



FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

July 14, 2000

Notice 2000-43

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

**Sound Practices for
Equity Investment and Merchant Banking**

DETAILS

The Board of Governors of the Federal Reserve System has issued examination guidance identifying sound practices for equity investment and merchant banking. The guidance, contained in a supervisory letter sent to Federal Reserve bank examiners, supervisors, and banking organizations supervised by the Federal Reserve, codifies and supplements existing supervisory practices.

“While equity investments in non-financial companies can contribute substantially to earnings, such investments, like other rapidly growing and highly profitable business lines, can entail significant market, liquidity and other risks,” writes Richard Spillenkothen, director of the Board’s Division of Banking Supervision and Regulation. “Sound investment and risk management practices and strong capital positions are critical elements in the prudent conduct of these activities.”

The guidance advises supervisors to encourage banking institutions to make appropriate public disclosures relevant to their equity investments, including accounting techniques and valuation methods used, realized and unrealized gains and losses, and insights regarding the potential performance of investments under alternative market conditions. Merchant banking and equity investment have emerged as an increasingly important source of earnings at some institutions, and the Gramm-Leach-Bliley Act enacted in November provides additional merchant banking authority for financial holding companies.

ATTACHMENTS

The Board's supervisory letter and examination guidance are attached.

MORE INFORMATION

For more information about the guidance, please contact one of the following persons in the Banking Supervision Department: Gayle Teague, (214) 922-6151, or Dick Burda, (713) 652-1503. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254 or access District Notices on our web site at <http://www.dallasfed.org/banking/notices/index.html>.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 00-9 (SPE)
June 22, 2000

**TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE SUPERVISORY
STAFF AT EACH FEDERAL RESERVE BANK AND TO FINANCIAL HOLDING
COMPANIES AND OTHER BANKING ORGANIZATIONS SUPERVISED BY THE
FEDERAL REERVE THAT ENGAGE IN EQUITY INVESTMENT AND MERCHANT
BANKING ACTIVITIES**

**SUBJECT: Supervisory Guidance on Equity Investment and Merchant Banking
Activities**

Over the past several years, investing in equities and equity interests of non-public companies, and lending to private equity-financed companies, have emerged as increasingly important sources of earnings and business relationships at a number of banking organizations. These activities historically have been conducted primarily through small business investment corporations (SBICs) and Edge Act subsidiaries of banks and bank holding companies, and through the authority granted to bank holding companies (BHCs) to make investments in up to five percent of the outstanding voting shares of any company. The merchant banking provisions of the Gramm-Leach-Bliley Act (GLB Act) provide additional authority to financial holding companies to make equity investments in non-financial companies.¹ An interim rule implementing the merchant banking authority of the GLB was adopted by the Board of Governors and the Department of Treasury on March 17, 2000.²

While equity investments in non-financial companies can contribute substantially to earnings, such investments, like other rapidly growing and highly profitable business lines, can entail significant market, liquidity, and other risks. Such activities can also give rise to increased volatility of earnings and capital. It is the responsibility of a banking organization's senior management and board of directors to ensure that the risks associated with private equity investments and merchant banking activities do not adversely affect the safety and soundness of the banking organization and, as a result, any affiliated insured depository institutions. To this end, sound investment and risk management practices and strong capital positions are critical elements in the prudent conduct of these activities.

The attached document provides guidance on sound practices for managing the risks of equity investment activities. The guidance reflects actual industry practices compiled from a number of industry and supervisory sources including insights gained during supervisory reviews of banking organizations engaged in equity investment activities under SBIC and BHC authorities. Accordingly, the attached guidance provides useful management infrastructure and control benchmarks for those institutions that are currently engaged in equity investment

activities, considering significant expansion of existing activities, or entering this business line for the first time.

The guidance summarizes the legal and regulatory authority under which banking organizations and financial holding companies may make equity investments, discusses basic safety and soundness issues regarding the management of equity investments, and identifies sound investment and risk management practices that merit the attention of both management and supervisors. The guidance also addresses sound practices in providing traditional lending-based banking services to portfolio companies, to portfolio company managers, and to general partners of equity investment ventures and funds. The guidance is general in scope and is intended to apply to the equity investment activities of financial holding companies, bank holding companies, state member banks, and their subsidiaries and affiliates -- regardless of the statutory or regulatory authority under which investments are made.

Market discipline is an important mechanism for controlling risk-taking and reinforcing supervisory efforts to promote safety and soundness in banking organizations and in financial markets more generally. For this reason, the attached guidance discusses the need for supervisors to encourage banking organizations to make appropriate public disclosures of their equity investment activities and sets forth recommendations for the scope of such disclosures. Topics relevant for public disclosure include: the types and nature of equity investments; the initial cost, carrying value, and fair value of investments; accounting techniques and valuation methodologies; and insights regarding the potential performance of equity investments under alternative market conditions. While a few institutions have made significant strides in improving public disclosure of their equity investment activities, considerable opportunities for improvement remain.

The potential risks and returns of equity investment and merchant banking activities exceed those of many more traditional banking activities. Consequently, organizations substantially engaged in these activities should have strong capital positions, with capital backing these businesses that is well above the current minimum regulatory requirements for traditional banking activities. They should also have robust internal methods for allocating capital that fully reflect the risks inherent in these activities.³

In supervising equity investment and merchant banking activities, the Federal Reserve's primary objective is to identify material risks to, and promote the safety and soundness of, state member banks conducting these activities and of banks and other insured depository institutions affiliated with BHCs engaged in these business lines. Accordingly, Federal Reserve supervisors should place appropriate attention on equity investments and merchant banking activities in preparing institutional risk assessments, developing supervisory strategies, and, where appropriate, conducting on-site inspections and targeted reviews. Consistent with the Federal Reserve's role as umbrella supervisor of FHCs and BHCs, supervisors should, where appropriate and available, utilize fully the findings of primary bank supervisors and functional regulators of holding company affiliates in reviewing the potential risks of equity investment activities.

In reviewing the merchant banking activities of FHCs and the equity investment activities of BHCs, supervisors should ensure that there is an appropriate

focus on the impact of these activities on affiliated depository institutions. Assessments of the possible impact of these activities should take into account the potential risks and returns associated with the activities, potential volatility in some segments of the equity markets, the increasing competition for private equity investments, and the potential for new (and possibly inexperienced) financial institutions entering this business.

Deficiencies in any of the areas covered in the attached guidance should be brought to the attention of senior management or, if necessary, the board of directors to ensure that appropriate corrective action is taken in a timely and effective manner. Where such deficiencies pose material risks to depository institutions that are not supervised by the Federal Reserve, the Reserve Banks should communicate their concerns to the appropriate primary bank supervisor.

Reserve Banks should distribute this letter and the attached guidance to the appropriate financial holding companies and other banking organizations under their jurisdiction. Reserve Banks should also ensure that all central points of contact, examiners, and other staff involved in the supervision of banking organizations' investment activities review the attached guidance as well as the interim merchant banking rule and focus their supervisory efforts accordingly.

Questions regarding this guidance should be directed to James Embersit, Manager, Capital Markets, at (202) 452-5249 or Mary Frances Monroe, Senior Supervisory Financial Analyst, Capital Markets, at (202) 452-5231.

Richard Spillenkothen
Director

[Attachment](#) (62K PDF)

Notes:

1 References to equity investments in this letter and the attached guidance are references to equity investments in non-financial companies unless otherwise noted. Non-financial companies include companies that engage in activities other than financial activities that a financial holding company may conduct pursuant to section 4 of the Bank Holding Company Act, 12 U.S.C. 1843, as amended by the GLB Act, and the regulations and interpretations thereunder, including the interim regulations adopted by the Board and the Treasury Department.

2 This interim rule, which is subject to revision after the comment period that ended May 22, 2000, is available on the Board's web site:
www.federalreserve.gov/boarddocs/press/BoardActs/2000.

3 On March 22, 2000, the Board issued for a 60-day public comment period a proposed rule regarding capital requirements for equity investment activities of

banking organizations. These proposed requirements will not take effect until public comments have been assessed and a final rule is adopted by the Board. The proposed capital rule is available on the Board's web site:
www.federalreserve.gov/boarddocs/press/BoardActs/2000/20000317/attachment2.pdf.

**Guidance on Equity Investment and Merchant Banking Activities of
Financial Holding Companies and Other Banking Organizations
Supervised by the Federal Reserve**

I. Introduction

Over the past several years, investing in the equity of non-financial companies¹ and lending to private equity-financed companies, have emerged as increasingly important sources of earnings and business relationships at a number of banking organizations.² While equity investments in non-financial companies can contribute substantially to earnings, such investment activities, like many other fast growing business lines, can entail significant market, liquidity, and other risks. Equity investments can also give rise to increased volatility of both earnings and capital. Accordingly, sound investment and risk management practices are critical in conducting these activities.

This guidance discusses various sound practices related to the equity investment activities of banking organizations that merit the attention of management, examiners, and other supervisory staff. The guidance first describes the legal and regulatory authority under which banking organizations may make equity investments. It then discusses basic safety and soundness issues regarding the management of equity investments at banking organizations and identifies sound management practices for conducting these activities. The guidance specifically targets the equity investment activities of financial holding companies (FHCs), bank holding companies (BHCs), state member banks, and their affiliates, regardless of the authority under which investments are made.

Given the important role that market discipline plays in controlling risks, the guidance also addresses the need for supervisors to encourage appropriate public disclosures of equity investment activities by banking organizations and sets forth recommendations for the scope of such disclosures. Finally, the guidance discusses various issues involving the provision of traditional credit-based banking services to: 1) non-financial companies in which a banking organization has an equity interest (i.e., portfolio companies); 2) portfolio company managers; and, 3) general partners of equity investment ventures and funds that may have an association with a portfolio company.

¹ References to equity investments in this guidance are references to equity investments in non-financial companies unless otherwise noted. Non-financial companies include companies that engage in activities other than financial activities that a financial holding company may conduct pursuant to section 4 of the Bank Holding Company Act, 12 U.S.C. 1843, as amended by the Gramm-Leach-Bliley Act, and the regulations and interpretations thereunder, including the regulations involving merchant banking adopted by the Board of Governors and the Treasury Department.

² The term private equity technically refers to shared-risk investments outside of publicly quoted securities. However, increasingly it has become an inclusive term of art that covers activities such as venture capital, leveraged buy-outs, mezzanine financing and holdings of publicly quoted securities obtained through these activities. This broader concept is employed for the purpose of this guidance.

II. Legal and Regulatory Authority

FHCs, BHCs, and depository institutions are able to make equity investments under several statutory and regulatory authorities.

- Under sections 4(c)(6) and 4(c)(7) of the Bank Holding Company Act (BHC Act), BHCs may invest in up to 5 percent of the outstanding voting shares of any one company and up to 25 percent of the total equity of a company, with no aggregate limits on the total dollar amount of equity investments held by the BHC.
- Banking organizations can make equity investments through Small Business Investment Corporations (SBICs), which can be a subsidiary of a bank or BHC. Investments made by SBIC subsidiaries are allowed up to a total of 50 percent of a portfolio company's outstanding shares, but can only be made in companies defined as small business, according to SBIC rules. A bank's aggregate investment in the stock of SBICs is limited to 5 percent of the bank's capital and surplus. In the case of BHCs, the aggregate investment is limited to 5 percent of the BHC's proportionate interest in the capital and surplus of its subsidiary banks.
- Under Regulation K, which implements sections 25 and 25A of the Federal Reserve Act and section 4(c)(13) of the BHC Act, banking organizations may, with Board approval, make portfolio investments that in the aggregate do not exceed 25 percent of the Tier 1 capital of the BHC. In addition, individual investments must be less than 20 percent of a portfolio company's voting shares and not exceed 40 percent of the portfolio company's total equity.³
- More recently, under the Gramm-Leach-Bliley (GLB) Act, FHCs may engage in a broad range of merchant banking activities.⁴ Permissible merchant banking activities are broadly defined to include "investments in any amount of the shares, assets, or ownership interests of any type of non-financial company." Regulations governing the conduct of merchant banking activities are issued jointly by the Board of Governors and the U.S. Department of Treasury⁵.

³ Also included in calculating a banking organization's investment are shares of the corporation held in trading or dealing accounts or under any other authority. The 25 percent of Tier 1 capital limitation increases to 100 percent of Tier 1 capital for certain non-BHC investors. See Regulation K for more detailed information.

⁴ A BHC may qualify as an FHC if each of its depository institutions is well managed and well capitalized. The Board must also find that each of the subsidiary insured depository institutions of the BHC has at least a satisfactory Community Reinvestment Act rating when the company elects to be an FHC.

⁵ An interim rule implementing the merchant banking authority of the GLB was adopted by the Board of Governors and the Department of Treasury on March 17, 2000. This interim rule is subject to revision pending industry comments that were due on May 22, 2000.

Equity investments made under any of these authorities may be in publicly traded securities or privately held equity interests. The investment may be made as a direct investment in a specific portfolio company, or may be made indirectly through a pooled investment vehicle, such as a private equity fund. In general, private equity funds are investment companies, typically organized as limited partnerships, that pool capital from third party investors to invest in shares, assets, and ownership interests in companies for resale or other disposition.⁶ Private equity fund investments may provide seed or early-stage investment funds to start-up companies, or finance changes in ownership, middle-market business expansions, and mergers and acquisitions.

This guidance is meant to apply to all equity investments in non-financial companies, public or private, *and regardless of the authority under which such investments are made.* Accordingly, this guidance applies to the equity investment activities of state member banks and their affiliates and subsidiaries. It also applies to the investment management practices of FHCs and BHCs, which should control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries and affiliates. Also, the basic principles set forth in this guidance should be incorporated into the U.S. operations of foreign banking organizations, with appropriate adaptations to reflect the fact that: (i) those operations are an integral part of a foreign bank which should be managing its risks on a consolidated basis; and (ii) the foreign bank is subject to overall supervision by its home authorities.

III. Sound Practices

High returns in both equity investments and in lending to private equity-financed companies over the past few years have spurred an increased flow of funds into this segment of the market. Various types of institutional investors, including pension funds, endowments, banking organizations, and other financial institutions, have allocated increasing portions of their investment portfolios to equity investment-related activities, and competition in this market has increased substantially. As has often been the case in other rapidly expanding and highly profitable business lines, business and competitive pressures can lead to compromises in due diligence, the use of overly optimistic assumptions, and breakdowns in internal controls. Accordingly, sound investment and risk management practices are crucial to the success of equity investment activities.

As with any financial activity, sound management practices for these activities involve:

- Active involvement and oversight by the board of directors and senior management;
- Appropriate policies, limits, procedures, and management information systems that govern all elements of the investment decision-making and management process; and,
- Adequate internal controls.

⁶ Private equity funds are defined in detail in the Board's rules and regulations on merchant banking adopted by the Board of Governors and the Treasury Department.

Management at banking organizations, examiners, and other supervisors should review each of these areas to identify any deficiencies in the management of equity investment activities that may pose potential risks to the financial condition of state member banks and other insured depository institutions affiliated with FHCs and BHCs. Supervisory efforts in this area should be targeted appropriately in accordance with Federal Reserve policies on risk-focused supervision by taking into account both the findings of internal audit and other independent reviews, and the materiality of these activities to the banking organization. Consistent with the Federal Reserve's role as umbrella supervisor, reviews of the merchant banking activities of FHCs and the equity investment activities of BHCs should focus on the potential exposure these activities may pose to insured depository affiliates and should, where appropriate and available, utilize fully the findings of primary bank supervisors and functional regulators of holding company affiliates. At the same time, supervisory and examination staff should ensure that they continue to conduct sufficient and targeted transaction testing across legal entity lines if necessary to fully assess the adequacy of business line risk management. Transaction testing should be consistent with the risk profile of the institution and the materiality of the activity to the institution's financial condition.

As with all financial activities, institutions should ensure that they have sufficient capital for conducting equity investment activities. Consistent with SR Letter 99-18 (July 1, 1999), banking organizations conducting material equity investment activities are expected to have an internal capital allocation system that meaningfully links the identification, monitoring, and evaluation of the risks of the institution's equity investment activities to the determination of its needs for economic capital. A review of these systems should be an important part of the investment management process, as well as an integral element of on-going supervisory review and monitoring of this business line.

The following discussion provides specific guidance regarding each of the three key components of sound investment and risk management practices for equity investment activities. The guidance draws from actual industry practices compiled from a variety of industry and supervisory sources including insights gained during supervisory reviews of banking organizations engaged in equity investment activities under SBIC and BHC authorities.

A. Oversight by the Board of Directors and Senior Management

Equity investment activities require the active oversight of the board of directors and senior management of the institution conducting the activities. The board should approve portfolio objectives, overall investment strategies, and general investment policies that are consistent with the institution's financial condition, risk profile, and risk tolerance. Portfolio objectives should address the types of investments, expected business returns, desired holding periods, diversification parameters, and other elements of sound investment management oversight. Board-approved objectives, strategies, policies, and procedures should be documented and clearly communicated to all personnel involved in their implementation. The board should actively monitor the performance and risk profile of equity investment business lines in light of the established objectives, strategies, and policies.

The board should also ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling, and reporting on the risks of equity investments. The board should approve policies that specify lines of authority and responsibility for both acquisitions and sales of investments. The board should also approve limits on aggregate investment and exposure amounts, the types of investments (e.g., direct and indirect, mezzanine financing, start-ups, seed financing, etc.) and appropriate diversification-related aspects of equity investments such as industry, sector, and geographic concentrations.

For its part, senior management must ensure that there are adequate policies, procedures, and management information systems for managing equity investment activities on a day-to-day and longer-term basis. Management should set clear lines of authority and responsibility for making and monitoring investments and for managing risk. Management should ensure that an institution's equity investment activities are conducted by competent staff, whose technical knowledge and experience is consistent with the scope of the institution's activities.

B. Management of the Investment Process

Institutions engaging in equity investment activities should have a sound process for executing all elements of investment management, including initial due diligence, periodic reviews of holdings, investment valuation, and realization of returns. This process requires appropriate policies, procedures, and management information systems, the formality of which should be commensurate with the scope, complexity, and nature of an institution's equity investment activities. A sound investment process should be applied to all equity investment activities, regardless of the legal entity in which investments are booked. As always, any supervisory reviews of equity investment activities should be risk-focused, taking into account the institution's stated tolerance for risk, the ability of senior management to govern these activities effectively, the materiality of activities in light of the institution's risk profile, and the capital position of the institution.

Policies and Limits -- Institutions engaging in equity investment activities require effective policies that i) govern the types and amounts of investments that may be made, ii) provide guidelines on appropriate holding periods for different types of investments, and, iii) establish parameters for portfolio diversification. Investment strategies and permissible types of investments should be clearly identified. Portfolio diversification policies should identify factors pertinent to the risk profile of the investments being made, such as industry, sector, geographic, and market factors. Policies establishing expected holding periods should specify the general criteria for liquidation of investments and guidelines for the divestiture of an under-performing investment. Whereas decisions to liquidate under-performing investments are necessarily made on a case-by-case basis considering all relevant factors, policies and procedures stipulating more frequent review and analysis are generally used to address investments that are performing poorly or have been in portfolio for a considerable length of time.

Policies should identify the aggregate exposure that the institution is willing to accept by type and nature of investment (e.g., direct/indirect, industry sectors). Adherence to such limits should take into consideration unfunded, as well as funded, commitments.

Where hedging activities are conducted, there should be formal and clearly articulated hedging policies and strategies that identify limits on hedged exposures and permissible hedging instruments.

Management and staff compensation play a critical role in providing incentives and controlling risks within a private equity business line. Accordingly, clear policies should govern compensation arrangements, including co-investment structures and sales of portfolio company interests by employees of the banking organization.

Procedures -- As with investment policies, many institutions have different procedures for assessing, approving, and reviewing investments based upon the size, nature, and risk profile of an investment. Often procedures used for direct investments are different than those used for indirect investments made through private equity funds. For example, different levels of due diligence and senior management approvals may be required. Accordingly, in constructing management infrastructures for conducting these activities management should ensure that operating procedures and internal controls appropriately reflect the diversity of investments. Supervisors should recognize this potential diversity of practice when conducting reviews of the equity investment process. Focus should be placed on the appropriateness of the process employed relative to the risk of the investments made and the materiality of this business line to the overall soundness of the banking organization and the potential impact on affiliated depository institutions.

Investment analysis and approvals - Well-founded analytical assessments of investment opportunities and formal processes for approving investments are critical in conducting equity investment activities. While analyses and approval processes may differ by individual investments and across institutions, the methods and types of analyses conducted should be appropriately structured to assess adequately the specific risk profile, industry dynamics, management, and specific terms and conditions of the investment opportunity, as well as other relevant factors. All elements of the analytical and approval processes from initial review through formal investment decision should be documented and clearly understood by staff conducting these activities.

An institution's evaluation of potential investments in private equity funds, as well as reviews of existing fund investments, should involve assessments of the adequacy of a fund's structure, with due consideration given to: i) management fees; ii) carried interest⁷ and its computation on an aggregate portfolio basis; iii) the sufficiency of capital commitments by general partners in providing management incentives; iv) contingent liabilities of the general partner; v) distribution policies and wind-down provisions; and, vi) performance benchmarks and return calculation methodologies.

Investment risk ratings - It is a sound practice to establish a system of internal risk ratings for equity investments. This involves assigning each investment a rating based on factors such as the nature of the company, strength of management, industry dynamics, financial condition, operating results, expected exit strategies, market conditions, and other pertinent factors.

⁷ The carried interest is the share of a partnership's return received by general partners or investment advisers.

Different rating factors may be appropriate for indirect investments and direct investments. For example, rating factors for investments in private equity funds could include an assessment of the fund's diversification, management experience, liquidity, and actual and expected performance. Rating systems should be used for assessments of both new investment opportunities and existing portfolio investments.

Periodic Reviews - Management should ensure that there is periodic and timely review of the institution's equity investments. Reviews should be conducted at both individual investment and portfolio levels. Depending on the size, complexity, and risk profile of the investment, reviews should, where appropriate, include factors such as:

- the history of the investment, including the total funds approved;
- commitment amounts, principal cash investment amounts, cost basis, carrying value, major investment cash flows, and supporting information including valuation rationales and methodologies;
- the current actual percentage of ownership in the portfolio company on both a diluted and undiluted basis;
- a summary of recent events and current outlook;
- recent financial performance of portfolio companies, including summary compilations of performance and forecasts, historical financial results, current and future plans, key performance metrics, and other relevant items;
- internal investment risk ratings and rating change triggers;
- exit strategies, both primary and contingent, and expected internal rates of return upon exit; and
- other pertinent information for assessing the appropriateness, performance, and expected returns of investments.

Portfolio reviews should include an aggregation of individual investment risk and performance ratings, analysis of appropriate industry, sector, geographic and other pertinent concentrations, as well as total portfolio valuations. Portfolio reports containing the cost basis, carrying values, estimated fair values, valuation discounts, and other factors summarizing the status of individual investments are integral tools for conducting effective portfolio reviews. Reports containing the results of all reviews should be available to supervisors for their inspection.

Given the inherent uncertainties in equity investment activities, institutions should include in their periodic reviews consideration of best case, worst case, and probable case assessments of investment performance. Such reviews should evaluate changes in market conditions and alternative assumptions used to value investments -- including expected and

contingent exit strategies. Major assumptions used in valuing investments and forecasting performance should be identified. Such assessments need not be confined to quantitative analyses of potential losses, but may also include qualitative analyses.

As in the case of all investment management systems, the formality and sophistication of investment reviews should be appropriate for the overall level of risk incurred by the banking organization from this business line.

Valuation and Accounting - Valuation and accounting policies and procedures can significantly impact the earnings of institutions engaged in equity investment activities. For some equity investments, valuation can be more of an art than a science. Many equity investments are made in privately held companies, for which independent price quotations are either unavailable or not available in sufficient volume to provide meaningful liquidity or a market valuation. Valuations of some equity investments may involve a high degree of judgment on the part of management or the skillful use of peer comparisons. Similar circumstances may exist for publicly traded securities that are thinly traded or subject to resale and holding period restrictions or when the institution holds a significant block of a company's shares. Accordingly, clearly articulated policies and procedures on the accounting and valuation methodologies used for equity investments are of paramount importance.

There are several methods used in accounting for equity investments. Under generally accepted accounting principles (GAAP), equity investments held by investment companies, held by broker/dealers, or maintained in the trading account⁸ are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to Tier 1 capital. For some holdings, fair value may reflect adjustments for liquidity and other factors.

Equity investments not held in investment companies, broker/dealers, or the trading account that have a readily determinable fair value (quoted market price) are generally reported as available for sale (AFS). They are marked-to-market with unrealized appreciation or depreciation recognized in GAAP-defined "comprehensive income" but not earnings. Appreciation or depreciation flows to equity, but for regulatory capital purposes only depreciation is included in Tier 1 capital.⁹ Equity investments without readily determinable fair values generally are held at cost, subject to write-downs for impairments to the value of the asset.

As is the case with all assets, impairments of value should be promptly addressed. Institutions should ensure that they have taken write-downs in a timely manner and in an appropriate amount.

In determining fair value, the valuation methodology plays a critical role. Clearly articulated methods for valuing investments are critical to the effective management of equity investments. Formal valuation and accounting policies should be established for investments in

⁸ The investments referred to in this letter would not normally be held in the trading account since they are not intended to be traded actively.

⁹ Under regulatory capital rules, Tier 2 capital may include up to 45 percent of the unrealized appreciation of AFS equity investments with readily determinable fair values.

public companies, direct private investments, indirect fund investments, and where appropriate, other types of investments with special characteristics. In establishing valuation policies, institutions should consider market conditions, taking account of lockout provisions, Securities and Exchange Commission Rule 144 restrictions, liquidity features, dilutive effects of warrants and options, and industry characteristics and dynamics.

For institutions acting as general partners of private equity funds, “clawback” or “look back” provisions of partnership agreements can pose additional challenges in accounting for and valuing the distributions received from the funds they manage. Clawback provisions are promises made by general partners to repay limited partners at the end of the term of a fund if the general partner has received more than its contractually defined compensation or “carried interest” over the life of the fund. Clawback provisions can come into play in situations where the liquidation and associated disposition of both limited partner and general partner returns on good performing investments in the fund occurs before the liquidation of poorer performing investments. Often, escrow accounts are established to hold a portion of the general partners’ carried interest during the life of the fund. Where applicable, institutions should appropriately recognize the estimated impact of these provisions in accounting for and valuing general partner activities, including the earnings therefrom.

Accounting and valuation of equity investments should be subject to regular periodic review. In all cases, valuation reviews should produce documented audit trails that are available to supervisors and auditors. Such reviews should assess the consistency of the methodologies used in estimating fair value.

Accounting and valuation treatments should be assessed in light of their potential for abuse through the inappropriate management or manipulation of reported earnings on equity investments. For example, high valuations may produce overstatements of earnings through gains and losses on investments reported at “fair value.” On the other hand, inappropriately understated valuations can provide vehicles for smoothing earnings by recognizing gains on profitable investments when institutions’ earnings are otherwise under stress. While reasonable people may disagree on valuations given to illiquid private equity investments, institutions should have rigorous valuation procedures that are applied consistently.

Given uncertainties in valuation methodologies and the relatively high volatility of the equity market, equity investments that are reported at fair value can contribute to earnings volatility at institutions where such activities play a major role. With the increasing contribution of these activities to the earnings of some banking organizations, the potential impact of equity investments on the composition, quality, and sustainability of overall earnings should be appropriately recognized and assessed by both management and supervisors.

Exit strategies - Returns and reported earnings on equity investments are highly affected by assumed and actual exit strategies. The principal means of exiting an equity investment in a privately held company include initial public stock offerings, sales to other investors, and share repurchases. An institution’s assumptions regarding exit strategies can significantly affect the valuation of the investment. The importance of reasonable and comprehensive primary and contingent take-out strategies for equity investments should be emphasized. Management should

periodically review investment exit strategies with particular focus on larger or less liquid investments.

Disposition of investments - Policies and procedures should be established to govern the sale, exchange, transfer, or other disposition of the institution's investments. These policies and procedures should state clearly the levels of management or board approval required for the disposition of investments, and, in the case of investments held under the merchant banking provisions of the GLB Act, should take account of the time limits for holding merchant banking investments in the rules and regulations specified by the Board of Governors and the Department of Treasury.

Capital - Given the potential volatility of returns on equity investments, the risks associated with private equity investment and merchant banking business lines can exceed those of many more traditional banking activities. Accordingly, and consistent with the general guidelines identified in SR Letter 99-18 (July 1, 1999), banking organizations conducting material equity investment activities should have internal methods for allocating economic capital based on the risk inherent in these activities. Such methods should incorporate the identification of all material risks and their potential impact on the safety and soundness of the institution. The amount and percentage of capital that is dedicated to this business line should be appropriate to the size, complexity, and financial condition of the banking organization. Organizations substantially engaged in these activities should have strong capital positions supporting their equity investments and should allocate economic capital to them well in excess of the current regulatory minimums applied to lending activities. Accordingly, assessments of capital adequacy should cover not only the institution's compliance with regulatory capital requirements and the quality of regulatory capital, but should also include an institution's methodologies for internally allocating economic capital to this business line.

C. Internal Controls

An adequate system of internal controls, with appropriate checks and balances and clear audit trails, is critical to the effective conduct of equity investment activities. Appropriate internal controls should address all of the elements of the investment management process, and should focus on the appropriateness of existing policies and procedures, adherence to policies and procedures, and the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting. Departures from policies and procedures should be documented and reviewed by senior management. This documentation should be available for examiner review.

As with other financial activities, assessments of compliance with both written and implied policies and procedures should be independent of line decision-making functions to the fullest extent possible. Large complex banking institutions with material equity investment activities should have periodic independent reviews of their investment process and valuation methodologies by internal auditors or independent outside parties. In smaller, less complex institutions where limited resources may preclude independent review, alternative checks and balances should be established. Such checks and balances may include random internal audits, reviews by senior management independent of the function, or the use of outside third parties.

Documentation -- Documentation of key elements of the investment process, including initial due diligence, approval reviews, valuations, and dispositions, is an integral part of any private equity investment internal control system. Accordingly, institutions should appropriately document their policies, procedures, and investment activities and should make this documentation accessible to supervisors.

Institutions should be aware that the statutory and regulatory authority under which some equity investment activities are conducted may impose specific documentation and record-keeping requirements. For example, merchant banking regulations may have special books and records requirements such as:

- records of transactions between an FHC and companies held under merchant banking authority, specifically documenting transactions that are not on market terms;
- incentive arrangements in connection with controlling or advising a fund, including the carrying value and market value of the arrangement and amounts that may be payable based on future asset performance; and
- documentation of the legal separation between the holding company and the portfolio company.

Legal Compliance -- Compliance with all federal laws and regulations applicable to the institution's investment activities should also be a focus of an institution's system of internal controls. Regulatory compliance requirements, in particular, should be incorporated into internal controls so managers outside of the compliance or legal functions understand the parameters of permissible investment activities.

It is important to recognize that the conduct of private equity and merchant banking activities are subject to different laws and regulations, depending upon the authority under which the activities are conducted. For example, regulations on merchant banking investments may call for holding period limits and restrict involvement with portfolio companies by defining prohibitions on routinely managing or operating a company in which it has made a merchant banking investment. Accordingly, management should have a system in place, consistent with applicable laws and regulations, to ensure that impermissible control is not exercised over these activities. This practice is also important to protect the institution from lender liability claims.

Likewise, certain cross-marketing restrictions may apply to depository institutions held by FHCs and portfolio companies controlled under statutory merchant banking authority. Management should ensure that these limits are observed. Also, the limitations in sections 23A and 23B of the Federal Reserve Act on transactions between a depository institution and its affiliates are presumed by the GLB Act to apply to certain transactions between a depository institution and any portfolio company in which an affiliate of the institution owns at least a 15 percent equity interest. This ownership threshold is lower than the ordinary definition of an affiliate, which is typically 25 percent.

Moreover, to ensure compliance with federal securities laws, institutions should establish policies, procedures, and other controls addressing insider trading. A “restricted list” of securities for which the institution has inside information is just one example of a widely used mechanism for controlling the risk of insider trading. In addition, control procedures should be in place to ensure that appropriate reports are filed with functional regulators.

Compensation -- Often, key employees in the private equity investment units of banking organizations may co-invest in the direct or fund investments made by the unit. The return on this co-investment, which the FHC may underwrite, may constitute a significant portion of the compensation of these employees. These co-investment arrangements can be an important incentive mechanism and risk control technique and can help to attract and retain qualified management. However, “cherry picking,” or selecting only certain investments for employee participation while excluding others, should be discouraged.

In many cases, the employees’ co-investment may be funded through loans from affiliates of the banking organization, which, in turn, hold a lien against the employees’ interests. The administration of the compensation plan should be appropriately governed pursuant to formal agreements, policies, and procedures. Among other matters, policies and procedures should address the terms and conditions of employee loans and sales of participants’ interests prior to the release of the lien.

IV. Disclosure of Equity Investment Activities

Given the important role that market discipline plays in controlling risk, institutions should ensure that they adequately disclose information necessary for the markets to assess their risk profiles and performance in this business line. Indeed, it is in the interest of the institution itself, as well as its creditors and shareholders, to disclose publicly information about earnings and risk profiles. Institutions are encouraged to disclose in public filings information on the type and nature of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital. Supervisors should fully utilize such disclosures, as well as periodic regulatory reports filed by publicly held banking organizations, as part of the information that they review routinely.

The following topics are relevant for public disclosure, though disclosures regarding each of these topics may not be appropriate, relevant, or sufficient in every case:

- The size of the portfolio;
- The types and nature of investments (*e.g.*, direct/indirect, domestic/international, public/private, equity/debt with conversion rights);
- Initial cost, carrying value, and fair value of investments, and where applicable, comparisons to publicly quoted share values of portfolio companies;
- The accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices;

- The realized gains (losses) arising from sales and unrealized gains (losses); and
- Insights regarding the potential performance of equity investments under alternative market conditions.

V. Institutions Lending To or Engaging In Other Transactions with Portfolio Companies

Additional risk management issues may arise when a banking institution or an affiliate lends to or has other business relationships with: i) a company in which the banking institution or an affiliate has invested (*i.e.*, a portfolio company); ii) the general partner or manager of a private equity fund that has also invested in a portfolio company; or iii) a private equity-financed company in which the banking institution does not hold a direct or indirect ownership interest but is an investment or portfolio company of a general partner or fund manager with which the banking organization has other investments. Given their potentially higher than normal risk attributes, institutions should devote special attention to ensuring that the terms and conditions of such lending relationships are at arms-length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners.

Lending and other business transactions between an insured depository institution and a portfolio company that meets the definition of an affiliate must be negotiated on an arms-length basis, in accordance with section 23B of the Federal Reserve Act. The holding company should have systems and policies in place to monitor transactions between the holding company, or a non-depository institution subsidiary of the holding company, and a portfolio company. (These transactions are not typically governed by section 23B of the Federal Reserve Act.) A holding company should assure that the risks of these transactions, including exposures of the holding company on a consolidated basis to a single portfolio company, are reasonably limited and that all transactions are on reasonable terms, with special attention paid to transactions that are not on market terms.

Where a banking organization lends to a private equity-financed company in which it has no equity interest but where the borrowing company is a portfolio investment of private equity fund managers or general partners with which the institution may have other private-equity related relationships, care must be taken to ensure that the extension of credit is conducted on reasonable terms. In some cases, supervisors have found that lenders may wrongly assume that the general partners or another third party implicitly guarantees or stands behind such credits. Reliance on implicit guarantees or comfort letters should not substitute for reliance on a sound borrower that is expected to service its debt with its own resources. As with any type of credit extension, absent a written contractual guarantee, the credit quality of a private equity fund manager, general partner, or other third party should not be used to upgrade the internal credit risk rating of the borrower company or prevent the classification or special mention of a loan. Any tendency to relax this requirement when the general partners or sponsors of private equity-financed companies have significant business dealings with the banking organization should be strictly avoided.

When an institution lends to a portfolio company in which it has a direct or indirect interest, implications arise under Sections 23A and 23B of the Federal Reserve Act, which govern credit-related transactions and asset purchases between a depository institution and its affiliates. Section 23A applies to transactions between a depository institution and any company where the institution's holding company or shareholders own at least 25 percent of the company's voting shares. The GLB Act extends this coverage by establishing a presumption that a portfolio company is an affiliate of a depository institution if the FHC uses the merchant banking authority of the GLB Act to own or control more than 15 percent of the equity of the company. Institutions should obtain the assistance of counsel in determining whether such issues exist or would exist if loans were extended to a portfolio company, general partner or manager. Supervisors should ensure that the institution has conducted a proper review of these issues to avoid violations of law or regulations.

In addition to limiting and monitoring exposure to portfolio companies that arises from traditional banking transactions, BHCs should also adopt policies and practices that limit the legal liability of the BHC and its affiliates to the financial obligations and liabilities of portfolio companies. These policies and practices include, for example, the use of limited liability corporations or special purpose vehicles to hold certain types of investments, the insertion of corporations that insulate liability between the BHC and a partnership controlled by the BHC, and contractual limits on liability. BHCs that extend credit to companies in which the BHC has made an equity investment should also be aware of the potential for equitable subordination of the lending arrangements.