Financial Institutions Regulation Group
Client Alert:

“All that glitters is not gold”\(^1\): The Federal Reserve’s unsupported recommendation to eliminate merchant banking investments.

What is this recommendation?

On September 8, 2016, three federal agencies, the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the Federal Deposit Insurance Corporation (the “FDIC”) and the Office of the Comptroller of the Currency (the “OCC”) (collectively, the “Agencies”) issued a lengthy 107 page report (the “Report”) to Congress and the Financial Stability Oversight Council (“FSOC”).\(^2\)

The Report was issued pursuant to Section 620 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which required the Agencies to “jointly review and prepare a report on the activities that a banking entity … may engage in under … law. [t]he agencies shall review and consider … financial, operational, managerial, or reputational risks associated with … and risk mitigation activities undertaken by the banking entity with regard to the risks. [t]he report shall include recommendations … whether each activity or investment has or could have a negative effect on the safety or soundness of the banking entity or the United States financial system …”\(^3\)

\(^1\)William Shakespeare, *The Merchant of Venice*, Act II, Scene VII.


\(^3\) Section 620, *Study of Bank Investment Activities*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203 (July 21, 2010). The Report was required under Section 620 to be issued no later than 18 months after the effective date of the Dodd-Frank Act, which date was January 21, 2012. We believe, therefore, that the Report and the analysis and recommendations contained therein do not comply with the statutory requirements, and may not be used by Congress or FSOC as a basis for further lawmaking or rulemaking.
While the Agencies jointly issued the Report, and may have jointly prepared the Report, the Report itself contains three separate sections from each Agency reviewing bank activities and investments and making recommendations concerning the banking entities it supervises. The recommendations of the FDIC\(^4\) and the OCC\(^5\) are relatively constrained, and show a need to continue to review the covered areas.

The recommendations of the Federal Reserve follow a review of the activities and investments of bank holding companies (“BHCs”) and financial holding companies (“FHCs”), and the risks and risk mitigation efforts associated with those activities and investments. Among the four recommendations made by the Federal Reserve is one that Congress “repeal the authority of FHCs to engage in merchant banking authority activities” pursuant to Section 4(k)(4)(H) of the Bank Holding Company Act of 1956, as amended (the “BHC Act”).\(^6\)

**Where is the evidence?**

The “study” by the Federal Reserve is severely lacking in its analysis of the experiences of FHCs engaging in merchant banking investments from 1999 through 2016. There are six tables provided in Section I of the Report: five of the tables cite data from 2012 to 2015, while the sixth table lists data as of 2015. Only one table relates directly to FHC merchant banking activity, and it summarizes only the number of FHCs engaged in merchant banking investment activities and the aggregate carrying value of their investments.

Absent in any of the tables, or the Report at large, is any concrete support evidencing the Federal Reserve’s assertion that merchant banking investment activities pose a risk to banking organizations’ safety and soundness. The Federal Reserve cited no data to support its recommendation, notwithstanding that it controls all of the individual FHC and aggregate industry data on merchant banking investments. For example, many banking entities are required to file FR Y-12 and FR Y-12A reporting forms with the Federal Reserve.\(^7\) These forms provide treasure troves of insight into merchant banking activities. As the Federal Reserve itself says in the instructions to the FR Y-12 about its pur-

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\(^4\) Report at 74.

\(^5\) Id. at 105-107.

\(^6\) Id. at 28. The Federal Reserve also made three other recommendations: (i) to repeal the grandfathered commodities authority pursuant to Section 4(o) of the BHC Act, (ii) to repeal the exemption for industrial loan companies and (iii) to repeal the exemption for grandfathered savings and loan holding companies.

pose: “[t]he FR Y-12 report provides valuable supervisory information that permits examiners and other supervisory staff to monitor the ongoing growth and contribution to profitability of this increasingly active business line [merchant banking].” In addition, merchant banking investments are also reported on several other aggregated financial and structure reports.

Given all of this information, we assume that, as required by Section 620 of the Dodd-Frank Act, the Federal Reserve spent the last six years carefully studying whether merchant banking investments pose risks to banking entities, safety and soundness or the U.S. financial system. We also assume it considered whether any risks could be mitigated by additional prudential restrictions. We have to make these assumptions because the Federal Reserve has provided us with no guidance to support how it arrived at its conclusion and recommendation.

**Can we tell from the Report what the Federal Reserve is after here, really?**

It is hard to tell. The stated concerns of the Federal Reserve can be pulled from the Report in various places:

- **Page 31**: notes that merchant banking investments may include “portfolio companies engaged in physical commodities activities.”

- **Page 31**: notes that, in certain limited circumstances, “an FHC may routinely manage or operate a portfolio company as may be necessary to obtain a reasonable return on the resale or disposition of the investment. By involving itself … an FHC exposes itself to increased risks of being legally liable for the operations of the portfolio company … to satisfy the claims of creditors and tort claimants. For example, if the portfolio company is involved in an environmental event that causes significant losses, the FHC … may be exposed to substantial legal and environmental risk.”

- **Page 31**: “a repeal of merchant banking authority would … maintain the basic tenant of separation of banking and commerce.”

Keeping the above quotes in mind, we can then look for clues in earlier parts of the Report:

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8 See [http://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYj+5BzDaXx01/WWTwA=](http://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYj+5BzDaXx01/WWTwA=).
In an interview on CNBC discussing the recommendation to repeal merchant banking investments Federal Reserve Governor Daniel K. Tarullo was quoted as stating that the Federal Reserve felt that the potential risks to the economy (note, not to the FHCs) outweighed the actual benefits. He defended the recommendation, noting that while it is true that they have not seen any of these risks mature into “actual substantial loss, … if there is a lesson from the crisis it is that we should be trying to get ahead of potential risks and not waiting for disaster to befall us.”

There are many interesting things wrong with Governor Tarullo’s statement. First, as noted above, if the Federal Reserve has analyzed risks from merchant banking investments and made a determination about risk to the U.S. economy, where is that data and analysis? It is not represented in the Report at all. A quick search on the Federal Reserve website of speeches by Federal Reserve Governors and senior staff, and testimony to Congress, shows no mention of merchant banking investments in relation to, or as a cause of, the Great Recession (even though there literally are hundreds of such speeches and testimony).

There were two separate instances of testimony that referenced merchant banking (following the adoption of the statute and the rules that authorized such investments), although both of those were predominately concerned with the specific issue of FHC involvement in physical commodities activities (an area of activity and investments upon which a separate recommendation was made in the Report) as opposed to the greater issue of the risk of merchant banking investments to the U.S. economy.

Based on the standard of the recent MetLife federal court decision, this summary, unsupported holding falls short of the standard needed to designate something a risk to the financial stability of the U.S. economy or financial system. The Report contains a Federal Reserve recommendation pursuant to Section 620 of the Dodd-Frank Act, which is different than a SIFI designation by FSOC.

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11 See [https://www.metlife.com/assets/cao/sifupdate/MetLife_v_FSOC--Unsealed_Opinion.pdf](https://www.metlife.com/assets/cao/sifupdate/MetLife_v_FSOC--Unsealed_Opinion.pdf). In the MetLife case, FSOC had designated MetLife as a non-bank systemically important financial institution (“SIFI”). MetLife challenged this designation, and in the above order a federal court agreed and struck down the designation.
pursuant to Title I of the Dodd-Frank Act, but the basic need for data, evidence, transparency and an opportunity by affected entities to be heard should remain the same.

Second, as discussed below, if the Federal Reserve does believe that certain aspects of merchant banking investments are overly risky, then there are numerous ways of mitigating those risks short of repealing and eliminating a stable and profitable bank investment power.

If not from the actual Report, can we speculate as to why the Federal Reserve is making this extraordinary recommendation?

The Federal Reserve must truly believe that merchant banking investments represent a risk to the FHCs and the U.S. economy. Unfortunately, they appear to have no evidence that this is actually true, and Congress in the Gramm-Leach-Bliley Act of 1999 (the “GLB Act”) decided that limited amounts of merchant banking investments were not overly risky and were necessary to permit U.S. BHCs to maintain competitive equality with global banking competitors and capital trends.12

Thus, the Federal Reserve has in this Report committed itself to going backwards to November 1999. In some ways, this desire is not entirely surprising and has been hiding in broad daylight all this time. The Federal Reserve was cautiously enthusiastic about merchant banking investments at best during the debate over the GLB Act and seemed to accept them as a “necessary evil” to getting the rest of the statute passed into law.13

In the Report there are clues in the structure of the description of the activities and investments of banking entities, and the language used to describe areas the Federal Reserve favors. For example, there is the description of separation of banking and commerce at beginning of the Report, and the later discussion of GLB Act and merchant banking, as if that later Congressional Act was something less worthy than the former.

Finally, the recommendation itself provides clues as to the Federal Reserve’s motivations. Simply put, the recommendation does not at all follow the stated risk. It is a much too sweeping response to a much more limited, identified problem. If the Federal Reserve were truly just concerned about creditor or tort liability (as cited on page 28 of the Report and by Governor Tarullo), here is what the recommendation(s) would have looked like:

Repeal the following words from Section 4(k)(4)(H)(iv): “except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.”

Other options are also available: the Federal Reserve could have simply required an FHC to have 100 percent insurance when it did routinely manage or operate a portfolio company. Or, if the Federal Reserve’s true concern is physical commodities activities, the Federal Reserve could have linked its repeal proposal on merchant banking to its repeal proposal on physical commodities investments, and asked Congress for authority to ensure that FHCs cannot use either authority to make investments in that area.

Finally, are merchant banking investments really so risky?

They do not appear to be any riskier than any other bank activity. As discussed several times above, there is no evidence proposed in the Report as to a history of risky investing behavior by FHCs over the 17 years that merchant banking investments have been available.

There are, however, numerous safeguards built into the merchant banking statutory and regulatory framework to protect FHCs from the risks associated with overly aggressive equity investments. In part, this is because many observers anticipated the potential downside risks to FHC from these investments and moved aggressively initially to put in place strong safeguards to protect them.

First, the time period that merchant banking investments may be held is strictly limited. For investments held directly by an FHC, the time period is ten years; for investments held through a private equity fund, the time period is fifteen years. Having an investment period of limited duration protects FHCs from the risks that come with unlimited ownership periods and imposes discipline on their ownership processes. These investments are intended to be temporary.

Second, while owning merchant banking investments, an FHC may not routinely manage or operate any portfolio company in which it has invested. FHCs must hire competent, skilled, expert third party managers to manage their investments. This restriction reinforces the essential notion that these investments are intended to be passive, even if the FHC owns 100 percent of a portfolio company. There is an exception to this limitation for circumstances where

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14 Section 4(k)(4)(H)(iv) of the BHC Act is the provision that generally prohibits an FHC from routinely managing or operating a portfolio company, “except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.” By prohibiting an FHC from routinely managing or operating a portfolio company under any circumstance, the Federal Reserve would have addressed the primary risk it identified in the Report.
an FHC finds it necessary to manage or operate a portfolio company to obtain a reasonable return upon resale or disposition or to address a significant operating loss or a loss of senior management at an entity – an FHC is only permitted to do this for the period of time as may be necessary to address the issue. And while the Federal Reserve cited this exception as a significant risk factor, we do not have any evidence that it had been used excessively (or at all) by FHCs. It is hard to imagine FHCs being excited about stepping in for management at portfolio companies in industries where they have little or no expertise; instead, they are much more likely to be incentivized to find better third party management to maximize their return.

Merchant banking investments are subject to aggregate size limitations as well. An FHC (without further approval) is limited to merchant banking investments in the aggregate no greater than thirty percent of its tier one capital, or after excluding private equity merchant banking investments, twenty percent of its tier one capital.

Merchant banking investments held past the initial holding period are subject to a high “special” capital charge, and as acknowledged in the report itself, “revised risk-based capital standards for banking entities have also been implemented and do, in part, address the risks arising from merchant banking activities.”

In addition to the above, merchant banking investments are subject to cross-marketing and affiliate transaction restrictions designed to protect the FHC and its subsidiary banking institutions from making improper business transactions with a portfolio company solely because of the parent FHC’s investment in the company.

Finally, and perhaps most importantly, Congress in Section 619 of the Dodd-Frank Act passed the Volcker Rule, which placed strict limitations on the ability of FHCs to make many merchant banking investments through private equity or similar covered fund structures. The Volcker Rule greatly curtailed, but did not eliminate, the use of merchant banking investments by FHCs.

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15 See the Report, at 24.
17 Our previous client alerts exploring the effects of the Volcker Rule are available at http://www.milbank.com/news/index.html?action=news&industries=251&news_type=1. One of these alerts, Things the Media believes the Volcker Rule says...but it actually doesn’t, specifically discusses the impact of the Volcker Rule on FHC merchant banking authority.
Conclusion

In sum, there is no evidence that merchant banking investments have been an overly risky activity that, in the aggregate, presents a risk to the U.S. economy. There is, however, tons of evidence that it is a heavily supervised, routinely reported, well-managed and profitable activity for the banking industry. For the last 17 years the merchant banking investment activity has been a stable and transparent platform for FHCs; the only secret associated with it appears to be why the Federal Reserve now wants to ban it.
FINANCIAL INSTITUTIONS REGULATION GROUP
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