed, be in line with industry practice (in a way that the Fed's 50-percent charge is decidedly not) and would address the Fed's safety and soundness concerns. Through the supervisory process, the Fed should monitor the internal capital models applied by individual institutions to ensure that the models appropriately account for the risks of the firm's merchant banking activities. If a FHC fails to develop and maintain an adequate internal capital model, then that institution may be subjected to an additional special capital charge.

III. Maximum Investment Cap

Securities firms also are gravely concerned about the aggregate investment limits or caps placed on the total merchant banking investments made by FHCs. Such caps -- which are nowhere to be found in the GLB Act -- are based on the lesser of a fixed dollar limit ($6 billion or $4 billion, after excluding private equity fund investments) or a set percentage of Tier I capital (30 percent of Tier I capital or 20 percent, after excluding private equity investments).

SIA finds several aspects of these caps to be highly objectionable. First, the Fed and Treasury provide no explanation in their rulemaking as to why they believe percentage or dollar limits set at these levels are appropriate. These limits appear to be entirely arbitrary and certainly do not reflect the securities industry's past practice in making merchant banking investments.

In addition, the $6 billion flat dollar cap unfairly penalizes securities firms with large investment banking operations -- even those companies that have plenty of Tier I capital to support those venture capital programs. For example, under this dollar cap, a bank-affiliated securities firm with $60 billion in Tier I capital will hit the flat dollar limit at the same time as another firm that has less than half that amount in Tier I capital. SIA submits that the two institutions do not warrant the same regulatory treatment.

Furthermore, a percentage cap that is based on the carrying value of equity investments -- as is the case in the agencies' rule -- has the further perverse effect of penalizing firms with *successful* merchant banking programs. Another example illustrates the point: If two securities firms have invested the same amount of money in merchant banking, the firm with a strong merchant banking program, whose portfolio has shown significant gains, runs the danger of hitting the cap. The other firm, with a poor merchant-banking program that has achieved only losses, will not hit the cap and can continue making additional merchant banking investments. This is not a sensible result.

SIA also believes that the dollar limits are set at such a low level that securities firms with significant merchant banking operations will quickly reach -- or, in some cases, may have already passed -- the regulatory limits and, then, will be automatically precluded from further merchant banking investments if they become FHCs or prohibited from merging with other firms. Securities firms with significant merchant banking activities are not likely to take any chance of running into this type of barrier to their investment banking and venture capital business; rather, they may merely avoid affiliating with banks or becoming FHCs. In much the same fashion, a FHC with significant investment banking business may be prevented by the regulatory limits from acquiring a securities firm that also engages in significant venture capital activities. In this case, the caps would have significant antitrust consequences and would defeat the "two-way street."

IV. Maximum Holding Period

The maximum holding period on FHC merchant banking investments also has raised strong objections from the securities industry. The merchant banking rules generally permit FHCs to hold merchant banking investments for a period of up to 10 years. The Fed and Treasury allow a longer holding period only in extraordinary circumstances, with prior approval and subject to a 100-percent capital charge.

As an initial matter, SIA believes that the imposition of an across-the-board maximum holding period is inconsistent with both the plain meaning of the GLB Act and its unambiguous legislative history. The GLB Act requires only that a merchant banking investment be held for no longer than such period of time as will allow the sale or disposition of the investment, consistent with its financial viability. What the GLB Act specifically avoids is placing a pre-set time limit on how long investments may be held. The legislative history makes it even clearer that Congress intended the holding period for an investment to be flexible and left within the discretion of the FHC. For example, the House-Senate Conference Committee explicitly noted that the decision to dispose of an investment should be made by a FHC -- and not its regulators -- on the basis of a variety of business and economic factors.

On this basis, SIA submits that the GLB Act was not intended to permit the Fed and Treasury to impose a pre-set limit on how long investments may be held. SIA also believes that there is no statutory basis for the requirement that the Fed approve applications to hold an investment beyond the 10-year limit. In fact, this "application" requirement is contrary to the entire approach in the GLB Act, which is designed to do away with applications and prior requests to the regulatory agencies to engage in permissible financial activities. Furthermore, the truly draconian capital charge of 100-percent that applies to investments held beyond the prescribed time limit is unjustifiably punitive and also should be eliminated. With all due respect to the agencies, SIA believes that there is no valid reason for such a charge to apply merely because a FHC could not dispose of a *bona fide* merchant banking investment within an arbitrarily determined amount of time.

SIA submits that the maximum holding period will have undesired safety and soundness effects. The holding period will pressure securities firms affiliated with FHCs to dispose of investments prematurely at a price below true value just to avoid the regulatory burdens and capital hits imposed by this rule. SIA's experience is that investments may be held for 10 years or more if there are circumstances that prevent their profitable sale or disposition. SIA believes that, when unusual circumstances require a FHC to hold an investment for more than 10 years, it is counterproductive and unsafe for the Fed and Treasury to impose rules that force a FHC to abandon that investment merely because some pre-set time period has been reached. Such an outcome is plainly not in the best interest of FHCs, their shareholders, the public, or the regulators.

V. Private Equity Funds

Finally, the Fed's and Treasury's rulemaking distinguishes between direct investments of FHCs and investments made through private equity funds. The rules impose fewer restrictions and limits on portfolio investments made through private equity fund vehicles. SIA supports, and believes quite appropriate, the decision to treat investments made through private equity funds differently from direct investments.

SIA believes, however, that the definition of private equity fund adopted by the Fed and Treasury is far too narrow and does not reflect the economic and business realities of how such funds are currently operated. Our experience indicates that most private equity funds will not meet the stringent definitions adopted by the agencies. For example, the agencies' definition restricts private equity funds to 12-year terms (with a maximum of three annual extensions thereafter). SIA's experience is that the tenure of private equity funds is often not limited to 12 years. In addition, the Fed and Treasury have stated that a qualifying private equity fund must be held by at least 10 investors that are unrelated to the FHC. Again, we believe that the 10-

investor requirement does not reflect securities industry practice; indeed, SIA's experience is that private equity funds often have fewer than 10 investors.

SIA submits that the narrow definition of private equity fund and the various other restrictions imposed on such funds by the rules are not justified on legitimate safety and soundness grounds. In fact, the imposition by the Fed and Treasury of record keeping, reporting and other requirements on private equity funds will significantly affect the operations, cost and performance of these funds. The net result may well be to chill private investor interest in bank-affiliated private equity funds and, thereby, force securities firms affiliated with FHCs to make more direct investments. This is the exact opposite result from what the Fed and Treasury should hope to achieve because investments made through private equity vehicles inherently raise fewer regulatory concerns due to the presence of outside investors who impose significant market discipline on investments made through such funds.

VI. Conclusion

The securities industry believes that full merchant banking authority is one of the most important new powers in the GLB Act for securities firms affiliated with FHCs. SIA submits that the restrictive posture taken by the Fed and Treasury in their merchant banking rules undermines the authority granted by Congress to FHCs and endangers the financial services reform born of years of painstaking effort by the Members of this Subcommittee, others in Congress, the Fed, the Treasury and industry participants. SIA hopes that these hearings will result in the Fed and Treasury taking a different tack -- one that relies more on the Fed's supervisory authority. SIA looks forward to working with Congress and the regulatory agencies to craft new merchant banking rules that advance the goals of financial services reform and safeguard safety and soundness to FHCs and their affiliated depository institutions.

Our comment letter to the Fed and Treasury, which is attached, provides more detail on the issues I have touched on, and also addresses other provisions in the rules that concern SIA. Chairman Baker and Members of the Subcommittee, SIA thanks you for holding these important hearings.