October 22, 2012

VIA EMAIL

To: Office of the Comptroller of the Currency
(regs. comments@occ.treas.gov)/Docket ID OCC-2012-0009
Board of Governors of the Federal Reserve System
(regs.comments@federalreserve.gov)/Docket No. R-1442 RIN-7100 AD87
Federal Deposit Insurance Corporation
(comments@FDIC.gov)/FDIC RIN 3064-AD96

Re: **SBIA Comment Letter 2 of 2 (Lower Middle Market Private Equity Funds)**
Regulatory Capital Rules: Standardized Approach
For Risk-Weighted Assets; Market Discipline and
Disclosure Requirements

We are the Small Business Investor Alliance ("SBIA"), the leading organization representing lower middle market private equity funds. These funds typically invest exclusively in small businesses, generally making debt and equity investments in the $1 million to $15 million range. SBIA also represents limited partners which make investments in lower middle market private equity funds.

We welcome the opportunity to comment on the joint notice of proposed rulemaking with respect to Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements ("Regulatory Capital Rules"). In particular, we welcome the opportunity to respond to Question 19 from the Regulatory Capital Rules which asks what other types of equity exposures should be excluded from the non-significant equity exposure calculation under the alternative approach and what is the approximate amount of these exposures in relation to a banking organizations' total capital. For the reasons stated below, we strongly support adoption of a safe harbor for lower middle market private equity and venture capital funds (with less than $350 million per fund) from the non-significant equity exposure calculation under the alternative approach and classifying small private equity funds at the 100

percent level, which is similar to the risk weight applied to bank investments made to help small businesses and other community development initiatives.

Federal agencies need to make clear and consistent in the final rule that the safe harbor exempts private equity funds of less than $350 million and the safe harbor should only be applied on a per fund basis. Many investment teams manage several funds bringing their total assets under management ("AUM") to well above $350 million. However, fund size, not AUM, is the largest determinant of investment size and funds of less than $350 million are squarely focused on the small and lower middle market. Therefore, the safe harbor should not discriminate against investment teams that manage more than one fund, because all lower middle market private equity funds are delivering additional capital resources to US small business. Currently, there are 2,315 small private equity and venture capital firms with funds under $350 million.[1]

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<u>Impact of Lower Middle Market Private Equity Funds on Small Business Sector</u>

Private equity funds in the lower middle market space are a very important source of capital and take an active role in managing small businesses. These funds cover an investing spectrum from pre-revenue businesses through established small businesses. The common thread is that they all invest in and grow small businesses.

Private equity funds have played key roles in financing the early growth of many well-known companies, including Apple, Starbucks, Staples, Microsoft, and Amazon. They have also financed the growth of many more companies which you may have never heard of, but likely provide goods and services you use every day.

Investment funds that serve small businesses and entrepreneurs pose no systemic risk, but are crucial to economic growth and job creation. Despite the slow economic recovery, 65 percent of private equity companies reported an increase in employment within their portfolio companies last year, with another 24 percent stating that the headcount remains consistent following acquisition.[2]

Lower middle market private equity funds are much more likely to invest in small businesses than larger companies. Lower middle market private equity funds invest in smaller businesses because they can often acquire a more meaningful stake in a smaller company at a more

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[1] Data compiled on October 19, 2012from Pitchbook (www.pitchbook.com), a private equity and venture capital database.

[2] Private Equity Survey: Creating Value; Spurring Growth. McGladrey and Pitchbook. May 2012. http://mcgladrey.com/Private-Equity-Groups/2012-Private-Equity-Survey

attractive price than they could were they to invest in larger companies. Managers of smaller funds seek to build a diversified portfolio of investments, so the manager of a $100 million fund would typically seek to allocate those funds to 15 or 20 investments in different firms.

Following the investment, private equity fund managers work closely with a company's management team on many specific aspects to accelerate the company's growth. Fund managers have years of operations experience to help small businesses and entrepreneurs take the next step in growing their business. Fund managers work to improve the profitability by developing better products and services, expanding the sales channels, and introducing the portfolio companies to new supply chains. Fund managers work with the CFOs of its portfolio companies to improve financial operations and IT systems, reduce costs, and streamline financial reporting processes.

Small businesses rely on lower middle market private equity companies for value creation. The ability to create value in portfolio companies requires a capable management team, a comprehensive and customized performance plan, and the ability to generate key performance indicators and financial information. This is critical for small businesses that lack expertise in operations and financial management. Over 90 percent of private equity firms implement a 100-day and/or a 12-36 month plan with their portfolio companies to improve performance.[3] This is a critical point, because private equity firms don't just throw money at a business and expect it to grow. They are active participants at every stage of business development to help vibrant and motivated entrepreneurs grow their companies to support local communities. For these reasons, small businesses truly benefit from the operational experience of their private equity partners.

Banks are a very important source of capital for lower middle market private equity funds. Without banks as investors, lower middle market private equity funds would have less capital to finance America's most promising small businesses. According to Pitchbook, 59 banks have invested in small domestic private equity and venture capital firms with funds under $350 million.[4] Banks accounted for approximately 11 percent of the total investments in private equity companies worldwide in 2008. The total investments in private equity for banks dropped to 8 percent by 2011.

Banks currently hold an estimated aggregate allocation of investments in private equity of $96.6 billion out of $37.5 trillion in total assets. This accounts for less than two-tenths of one percent of their total asset allocation.[5]

In the last year, three of the largest banks in the United States – Citigroup, JP Morgan Chase, and Wells Fargo – were all well below 1 percent of total assets invested in private equity and venture capital. Citigroup's investments in private equity averaged less than 0.06 percent; JP Morgan

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[3] Private Equity Survey, McGladrey and Pitchbook, May 2012.

[4] Data compiled from Pitchbook on October 19, 2012.

[5] Preqin Special Report. May 2012.

Chase's investments averaged less than 0.34 percent; and Wells Fargo's averaged less than 0.36 percent.[6]

We encourage the regulatory agencies to remove regulatory burdens and hurdles for banks investing in small private equity funds in order to ensure that these funds can continue to provide small businesses long-term financing and work with the management teams of these firms to build their companies and create jobs. The impact of banking regulations is the single biggest factor that contributed to the decrease in bank investments in private equity. According to a May 2012 study by Preqin on Banks as Investors in Private Equity, 30 percent of banks worldwide cited "regulations" as the single biggest challenge facing banks seeking to operate effective private equity programs. This was the single biggest challenge facing banks in the study.[7]

The impact of regulation on banks investment in private equity has resulted in many banks deciding to sell their private equity assets. According to the Preqin report, 10 percent of banks worldwide have already ceased to invest in private equity or plan to stop investments in private equity due to the regulatory environment. In addition, 17 percent of banks have significantly reduced or slightly reduced their exposure to private equity. Of the 26 percent of banks that have already stopped or reduced their investments in private equity, 90 percent of these banks are based in a highly regulated country such as the United States or Europe.[8]

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Regulatory Capital Rules Treatment of Bank Investments in Small Private Equity Funds as set forth in Question #19 in the proposal:

Question #19: The agencies solicit comment on an alternative proposal to simplify the risk-based capital treatment of banking organizations' non-significant equity exposures by assigning a 100-percent risk weight to equity exposures to small business investment companies and to DPC equity exposures, consistent with the treatment of community development investments and the effective portion of hedged pairs. **What other types of equity exposures (excluding exposures to small business investment companies and equities take for DPC) should be excluded from the non-significant equity exposure calculation under the alternative approach and what is the approximate amount of these exposures in relation to banking organizations' total capital? What would be an appropriate measure or level for determining whether equity exposures in the aggregate are "non-significant" for a banking organization?**

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[6] Data compiled from company reports (http;//edgar.sec.gov) on October 17, 2012.

[7] Preqin Special Report: Banks as Investors in Private Equity. May 2012. http://www.preqin.com/docs/reports/Preqin_Special_Report_Banks_as_Investors_in_Private_Equity.pdf

[8] Preqin Special Report. May 2012.

Reply: Under the Regulatory Capital Rules, bank investments in small private equity companies are considered "non-significant equity exposures" and a banking organization would be permitted to apply a 100 percent risk weight to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of the banking organizations total capital. Under this approach, the banking organization would be required to place all the non-significant equity exposures in one bucket to make sure they do not exceed 10 percent of the banking organizations total capital. If the banking organization exceeds the 10 percent cap, then the risk weighting for such lower middle market private equity investments above the 10 percent cap would increase to 300 percent or 400 percent, depending on whether the investments are made in a publicly-traded or not a publicly-traded private equity company. Simply put, at those levels of risk weighting, banks would stop making investments in lower middle market private equity companies because they would have to set aside 3 or 4 dollars for every dollar of investment in a private equity company. This is uneconomical for banks and they would go elsewhere with their capital.

The purpose of increasing the risk weighting of bank assets is that a bank has to hold additional capital to account for the higher risk level assigned to the assets by the regulators in order to maintain the bank's capital adequacy ratios required by U.S. regulations. From a policy perspective, a risk weighting of greater than 100 percent indicates a regulatory conclusion that the asset is riskier and requires more capital support. A risk weighting of 100 percent essentially is a judgment call by the regulatory officials that the asset is "neutral" as to risk and does not need additional capital support beyond the standard capital requirements applicable to banks.

As we stated earlier, the average aggregate asset allocation of banks worldwide in private equity is less than two-tenths of one percent of their total assets. And even in the largest US-based banks – Citigroup, JP Morgan Chase, and Wells Fargo – the average private equity investment is below a half of one percent. This is not a significant amount of their total asset base, and would not make up what is considered to be a systemically risky asset allocation. Therefore, the fact that some banks would be required to set aside more than a 1:1 ratio of capital for every dollar invested in a private equity fund is punitive and hurts investments in small businesses.

There is no empirical evidence to suggest that lower middle market private funds are systemically risky. Lower middle market private equity companies invest in the most productive sector of our economy: small business. Small businesses accounted for 64 percent of the net new jobs in the United States between 1993 and 2011, currently make up 49.2 percent of private sector employment, and account for 46 percent of private sector output.[9]

The purpose of prudential regulations and capital requirements for banks is to prevent systemic risk in the banking system. The Financial Stability Oversight Council (FSOC) describes systemic risk as "risks to the stability of the financial system as a whole, as opposed to the risk

[9] U.S. Census Bureau, SUSB, CPS; International Trade Administration; Bureau of Labor Statistics, BED; Advocacy-funded research, Small Business GDP: Update 20022010, www.sba.gov/advocacy/7540/42371

facing individual financial institutions or market participants."[10] Financial risk includes all potential sources of instability in the financial system, not just the failure of a single large firm.

The FSOC states that a single entity may pose systemic risk if its relationships with others can spread and magnify shocks to the financial system. In our view, it is highly unlikely that a single private equity fund would pose that level of shock to the financial system because banks hold very little assets in private equity companies. In addition, because private equity companies hold diverse assets with up to 15 to 20 businesses as part of the portfolio, this reduces the risk that the private equity company will not be able to pay back its bank investors.

Regarding the structure and methodology of the proposed rule on Regulatory Capital Rules, there are some potential unintended consequences that should be noted. Most obviously, there is a danger of other investments "crowding out" the private equity exposures held by the bank because other equity exposures are also counted against the 10 percent of the bank's total capital cap. It is possible that the Regulatory Capital Rules might provide a disincentive for a bank to invest in private equity exposures because a bank may wish to utilize more of the 10 percent cap for other non-significant equity exposure investments. We do not believe that the regulatory agencies intended for such a possible outcome, but we note the danger due to the methodology proposed in the Rules.

One solution to this problem is to designate bank investments in lower middle market private equity funds (with less than $350 million per fund) with a 100 percent risk weighting in all instances without any reference to the 10 percent total capital cap. Again, this safe harbor should be applied to private equity funds on a per fund basis in order to prevent discrimination against investment teams that manage more than one fund. This would ensure that private equity investments in small businesses are not negatively impacted as a result of the capital surcharge.

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In conclusion, as the regulatory agencies develop the final regulatory capital rules, we urge you to pay particular attention to the impact that new regulations will have on the cost and availability of capital to smaller businesses. Lower middle market private equity firms are important to the long-term financing needs of small businesses, and any increase in the cost of investing in them will inhibit them from getting needed financing from banks. Regulators have an important responsibility to contain lending related risks that are systemic and therefore relevant to financial stability. However, please ensure that any future regulatory capital rules designed to address such systemic risk issues do not also penalize future investment in domestic small businesses.

[10] Financial Stability Oversight Council, annual report, Washington, DC, July 26, 2011, p. 3, available at http://www.treasury.gov/initiatives/fsoc/Pages/annual-report.aspx

We appreciate that the regulatory agencies have provided us the opportunity to comment on the regulatory capital rules. We are available to provide data and technical assistance to the agencies upon request, and we are available to meet with respect to these matters.

Respectfully submitted,

SMALL BUSINESS INVESTOR ALLIANCE

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