NO. 89367-5

SUPREME COURT
OF THE STATE OF WASHINGTON

CASHMERE VALLEY BANK,

Petitioner,

v.

STATE OF WASHINGTON,
DEPARTMENT OF REVENUE,

Respondent.

MEMORANDUM OF AMICUS CURIAE WASHINGTON BANKERS ASSOCIATION IN SUPPORT OF PETITION FOR REVIEW

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I. STATEMENT OF INTEREST OF AMICUS CURIAE

Washington Bankers Association ("WBA") is a Washington nonprofit corporation and is the trade association for banks of all sizes doing business in Washington. WBA engages in advocacy for its members and education of members' employees, among many other services. All or nearly all of WBA's members have invested in the same kind of mortgage-backed securities at issue in the Cashmere Valley Bank case. WBA therefore has a strong industry-wide interest in the outcome and rationale for this tax dispute.

II. STATEMENT OF ISSUE PRESENTED FOR REVIEW

WBA supports the Statement of Issue as framed by Petitioner Cashmere Valley Bank ("Cashmere").

III. STATEMENT OF THE CASE

WBA generally adopts the Statement of the Case presented by Cashmere in the Petition.

With a subject matter as complex as collateralized mortgage obligations ("CMOs") and real estate mortgage investment conduits ("REMICs"), there is sometimes an impulse to simplify their description for ease of understanding or argument. Given the many intersecting layers of law that govern CMOs and REMICs – bank investment regulations, residential lending regulations, securities law, trust law, civil rules of procedure, and taxation among them – it is important not to let a shorthand expression, however appropriate in context, create a misunderstanding.

Over-simplified definitions of REMICs and CMOs frequently identify their function as investment securities and omit to state that they are formed as ***trusts*** to hold mortgage loans on behalf of beneficiary certificate holders. The briefing of the Department of Revenue ("Department") emphasizes this truncated view. For example: "[A] 'collateralized mortgage obligation' or 'CMO,' was a new debt *security* (*i.e.*, a bond) issued by Freddie Mac and collateralized with mortgage pass-through securities that had been issued and guaranteed by Freddie Mac." Brief of Resp. at 7-8 (emphasis added) (citing Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 Notre Dame L. Rev. 497, 506 (1989)). The court below followed suit: "REMICs and CMOs are *investment instruments* of pooled mortgage loans . . . ." *Cashmere Valley Bank v. State*, 175 Wn. App. 403, 407 ¶ 7, 305 P.3d 1123 (2013) (emphasis added). Cashmere, on the other hand, made the trust structure and the investors' beneficial interests clear in its briefing below. *See* App. Reply Brief at 2, 5, 10, 13-15, 18-20.

A more complete functional description of the mortgage-securitization structure, which applies equally to CMOs, REMICs, and other mortgage-backed securities, is as follows:

> In a mortgage securitization, mortgage loans are acquired, pooled together and then sold to a *common law trust* which in turn issues certificates to purchasers who are *beneficiaries of the trust* and who receive distributions from the *trustee* according to the cash flow generated by the pool of mortgages and the rights of the respective classes of certificate holders.

In re Lehman Bros. Securities & ERISA Litigation, 681 F. Supp. 2d 495,

496-97 (S.D.N.Y. 2010) (emphasis added), *aff'd* sub nom. *In re Lehman Bros. Mortgage-Backed Securities Litigation*, 650 F.3d 167 (2d Cir. 2011).

From what appears in the record, all of the REMICs[1] in question were structured as trusts. *See, e.g.,* CP 355, 362 (Fannie Mae Prospectus Supplement for "REMIC Trust 2000-38"); CP 479 (C. Zalesky identifying prospectus supplement for "Fannie REMIC Trust 1994-50"); CP 655 (C. Zalesky reading prospectus supplement for "Washington Mutual MSC Mortgage Pass-Through Certificates Series 2004-RA4 Trust").

IV. ARGUMENT

Review of the decision below is important because (i) the decision conflicts with the Court of Appeals' own decision in *Washington St. Dep't of Revenue v. Security Pac. Bank of Washington N.A.*, 109 Wn. App. 795, 38 P.3d 354 (2002) (RAP 13.4(b)(2)), and (ii) the Petition involves issues of substantial public interest relating to the need to decide tax disputes in light of the legal context (in this case, banking and trust law) in which the taxpayer's business is conducted and the tax issue arises (RAP 13.4(b)(4)).

A. The Decision in *Cashmere Valley* Is in Conflict with the Court of Appeals' Decision in *Security Pacific.*

WBA agrees with Cashmere that the decision of the court below is in conflict with its own prior decision in *Security Pacific*. WBA would identify the core of this conflict in somewhat different terms.

[1] REMICs are tax-favored CMOs. *See Cashmere Valley*, 125 Wn. App. at 412 ¶ 21, n.7. To qualify as a REMIC under the Internal Revenue Code, a CMO must be formed as an "entity." 26 U.S.C. § 860D(a). The Department agrees that CMOs and REMICs are indistinguishable for purposes of this case. *See* Answer at 2 n.1.

The court below in *Cashmere Valley* accused Cashmere of "incorrectly conflat[ing] the mortgages underlying its investments with the investments themselves." 175 Wn. App. at 413 ¶ 22. In the court's view:

> To simply argue that Cashmere's ultimate source of return – the underlying mortgages and trust deeds – is its primary source of security ignores the fact that Cashmere has no recourse to that ultimate source of payments. Because Cashmere does not have such recourse, Cashmere cannot show that its investments were primarily secured by first mortgages or trust deeds, and thus Cashmere cannot take the deduction.

Id. at 418-19 ¶ 34.

In WBA's view, it was the court in *Cashmere Valley* that was confused in equating *security* with *remedy*. The court in *Security Pacific* did not make this mistake. In that case, where the bank was lending to mortgage companies on revolving lines of credit so that they, in turn, could make home loans, the Department made the same argument that it makes here:

> [I]f a mortgage company defaulted on its obligation under the credit agreement, Security could not foreclose against the real property subject to the deeds of trust. The Department explained that Security's *remedy* was to assume ownership of the assigned promissory notes of the mortgage company's customers (i.e., homeowners).

109 Wn. App. at 801 (emphasis added). Further,

> To support its argument, the Department notes that when a mortgage company defaulted, Security did not foreclose against the real property, but instead it sold the mortgage loans on the secondary market.

Id. at 809.

The court was not persuaded that these limitations on the bank's remedies undermined the fact that its primary security lay in the underlying mortgages. "Security's action after default by a mortgage company is consistent with the Board [of Tax Appeals]'s finding that the underlying real property comprised *the only valuable security* for the loans." *Id.* at 810 (emphasis added). In other words, for the court in *Security Pacific*, there was no one-to-one relationship between the security for a loan and the remedy for default. The opinion of *Cashmere Valley* is directly in conflict with this understanding of lending security.

B. There Is a Substantial Public Interest in Review by This Court to Avoid Incoherence in the Relationship Between the B&O Tax and Other Applicable Washington and Federal Law.

The opinion below is damaging to the public interest because it divorces the Washington law of security interests from the banking and trust law that give these secured transactions (and securities) their context. Notably, the court cites no authority (other than the Department) for its explanation of CMOs and REMICs. *See Cashmere Valley,* 175 Wn. App. at 407-08 ¶¶ 6-8, 410-13 ¶¶ 15-21.

1. Cashmere Could Invest in CMOs and REMICs Only Because They Are "Secured" Investments Under Federal Bank Regulatory Law.

State banks like Cashmere are regulated by the FDIC pursuant to 12 U.S.C. § 1828 and related statutes. FDIC-insured state banks are subject to the same investment restrictions as national banks. *See* 12 U.S.C. § 1831a(a)(1) (confining state banks to activities permissible for

national banks, with exceptions not relevant here); *id.* § 1831a(h) (defining "activity" to include "acquiring or retaining any investment").

The Comptroller of the Currency ("OCC") has responsibility for regulating the investments of national banks in the interest of "safe and sound banking practices" pursuant to 12 C.F.R. § 1.1(b). The OCC's regulations limit and place conditions on banks' "purchase and sale" of five "types" of securities. *See id.* § 1.3. These five "types" are defined in Section 1.2 of the regulations. The OCC's guidebook, *Activities Permissible for a National Bank, Cumulative* (April 2012), summarizes the authority of banks to invest in CMO certificates under these regulations as follows: "National banks may purchase CMOs, which may be classified as Type I, IV, or V securities under 12 CFR 1." *Id.* at 84 (*available at* http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/bankact.pdf) (excerpt attached as App. A).

The OCC's security definitions show that, contrary to the court's opinion below, ***all*** of the CMOs and REMICs in which Cashmere invested were – and were required to be – ***"secured"*** investments.

"Type V security" is defined to mean "a security that is: (1) Investment grade; (2) Marketable; (3) Not a Type IV security; and (4) ***Fully secured*** by ***interests*** in a pool of loans to numerous obligors and in which a national bank could invest directly." 12 C.F.R. § 1.2(n) (emphasis added).

"Type IV securities" are defined (as relevant here) as a "residential mortgage-related security as described in Section 3(a)(41) of the Securities Exchange Act of 1934." *Id.* § 1.2(m)(3).[2] Under the latter statute, such a security *either*

> represents ***ownership*** of one or more promissory notes or certificates of interest or participation in such notes (including any rights designed to assure . . . receipt of amounts payable . . .), which notes . . . are ***directly secured by a first lien*** on a single parcel of real estate.

15 U.S.C. § 78c(a)(41)(A) and (A)(i) (emphasis added), *or* is "***secured*** by one or more promissory notes or certificates of interest or participations in such notes" and those notes meet the foregoing requirements of subparagraph (A). *Id.* § 78c(a)(41)(B) (emphasis added). Consequently, all REMIC certificates purchased by Cashmere, whether described as a Type IV or Type V security, were ***"secured"*** investments.[3]

Why does federal banking law treat as "secured" what the court below saw as "not secured at all"? *See Cashmere Valley,* 175 Wn. App. at 417 ¶ 32. The answer lies in the flow-through nature of the investors' beneficial ***interests*** in trusts and beneficial ***ownership*** of trust assets.

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[2] Technically, CMO and REMIC certificates are qualified "Type IV securities" *if* issued pursuant to the cited statute or certain other statutes not relevant here. *See* OCC, *Investment Securities [Comptroller's Handbook (Section 203)]* at 3 (1990) (excerpt attached as App. B), *available at* *http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/investsecurities1.pdf*. Cashmere's compliance with the investment limitations is not in question.

[3] Certificates in a REMIC sponsored by Fannie Mae or Freddie Mac would be a Type IV security but for the fact that all obligations issued by these agencies are expressly permitted investments under 12 U.S.C. § 24 (Seventh) and therefore qualify as "Type I securities" under 12 C.F.R. § 1.2(j)(5). *See id.* § 1.2(m)(3) (excluding Type I securities from the Type IV class).

2. Cashmere's Investments in CMOs and REMICs Were "Secured" Under Federal Law Because the Security Interests Were Held For Cashmere's Benefit Under Trust Law.

A trustee holds legal title to trust property for the benefit of the trust beneficiaries. *See* Restatement of Trusts (Third) § 2 & comment d (2003). The trust property may include equitable interests created under other trusts. In other words, a beneficiary of "Trust A" may place her beneficial ownership of the assets of Trust A in "Trust B" for the benefit of X, Y, and Z. *See id.* comment d & illustration 2.

This happens in a REMIC that holds other mortgage-backed securities. The trustee of the underlying conduit holds and manages a pool of mortgage loans for the benefit of the equitable owners of that loan pool (*i.e.,* the trustees of the second-level trusts), who themselves manage their equitable interests for the benefit of *their* trusts' beneficiaries.

The court below did not recognize the significance of the trust relationship involved in REMICs. The court quoted Fannie Mae's servicing guidelines, "Fannie Mae is at all times the owner of the mortgage note, whether the note is in our portfolio or whether we own it as trustee for [a mortgage-backed security] trust," as support for concluding that the REMIC certificate holders do not hold "equity" in the trust. *See Cashmere Valley,* 175 Wn. App. at 413 n.10. Contrary to the court's view and the Department's argument, *see* Answer at 15, in fact the investors' equitable interest in the REMIC's notes is *necessarily* implied by Fannie Mae's own statement that it owns the note *in trust.*

The blinkered approach of the court below harms the public interest in coherence in the law. The sounder view recognizes that the trust beneficiaries of a CMO have "secured" status even without a pro rata interest in the mortgage pool: "The mortgages that ***secure*** the mortgage-backed security are placed in a securitization ***trust***, and the trustee, or in this case the trustee's delegate (the plaintiff), is responsible for servicing them." *CWCapital Asset Management, LLC v. Chicago Properties, LLC*, 610 F.3d 497, 506 (7th Cir. 2010). *Cf.* Answer at 19 (discussing opposite conclusion of Department and court below).

3. The Priority of Trustees' Recourse Against Collateral Versus Beneficiaries' Direct Recourse Is Standard and Traditional *Procedure.*

The conclusion of the court below that REMIC investments are not secured by underlying mortgages was uninformed. The barriers to a trust beneficiary's direct recourse against those who owe obligations to the trust are a function of judicial economy and fairness to defendants, not a result of the beneficiary's lack of a beneficial ownership interest in the collateral.

Why can't the beneficiaries of a trust act directly to enforce the promises of trust obligors? Even though trust "beneficiaries, to be sure, have more than a mere claim against the trustee; they have an equitable interest in the trust property," 5 Scott & Ascher on Trusts § 28.2, at 1941 (5th ed. 2008), the beneficiaries are generally not allowed to bring suit on behalf of the trust *as a matter of procedure.* This saves judicial resources and avoids multiple actions on the same claim.

> The substantive basis for the real party in interest rule is to prevent just this kind of multiplication of lawsuits arising from the same facts, in order to protect potential defendants from the harassment, vexation, and expense of having to meet several lawsuits from different claimants involving the same claim or demand; and to insure that such defendants will be protected from further annoyance or loss in the future once a judgment is entered in a lawsuit on such a claim.

Saks v. Damon Raike & Co., 7 Cal. App. 4th 419, 431-32, 8 Cal. Rptr. 869 (1992) (dismissing action by trust beneficiaries to recover from trust's investment advisor). *See* Petition at 17; *see also Automotive United Trades Org. v. State,* 175 Wn.2d 214, 225 ¶ 21, 285 P.3d 52 (2012) (beneficiary not normally a necessary party to trustee's action).

The contractual limitations on Cashmere's rights to direct recourse against mortgage collateral are therefore best understood as a variant of what civil procedure and trust law already require – that the trustee act on behalf of the beneficial owners of the mortgage loans.

V. CONCLUSION

For the foregoing reasons, WBA requests that the Court grant the Petition for Review.

RESPECTFULLY SUBMITTED this 14th day of November, 2013.

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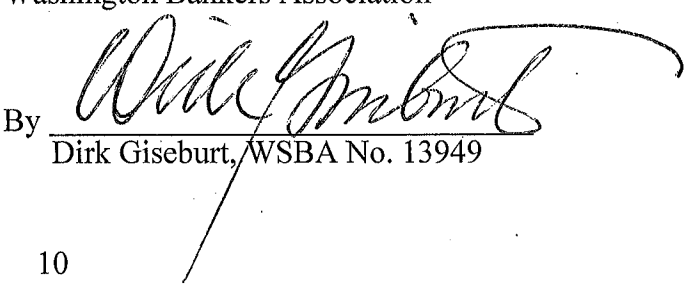

By _____
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APPENDIX A

Comptroller of the Currency
Administrator of National Banks

Activities Permissible for a National Bank, Cumulative

2011 Annual Edition

April 2012

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significance for consumers of those differences. For example, the advisory informs consumers that various methods for electronic check processing may mean that funds are taken from consumers' bank accounts more quickly than before. As a result, it is even more important for consumers to ensure that they have enough money in their accounts to cover checks at the time they write them. The advisory also discusses the different laws and regulations governing check transactions, how consumers' rights may vary depending on how a check is processed, and how consumers may resolve problems in connection with their checks. OCC Consumer Advisory 2005-1(August 2, 2005), OCC News Release 2005-75 (August 2, 2005).

INVESTMENTS[1]

- **Acquisition of Preferred Securities.** A national bank may purchase and hold the preferred securities of two special-purpose entities that hold interests in Australian mortgage assets. OCC Interpretive Letter No. 1027 (May 3, 2005).

- **Acquisition of Preferred Stock of an Unaffiliated Company.** A national bank has authority to acquire and hold the preferred stock of an unaffiliated company, pursuant to its authority to discount and negotiate evidences of debt, where the preferred stock is in substance a debt obligation of the issuer. The bank acquired the preferred stock as partial consideration for the disposition of a loan portfolio to the company. The bank's existing holdings represent less than 5 percent of the bank's capital and surplus and are within applicable prudential standards and regulatory limits. OCC Interpretive Letter No. 941 (June 11, 2002).

- **Agricultural Cooperative.** Under Part 24, a national bank may purchase common stock in an agricultural cooperative, where the bank's liability was limited to the amount of its equity investment. The cooperative was initiated by a local economic development authority and local farmers and businesses as a way to promote the economic development of the area, and had received financial support from both the economic development authority and the federal government. The cooperative also benefited low- and moderate-income individuals by creating permanent jobs for those individuals. Approval Letter (September 4, 2001), National Bank Community Development Investments 2001 Directory.

- **Agricultural Credit Corporations.** National banks may purchase stock of a corporation organized to make loans to farmers and ranchers for agricultural purposes. An investment in such an agricultural credit corporation may not exceed 20 percent of a national bank's capital and surplus, unless the national bank owns at least 80 percent. 12 USC 24(Seventh).

[1] For investments in partnerships, note that subsidiaries of national banks may become general partners, but national banks may not.

- **Asset-Backed Securities.** National banks may invest up to 25 percent of capital and surplus in marketable investment grade securities that are fully secured by interests in a pool of loans to numerous obligors and in which a national bank may invest directly. 12 CFR 1.2(m), 1.3(f).

- **Banker's Acceptances.** National banks may invest in banker's acceptances created by other nonaffiliated banks without limit, if they are created in accordance with 12 USC 372, and are thus "eligible" for discount with a Federal Reserve bank. But section 372(b), (c), and (d) restrict investment in the aggregate amount of the banker's acceptances created by any one bank. Holdings of "ineligible" banker's acceptances must be included in the purchasing bank's lending limit to the accepting bank. 12 USC 84; 12 CFR. 32.

- **Banker's Banks.** National banks may invest in banker's banks, or their holding companies, in an amount up to 10 percent of the national bank's capital stock and unimpaired surplus. In addition, national banks may not hold more than 5 percent of the voting securities of a banker's bank or holding company. 12 USC 24(Seventh). A banker's bank may be organized as a national bank, and the OCC may waive requirements that are applicable to national banks in general if they are inappropriate for a banker's bank and would impede the provision of its services. 12 USC 27(b); 12 CFR 5.20.

- **Bank-Owned Life Insurance (BOLI).** A national bank's investment in separate-account bank-owned life insurance will be considered a qualified investment under the Community Reinvestment Act (CRA) if the separate account in which the bank invests is comprised of investments intended to be qualified under the CRA. OCC Interpretive Letter No. 1008 (July 19, 2004).

- **Bank's Own Stock.** National banks may purchase treasury stock to fulfill a legitimate corporate purpose, including in connection with an employee stock purchase plan, directors qualifying shares, or a reverse stock split. 12 USC 83; OCC Interpretive Letter No. 825, reprinted in [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,274 (March 16, 1998); OCC Interpretive Letter No. 786, reprinted in [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,213 (June 9, 1997); OCC Interpretive Letter No. 660, reprinted in [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,608 (December 19, 1994). National banks may make loans on the security of their own shares pursuant to 12 USC 83 and 12 CFR 7.2019.

- **Bank Premises.** National banks may invest in bank premises without OCC approval, if 1) the aggregate amount of the investment is less than or equal to the national bank's capital stock; or 2) the aggregate amount of the investment is less than or equal to 150 percent of the national bank's capital and surplus, and the national bank is well capitalized and has a CAMEL rating of 1 or 2, provided that the bank provides the OCC notice 30 days after this investment. Prior OCC approval is required for investments in bank premises that do not meet the above criteria, but the application may be deemed approved after 30 days, unless the OCC notifies the bank otherwise. 12 USC 29, 371d; 12 CFR 5.37, 7.1000; Conditional Approval No. 298 (December 15, 1998).

- *Bank Premises*. A national bank may hold, as permissible bank premises, commercial facilities with lodging for out-of-town bank visitors. The bank may make excess space available to the general public. OCC Interpretive Letter No. 1045 (December 5, 2005).

- *Bank Premises*. A national bank may hold, as permissible bank premises, a building that consists of both office space and commercial facilities for lodging out-of-town bank visitors. The bank may make excess space available to the general public and, in order to make the building financially feasible, may develop and sell residential condominiums on four floors. OCC Interpretive Letter No. 1044 (December 5, 2005).

- *Bank Premises*. A national bank may construct a new office complex on existing bank premises and lease unused space as excess bank premises. OCC Interpretive Letter No. 1034 (April 1, 2005).

- *Bank Premises*. A national bank may lease a portion of parkland, held as bank premises, to third party. OCC Interpretive Letter No. 758 (April 5, 1996).

- *Bank Premises*. A national bank may add space to two existing bank buildings and lease all new space to third parties. OCC Interpretive Letter (March 10, 1994), available in Lexis-Nexis.

- *Bank Premises*. A national bank may lease condominium, used for out-of- area bank visitors, to third parties when not in use by bank visitors. OCC Interpretive Letter No. 1043 (July 8, 1993).

- *Bank Premises*. A national bank may license use of space on its premises to a third party. OCC Interpretive Letter No. 630 (May 11, 1993).

- *Bank Premises*. A national bank may hold condominium for use of out-of- area visitors. OCC Interpretive Letter No. 1042 (January 21, 1993).

- *Bank Premises*. A national bank may purchase building to house its retail brokerage business, and lease building to third-party broker that will have dual employees with the bank. OCC Interpretive Letter (June 24, 1992), available in Lexis-Nexis.

- *Bank Premises*. A national bank may lease portion of storage facility on bank premises to unrelated third party. OCC Interpretive Letter (December 16, 1991), available in Lexis-Nexis.

- *Bank Premises*. A national bank authorized to develop portion of new bank premises building as office condominium and sell the condominiums. OCC Interpretive Letter (August 14, 1985), available in Lexis-Nexis.

- *Bank Premises*. A national bank may lease lobby space to variety of third parties. OCC Interpretive Letter No. 274 (December 2, 1983).

- *Bank Premises*. A national bank may own apartment in Los Angeles for use by its CEO who maintains his primary residence elsewhere. OCC Interpretive Letter No. 2 (December 13, 1977).

- *Bank Premises*. A national bank may occupy percentage of office complex and lease remaining space to third parties. Wirtz v. First National Bank & Trust Co., 365 F.2.d 641 (10th Cir. 1966) (August 30, 1966).

- *Bank Premises*. A national bank has authority to tear down bank building and construct new six-story office building in which bank will occupy only first floor, and lease excess space to third parties. Wingert v. First National Bank, 175 F. 739 (4th Cir. 1909), appeal dismissed, 223 U.S. 670, 672 (1912) (December 16, 1909).

- *Bank Premises*. The National Bank Act does not preclude a national bank, acting in good faith, from maximizing the utility of its banking premises by leasing excess bank premises to third parties. Brown v. Schleier, 118 F. 981 (8th Cir. 1902), aff'd, 194 U.S. 18 (1904) (November 10, 1902).

- **Bank Service Companies.** National banks may invest in bank service companies if the amount invested does not exceed 10 percent of the bank's capital and surplus and all investments in bank service companies do not exceed 5 percent of the national bank's assets. 12 USC 1862; 12 CFR 5.35.

- **Business Trusts.** National banks may acquire certificates of participation in business trusts created to hold and manage a substantial portion of the bank's investment securities portfolio. OCC Interpretive Letter No. 745, reprinted in [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,110 (August 27, 1996).

- **CD Investments Up to 10 Percent Investment Limit.** In connection with a request for prior approval of an affordable housing investment, the OCC approved a national bank's request to self-certify future affordable, community development (CD) housing investments that would exceed 5 percent of its capital and surplus, up to a maximum of 10 percent of capital and surplus. The requirements of 12 CFR 24 relating to self-certification and all other requirements of the regulation will apply to the additional investments. Approval Letter (August 1, 2001), National Bank Community Development Investments 2001 Directory.

- **Certificates of a U.S. Agency Created Under the Foreign Assistance Act.** Certificates issued by a U.S. agency created under the Foreign Assistance Act may qualify as Type I securities under 12 CFR Part 1 and accordingly are available for investment by national banks without limitation, subject to safety and soundness considerations. OCC Interpretive Letter No. 1001 (May 3, 2004).

- **Clearinghouse.** In a reorganization of the clearinghouse into a holding company with subsidiaries, national banks may lawfully acquire and hold minority interests in both the

new holding company and its subsidiaries. OCC Interpretive Letter No. 993 (May 16, 2004).

- **Closed-End Mutual Fund.** National bank may purchase an equity interest in a closed-end mutual fund that finances affordable housing primarily for low- and moderate-income individuals. The fund is structured as a Business Development Company under the Investment Company Act of 1940. The fund purchases securities backed by loans to homebuyers with incomes below 80 percent of median income as well as loans to sponsors of multifamily housing units that use federal low-income housing tax credits or financing provided by HUD. The fund also invests in HUD-guaranteed securities that support community development in low-income areas. Approval of Bank's Self-Certification (April 20, 2001), National Bank Community Development Investments 2001 Directory.

- **Collateralized Bond Obligations.** National banks may purchase marketable, investment-grade collateralized bond obligations as Type III investments, even though certain of the underlying assets are not investment grade. Letter from Tena Alexander, Senior Attorney, dated August 3, 1999.

- **Collateralized Mortgage Obligations (CMO).** National banks may purchase CMOs, which may be classified as Type I, IV, or V securities under 12 CFR 1.

- **Commercial Mortgage-Related Securities.** National banks may invest in certain commercial mortgage-backed securities. 12 USC 24(Seventh); 12 CFR 1.2(l).

- **Commercial Paper (i.e., Short-Term, Unsecured Promissory Notes Usually Issued by Companies to Meet Their Immediate Cash Needs).** National banks may hold commercial paper as loans, subject to the lending limits and loan underwriting safety and soundness standards. 12 USC 24(Seventh) and 84; 12 CFR 1 and 32. National banks may issue commercial paper. OCC Interpretive Letter No. (May 4, 1973).

- **Community Development Entity Purchasing, Constructing, and Operating an Ethanol Plant.** Under 12 USC 24(Eleventh), a national bank may make an investment in a community and economic development entity that will purchase, construct, and operate an ethanol plant that is located in a low- and moderate- income (LMI) geography and will provide jobs to unskilled individuals. Community Development Investment Letter 2005-3 (July 20, 2005).

- **Community Reinvestment Act; Employment Fund.** A national bank's proposed investment in a fund with the purpose of providing employment for low- and moderate-income individuals would be a qualified investment under the Community Reinvestment Act regulations. The fund's sole purpose is to invest in a limited liability company that will employ individuals the majority of whom will be in the low- and moderate-income categories, and who will be expected to qualify for various federal employment tax credits. The bank's investment will finance the hiring of employees who will perform various types of work, including clerical, retail, security, and building maintenance. The

bank's investment will also help to finance the provision of ancillary services to facilitate employees' continued employment, such as job training, medical insurance, and employee assistance programs. OCC Interpretive Letter No. 983 (October 24, 2003).

- **Community Reinvestment Act; New Market Tax Credits.** A national bank's investment in connection with the New Markets Tax Credit program in a "Community Development Entity" (CDE), or a loan by a bank's CDE to a "Qualified Active Low-Income Community Business" or to another CDE, would receive consideration as a qualified investment or a community development loan, respectively, under the Community Reinvestment Act regulations. OCC Interpretive Letter No. 984 (December 17, 2003).

- **Connecticut Housing Finance Authority Bonds.** A national bank may purchase Connecticut Housing Finance Authority Bonds as Type I securities. They are subject to a 20 percent risk-weight under the OCC's risk-based capital regulation. OCC Interpretive Letter No. 907 (February 1, 2001).

- **Consolidation of Public Welfare Investments Into CDC.** A national bank may consolidate its public welfare investment activities in an existing community development corporation (CDC). The CDC would manage its portfolio so that the majority of its investments qualify as public welfare investment under 12 CFR 24. Thus, the CDC would be primarily engaged in making public welfare investment, and the bank's investments in the CDC would be designed primarily to promote the public welfare, as required by 12 USC 24(Eleventh). Approval Letter (February 14, 2000).

- **Convertible Bonds.** A federal branch's purchases of bonds convertible into equity are permissible investments under Part 1 if the bonds are the credit equivalent of investment grade and marketable. A national bank may purchase bonds convertible into equity where it does not exercise the conversion feature. OCC Interpretive Letter No. 930 (March 11, 2002).

- **Convertible Securities.** National banks may purchase securities convertible into stock, provided that convertibility is not at the option of the issuer. 12 CFR 1.6.

- **Corporate Debt Securities.** National banks may invest in any corporate debt security, provided the securities are marketable debt obligations that are not predominantly speculative in nature and total investments in any one issuer do not exceed 10 percent of the national bank's capital and surplus. 12 USC 24(Seventh); 12 CFR 1.

- **Corporations That Sell or Lease Check Cashing Machines.** National banks can hold a minority investment in a corporation that sells and leases check-cashing machines to third parties. Conditional Approval No. 307 (March 19, 1999).

- **Crime Prevention Programs in Nursing Homes.** A national bank may purchase preferred stock in a foundation that operates crime prevention programs in nursing homes. The foundation uses the bank's funds to purchase government and agency

securities. Interest earned on these securities is used to fund crime prevention activities in nursing homes located in low- and moderate-income areas or occupied by low- and moderate-income residents. Community Development Investment Letter 2003-4 (November 17, 2003).

- **Debt Rating Requirement for Establishing Financial Subsidiaries.** A national bank may rely on the rating assigned to the uninsured portion of the bank's certificates of deposit to satisfy the debt rating requirement necessary to establish a financial subsidiary under Section 121 of the Gramm-Leach-Bliley Act. The certificates of deposit qualify as "eligible debt" for purposes of the requirement under Section 121 that any of the 50 largest insured banks must have at least one investment grade rated issue of debt outstanding in order for the bank to establish a financial subsidiary. OCC Interpretive Letter No. 981 (August 14, 2003).

- **Delinquent Real Estate Tax Liens.** National banks may invest in delinquent real estate tax liens, where state law does not consider such liens to represent interests in real property. OCC Interpretive Letter No. 717, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,032 (March 22, 1996).

- **Deposit Accounts.** National banks also may make deposits in other depository institutions, provided that total deposits in any nonmember bank do not exceed 10 percent of the national bank's capital and surplus. 12 USC 463. National banks may purchase notes issued by another bank, affiliate, or bank holding company. OCC Interpretive Letter (October 12, 1970).

- **DPC Stock.** National banks may hold securities acquired through foreclosure or otherwise in the ordinary course of collecting a debt previously contracted (DPC). Such securities may be held five years, unless the OCC extends the holding period for up to another five years. 12 USC 24(Seventh) (incidental powers clause); OCC Interpretive Letter No. 643, reprinted in Fed. Banking L. Rep. (CCH) ¶ 83, 551 (July 1, 1992); OCC Interpretive Letter No. 511, reprinted in [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,213 (June 20, 1990).

- **Environmental Redevelopment Fund.** National bank may purchase member shares in a limited liability company (LLC) that primarily benefits low- and moderate- income areas. The LLC provides financing to private and public sector borrowers for environmental analysis and remediation of properties with environmental contamination issues for reuse to attract new and growing businesses, create jobs, provide affordable housing, and support other community development efforts. In addition to the LLC structure, the fund would also seek to protect investors by obtaining third-party insurance for projects that have residual risk, as well as pooled insurance for its portfolio. Approval of Bank's Self-Certification (July 18, 2001) National Bank Community Development Investments 2001 Directory.

- **Equity or Below-Investment-Grade Debt in Exchange for Corporate Debt.** A national bank may accept, as part of a court-administered bankruptcy proceeding, equity

or below-investment-grade debt in exchange for corporate debt originally acquired and held as a Type III investment security, under the authority of national banks to accept such securities in satisfaction of debts previously contracted. OCC Interpretive Letter No. 1007 (September 7, 2004).

- **Fannie Mae and Freddie Mac Perpetual Preferred Stock.** A national bank may invest in perpetual preferred stock issued by Fannie Mae and Freddie Mac without limit, subject to safety and soundness considerations. OCC Interpretive Letter No. 931 (March 15, 2002).

- **Federal Employment Tax Credits.** A national bank may purchase an equity interest in a limited liability company (LLC) whose primary purpose is to invest in an operating company that employs individuals, which employment is expected to qualify the operating for federal employment tax credits, including the Work Opportunity Credit, the Welfare to Work Credit, and the Renewal Community Employment Credit. The bank represented that most of the individuals will be low- and moderate-income individuals, and some may reside in low- and moderate-income areas and/or in areas that have been targeted for redevelopment by the federal government as renewal communities. The LLC will assign the individuals to provide labor hours with companies, many of which operate in low- and moderate-income areas or in areas that have been targeted for redevelopment by a government agency. In addition, the LLC will provide job training, medical insurance, and employee assistance programs for its employees. Community Development Investment Letter 2003-1 (September 26, 2003).

- **Financial Services Company Generating an Enhanced Yield Based on Foreign Tax Benefits.** A national bank operating subsidiary may invest in the preferred shares of a foreign domiciled company. A foreign domiciled bank will be the only other co-investor in the company. The foreign company will invest in long-term assets of the national bank and extend long term credit to the foreign bank co- investor. The structure of the transactions achieves for the company certain foreign tax benefits, which ultimately accrue to its investors. Conditional Approval No. 595 (June 5, 2003).

- **Financing Source for Charter School Facilities.** A national bank may invest in a financing source for charter school facilities when the funds will be made available to charter schools in the mid-Atlantic region that enroll students from predominantly low-income households or are located in predominantly low- income neighborhoods. Community Development Investment Letter 2005-2 (April 13, 2005).

- **Fixed Rate Annuities.** Fixed rate annuities purchased by a national bank are, in substance, debt obligations of the issuing insurance company. OCC Interpretive Letter No. 1021 (February 17, 2005).

- **Foreign Operating Subsidiary.** A national bank and a foreign bank may jointly own a foreign entity that will hold, purchase, and sell loans and other extensions of credit. Although the national bank owns only 10 percent of the voting rights, the entity qualifies

as an operating subsidiary of the national bank because the national bank may exercise control over it. Conditional Approval No. 646 (June 28, 2004).

- **Foreign Government Securities.** National banks may deal in, underwrite, or invest in securities of Canada and political subdivisions of Canada. 12 USC 24(Seventh); 12 CFR 1.2(i). National banks may also invest in the securities of other foreign governments, provided that the securities are marketable debt obligations that are not predominantly speculative in nature and no more than 10 percent of a national bank's capital and surplus is invested in the securities of any one foreign government. 12 CFR 1.2(e), (j).

- **Foundation.** A national bank may make an investment in a foundation that will use the funds to help capitalize a loan pool that makes loans that support affordable housing, community services, or permanent jobs for low- and moderate-income individuals, financing for small businesses; area revitalization or stabilization; or other activities, services or facilities that primarily promote the public welfare. The foundation is a community development financial institution certified by the U.S. Department of the Treasury. Community Development Letter 2003-2 (April 6, 2003).

- **Fund to Acquire Limited Partnership Interests in Native American Affordable Housing.** A national bank may made an investment in a fund created to acquire limited partnership interests in affordable rental housing properties that are located on, or near Native American reservations in Arizona, Wisconsin, Minnesota, Montana, North Dakota, South Dakota, and Wyoming. The fund's projects qualify for federal low-income housing tax credits and historic rehabilitation tax credits and primarily target low- and moderate-income persons and families. Each project is sponsored by an Indian tribe, an affiliated Tribal housing association, Indian housing authority, Indian tribally designated housing entity, Indian nonprofit housing corporation, or similar tribal entity. Approval Letter (April 10, 2000).

- **Gold Shares.** A national bank may buy and sell, for its own account, exchange- traded units of beneficial interest in gold. OCC Interpretive Letter No. 1013 (January 7, 2005).

- **Hedging DPC Stock.** A national bank may purchase and hold options on the shares of stock of a company when the bank has acquired shares of that company in satisfaction of debts previously contracted (DPC). The bank would hold the options to hedge the market risk associated with changes in the value of the DPC shares. OCC Interpretive Letter No. 961 (March 17, 2003).

- **Historic Tax Credit Investment.** National banks may invest in historic tax credit investment in the Central Vermont Arts Center Limited Partnership. The partnership will finance the renovation of a vacant historic property located in an economic revitalization area in Barre City, Vermont. The general partner and project sponsor is a nonprofit corporation that will also lease space for artists and operate an art gallery and teaching facility. The facility will support the establishment of small businesses by providing artists and artisans with studio space and an opportunity to market their work. The proposal was consistent with 12 CFR 24 because the project was intended to serve as the

cornerstone for renewed small business investment and area revitalization, and the property was located in an area that the local government had targeted for revitalization. Approval Letter (October 19, 2000).

- **Housing Investments.** National banks may invest in various HUD-insured loans and obligations issued by government housing projects. National banks may also invest in state housing corporations, subject to a limit of 5 percent of the national bank's capital stock paid and unimpaired plus 5 percent of its unimpaired surplus fund. 12 USC 24(Seventh).

- **Insurance Company Products and Investment Funds, Hedging.** National bank subsidiaries may hold various insurance company products and investment funds containing bank-ineligible securities to hedge, on a dollar-for-dollar basis, the subsidiary's obligations to make payments to employees under certain deferred compensation plans. OCC Interpretive Letter No. 878,reprinted in [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-375 (December 22, 1999).

- **Insurance, Investment in Company That Provides Marketing and Consulting Services to Insurance Agencies.** National bank's insurance agency subsidiaries may acquire a minority interest in a company that provides marketing and consulting services to insurance agencies. Conditional Approval No. 302 (January 21, 1999).

- **Insurance, Investment in Title Agency.** National bank's insurance subsidiary may acquire and hold a minority, noncontrolling interest in a title agency. The title agency can offer both lending and owner title insurance policies as agent, in connection with residential and commercial mortgage loans made by the bank, its affiliates, and by third parties and in cases where no loan is involved. The agency can also provide closing and escrow services and commercial and residential title abstracting services in connection with loans made by the bank, other lenders, and occasionally when no loan is involved. Conditional Approval No. 308 (April 8, 1999). [Editor's note: subsequent changes in the law have affected a national bank's authority to engage in title insurance activities. See 15 USC 6713.]

- **Insurance, Investment in Title Agency and Other Real Estate-Related Activities.** National bank's operating subsidiary may hold a minority investment in a company that engages in title insurance agency, real estate appraisal, loan closing, and other real estate loan-related and finder activities. Conditional Approval No. 332 (July 30, 1999).

- **Investment in Bank Holding Company as Consideration for Sale.** Where a group of financial institutions that jointly owned an EFT network was selling the network to a bank holding company, several national bank members of the group may acquire small equity interests in the bank holding company as consideration for their interests in the network. OCC Interpretive Letter No. 890 (May 15, 2000).

- **Investment in Fund for Solar-Energy Producing Facilities.** A national bank may invest in limited liability entities each of which will develop, acquire, install, and

maintain solar energy-producing facilities and provide electricity for specified properties. Community Development Investment Letter No. 2008-1 (July 31, 2008).

- **Investments in Partnership With Native American Nations.** National bank's community development corporation (CDC) subsidiary may provide financial support and financial services to assist economic development efforts of Native American nations directed toward low- and moderate-income communities. Specific proposed activities of the CDC include: 1) providing financial literacy services; 2) buying, selling, and leasing real estate, for example, in partnership with local housing authorities; and 3) providing, servicing, and maintaining ATMs and ATM and debit cards. Approval of Bank's Self-Certification (December 20, 2002), National Bank Community Development Investments 2002 Directory.

- **Limited Interests in Private Investment Funds.** A national bank may acquire for limited periods of time, limited interests in private investment funds for which it serves as investment manager, as a way to structure its compensation. Because the bank's ownership of limited equity interests in the funds it advises is restricted to a context where the holding is integral to facilitating a recognized bank- permissible activity, such holdings are permissible as an incident to the bank- permissible investment management activities. OCC Interpretive Letter No. 940 (May 24, 2002).

- **Limited Partnership as an Operating Subsidiary.** A national bank may establish a limited partnership (LP) as an operating subsidiary, with a wholly owned limited liability company (LLC) as the limited partner and a wholly owned corporation as the general partner, to conduct a bank permissible activity. The LLC and corporation are each directly and wholly owned by the bank, resulting in the bank exercising, indirectly through the LLC and corporation, all economic and management control over the activities of the LP. The LP will hold participation interests in loans originated and purchased by the bank. Corporate Decision No. 2004-16 (September 10, 2004).

- **Limited-Purpose Bank.** A national bank may, pursuant to 12 USC 24(7) and the four-part test for noncontrolling equity investments by national banks, acquire and hold a noncontrolling equity interest in a limited-purpose, state-chartered bank that will limit its activities to those permissible for a banker's bank, i.e., the proposed bank will 1) take deposits from depository institutions; 2) buy and sell loan participations; 3) engage in lending transactions permissible for a banker's bank; and 4) provide correspondent services to depository institutions. OCC Interpretive Letter No. 970 (June 25, 2003).

- **Merchant Processing.** Application by a national bank to establish an operating subsidiary to engage in merchant processing activities through a limited partnership. The subsidiary will serve as the general partner and hold a 1-percent ownership interest in the limited partnership. A second affiliated national bank will be a limited partner and hold a 99-percent noncontrolling ownership interest in the limited partnership. The limited partnership will engage in proprietary merchant services in which applications are handled online through a software application that enables the sales force to review the application in real time. Corporate Decisions Nos. 582 and 583 (March 12, 2003).

- **Money Market Preferred Stock.** National banks may invest in money market preferred stock as Type III investment securities, provided the investment is marketable and not predominantly speculative in nature. OCC Interpretive Letter No. 781, reprinted in [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) 81,208 (April 9, 1997). Municipal Revenue Bonds. Under 12 USC 24(Seventh), as amended by the Gramm-Leach-Bliley Act, a well-capitalized national bank may underwrite and deal in municipal revenue bonds issued by or on behalf of Puerto Rico. OCC Interpretive Letter No. 915 (August 15, 2001).

- **Mutual Fund Containing General Obligation and Municipal Revenue Bonds.** A national bank may invest in a mutual fund containing general obligation and municipal revenue bonds under 12 CFR 1.3(h)(2). The investment has a risk- weight dependent on the composition of the fund's assets, but in no event will the minimum risk-weight be less that 20 percent, and can be accounted for as either a "trading" or "available-for-sale" asset. OCC Interpretive Letter No. 912 (July 3, 2001).

- **Mutual Fund Shares.** National banks may purchase for their own accounts shares of any "investment company," with certain limitations. Shares of investment companies whose portfolios contain investments subject to the limits of 12 USC 24 may only be held in an account not in excess of either: 1) the amount equal to the appropriate investment limit for each security in the investment company or applied to the aggregate amount of the bank's pro rata holdings of that security in the investment company and the national bank's direct holding of that security; or 2) the most stringent investment limitation that would apply to any of the securities in the investment company's portfolio if those securities were purchased directly by the national bank. 12 CFR 1.4(e).

- **Noncontrolling Minority Interests (Including Limited Liability Companies).** National banks may acquire noncontrolling minority investments in business entities if the entities: 1) engage in activities that are limited to those that are part of or incidental to the business of banking (or otherwise authorized for a national bank), 2) the national bank can prevent the company from engaging in activities that are not part of, or incidental to, the business of banking or be able to withdraw its investment, 3) the national bank's loss exposure is limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligation of the enterprise; and 4) the investment is convenient or useful to the bank in carrying out its business and is not a mere passive investment unrelated to that national bank's banking business. Conditional Approval No. 371 (March 20, 2000). The following are examples of these investments:

  - *Investment in LLC (Automobile Loans).* National banks can acquire a noncontrolling investment, through an operating subsidiary, in a limited liability company (LLC) that provides automobile loans. Loan customers are people, who purchase cars over the Internet from other, non-national bank investors in the LLC. Conditional Approval No. 321 (July 28, 1999).

  - *Investments in LLCs (Cash Management, Electronic Payment, Information Reporting, and Data Processing Services).* National bank's operating subsidiary can assume

noncontrolling investments in limited liability companies that conduct cash management, electronic payment, information reporting, and data processing services. Conditional Approvals Nos. 324 (August 17, 1999) and 333 (October 19, 1999).

- *Investment in LLC (Credit Reporting Services).* National bank's operating subsidiary can hold a minority interest in a limited partnership to provide credit reporting services to the bank, its subsidiaries, affiliates, and eventually to nonaffiliated creditors. Conditional Approval No. 336 (November 2, 1999).

- *Investments in LLCs (Electronic Commerce).* National banks may acquire minority, noncontrolling interests in limited liability companies (LLC) that provide electronic commerce services and financial application software and related products. OCC Interpretive Letter No. 289 (May 15, 1989).

- *Investment in LLC (Employee Benefit Plans).* A national bank may acquire and hold noncontrolling equity interests in a limited liability company (LLC) that administers employee benefit plans for: 1) its investors, which are primarily financial institutions; and 2) other companies that have no equity interest in the LLC. OCC Interpretive Letter No. 994 (June 14, 2004).

- *Investment in LLC (Loans to and Investments in Medium- and Small-Sized Businesses.* National banks can acquire noncontrolling ownership interests in LLCs that make loans to and qualifying investments in medium- and small-sized businesses and invest in a small business investment company (SBIC), which, in turn, will make loans and invest in securities permissible under the SBIC Act. Conditional Approval No. 305 (March 15, 1999).

    - An SBIC is a privately organized and managed venture capital firm that is licensed and regulated by the Small Business Administration (SBA). An SBIC provides equity capital, long-term loans, debt-equity investments, and management assistance to qualifying small businesses, subject to significant regulatory restrictions. An SBIC is subject to limitations on the size and type of small businesses in which it may invest. Companies eligible for SBIC investments must have a net worth of under $18 million and under $6 million in net income at the time the investment is made. A national bank's aggregate SBIC investments are statutorily limited to 5 percent of the bank's capital and surplus.

    - Generally, an SBIC may invest in a variety of types of companies not limited to those that are financial in nature, but an SBIC may not invest in: other SBICS, finance and investment companies or leasing companies, unimproved real estate, companies with less than one-half of their assets and operations in the United States, passive or casual businesses (those not engaged in regular and continuous business operation), or companies that will use SBIC proceeds to invest in farmland.

- An SBIC may not have a controlling interest or own more than 50 percent of the voting equity of a company, in which it invests unless the SBIC has a plan of divestiture. In the latter case, the SBIC may have a controlling interest for up to seven years.

- An SBIC also must have experienced and qualified management, and to maintain diversification between an SBIC's investors and its management. In addition, an SBIC must conduct frequent investment valuations, file annual financial reports with the SBA, and submit to biennial compliance examinations by the SBA.

– *Investment in LLC (Origination of Residential Loans)*. National banks may make a direct, noncontrolling investment in a limited liability company (LLC) with an unaffiliated mortgage company as the other investor. The LLC may engage in the origination of residential mortgage loans with resale to investors in the secondary market. OCC Interpretive Letter No. 853, reprinted in [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,310 (February 16, 1999).

– *Investment in LLC (Title Insurance)*. National banks can acquire a noncontrolling interest in an LLC that engages in title insurance agency activity, loan closing, and other activities in connection with consumer and commercial loans made by the bank or the bank's lending affiliate. OCC Interpretive Letter No. 842, reprinted in [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,297 (September 28, 1998). [Editor's note: subsequent changes in the law have affected a national bank's authority to engage in title insurance activities. See 15 USC 6713.]

– *Second-Trust Deed Permanent Loan*. A national bank may invest, as a limited partner, in a community development entity formed under the federal new markets tax credit program which acquires real estate loan made to qualified, active, low-income community businesses. The specific investment fund invests in second-trust deed permanent loans on retail, office, commercial, and industrial projects. Approval of Bank's Self- Certification (November 22, 2004).

- **Nonprofit Making Loans to Low-Income Parents**. A national bank may invest in a private multi-service agency serving low-income parents transitioning from welfare to work. The agency provides small loans, for those workers who cannot get loans elsewhere, to help family members pay for unexpected expenses that can interfere with their ability to keep a job or stay in school. Community Development Investment Letter 2005-1 (April 7, 2005).

- **Other Issuers**. If an issuer does not fall within specified criteria for other categories of investment securities, a national bank may treat a debt security as an investment security for purposes of Part 1, if the national bank concludes, on the basis of estimates that the bank reasonably believes reliable, that the obligor will be able to satisfy its obligations under that security, and the national bank believes that the security may be sold with reasonable promptness at a price that corresponds reasonably to its fair value. The aggregate par value of these securities may not exceed 5 percent of the national bank's

capital and surplus. 12 CFR 1.4(i), OCC Interpretive Letter No. 779, reprinted in [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,206 (April 3, 1997).

- **Performance Note Loans (PNL).** National banks may purchase PNLs, issued by affiliates of private mortgage insurers, as loans. A PNL is a debt security bearing a variable interest rate linked to the performance of the mortgage loans that the lender originated and the mortgage insurer insured. OCC Interpretive Letter No. 833, reprinted in [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,287 (July 8, 1998), 834, reprinted in [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,288 (July 8, 1998).

- **Private Investment Fund.** National banks may acquire for their own account beneficial interests in a privately offered investment fund that would invest in loans, cash and cash equivalents, and an offshore fund that invests solely in loans. National banks may hold interests in the fund either as securities under the reliable estimates standard of Part 1 or as loan participations. OCC Interpretive Letter No. 911 (June 4, 2001).

- **Public Welfare Investments.** National banks have express authority to invest, directly or indirectly (such as through community development corporations), in investments designed primarily to promote the public welfare. These investments are limited to 5 percent of the national bank's unimpaired capital stock (actually paid in) and surplus fund. However, the OCC may approve investments up to a total of 10 percent of unimpaired capital and surplus for national banks that are at least adequately capitalized, if the OCC determines that an investment over the 5- percent limit will pose no significant risk to the deposit insurance fund. In no case may a public welfare investment expose a national bank to unlimited liability. 12 USC 24(Eleventh).

  - *Public Welfare Activities.* The types of activities that are considered to be public welfare investments include, but may not be limited to, those that provide or support affordable housing, community services, or permanent jobs for low- or moderate-income individuals; equity or debt financing for small businesses; and area revitalization or stabilization. 12 CFR 24.3(a). For example, national banks may invest in limited partnerships investing in affordable housing projects approved for low-income housing tax credits. E.g., letter from Janice A. Booker, Director, Community Development Division, to Yasumasa Gomi, Chairman of the Board, President, and CEO, The Bank of California (December 22, 1992). A national bank also may make an equity investment in a real estate investment trust that focuses primarily on community development activities, such as making investments in and purchasing loans that will benefit low- and moderate-income individuals and areas. Letter from Janice A. Booker, Director, Community Development Division, to Michael E. Bleier, General Counsel, Mellon Bank (February 25, 1999). National banks may also invest in and form community partnerships with community development financial institutions. Letter from Janice A. Booker, Director, Community Development Division, to Larry Hawkins, President, Unity National Bank (November 16, 1998).

- *Public Welfare Purpose*. By regulation, public welfare investments must primarily benefit low- and moderate-income individuals, low- and moderate-income areas, or other areas targeted for redevelopment by local, state, tribal or federal government (including federal enterprise communities and federal empowerment zones). 12 CFR 24.3(a). A majority of the activities of an investment must benefit the targeted beneficiaries in order for the activity to be designed primarily to promote the public welfare, but the remainder of the activities need not. OCC Interpretive Letter No. 837, reprinted in [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,291 (September 4, 1998).

- **Purchase of Bonds and Other Tax Exempt Instruments Issued by Government Agencies.** A national bank may purchase preferred shares in a trust that acquires and owns tax-exempt participating and nonparticipating first mortgage bonds and other tax-exempt instruments that are issued by various state or local government, agencies or authorities. The proceeds from the bonds are used for financing affordable housing development and rehabilitation, and most of those properties also benefit from the use of federal low-income housing tax credits. Community Development Investment Letter 2003-3 (September 30, 2003).

- **Purchase of Shares in CDC Subsidiary of Affiliated National Bank.** Four affiliated national banks may each purchase shares in an existing community development corporation (CDC) subsidiary that previously had been formed and capitalized by a fifth affiliated national bank. As a result of the new investments, the CDC subsidiary expanded its products and services to the states that the new shareholders served. Approval of Banks' Self-Certifications (January 30, 2002; January 31, 2002; May 9, 2002; and May 9, 2002), National Bank Community Development Investments 2002 Directory.

- **Real Estate (Non-Thrift/Bank Premises).** Aside from property necessary for the transaction of its business, the authority of national banks to purchase and lease real estate has been limited to special circumstances, including purchasing and leasing real estate for municipal purposes (including purchasing vacant land for this purpose) and purchasing residences of bank employees who have been transferred. In addition, national banks may purchase, hold, and convey real estate as mortgaged to them or conveyed as security for or in satisfaction of debts previously contracted, and as purchased at sales under judgments, decrees, or mortgages held by a bank or to secure debts due to it. National bank may not hold real estate conveyed to it to satisfy debts previously contracted for longer than five years, unless a period of up to an additional five years is approved by the OCC 12 USC 29; 12 CFR 7.1000; 12 CFR 34; OCC Interpretive Letter No. 847, reprinted in [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,302 (October 28, 1998).

- **Reinsurance Company.** Insurance agency operating subsidiary of a national bank may make a minority equity investment in a Bermuda reinsurance company that is necessary for the subsidiary to obtain liability insurance for itself. OCC Interpretive Letter No. 965 (February 24, 2003).

- **Reinsurer, Holding Noncontrolling Interests.** National banks may hold a noncontrolling interest in an insurance company that reinsures mortgage life, mortgage accidental death, and mortgage disability insurance on loans originated by the lenders with an ownership interest in the insurance company. OCC Interpretive Letter No. 835 reprinted in [1998-99 Transfer Binder] Fed. Banking L. Rep. (CCH) 81-289 (July 31, 1998).

- **Residential Mortgage-Related Securities.** National banks may invest in certain investment grade residential mortgage-related securities. 12 CFR 1.3(e).

- **Retention of Stock Holdings Resulting From Conversion.** Bank may retain shares of stock that it received as a result of being a policyholder of a mutual life insurance company that converted to stock form. The stock is not an impermissible purchase of stock, but a byproduct of the permissible activity of purchasing life insurance for the bank's needs. Divestiture of the stock will be required only if safety and soundness concerns arise in the future. This is an issue that many banks will face, as increasing numbers of life insurance companies "demutualize." OCC Interpretive Letter No. 905 (January 29, 2001).

- **Second-Trust Deed Permanent Loan.** A national bank may invest, as a limited partner, in a community development entity formed under the federal new markets tax credit program which acquires real estate loan made to qualified, active, low-income community businesses. The specific investment fund invests in second-trust deed permanent loans on retail, office, commercial, and industrial projects. Approval of Bank's Self-Certification (November 22, 2004).

- **Small Business Investments.** National banks may invest in investment-grade, small business-related securities that are fully secured by interests in a pool of loans to numerous obligors. National bank investments in securities of any one issuer rated investment grade in the third or fourth highest categories may not exceed 25 percent of the national bank's capital and surplus. In addition, national banks may invest in small business investment companies (SBIC) in an aggregate amount of up to 5 percent of the national bank's capital and surplus. 12 USC 24(Seventh); 12 CFR 1.3(a); OCC Interpretive Letter No. 373, reprinted in [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,543 (November 13, 1986).

- **Stock Warrants.** A national bank that permissibly acquired stock warrants of borrower (12 CFR 7.1006) may, under the specific circumstances and conditions represented by the bank, exercise the warrants in order to immediately sell the resulting stock. OCC Interpretive Letter No. 992 (May 10, 2004).

- **Streamlined Approval for CDC Investments in Connection With Thrift Conversion Into National Bank.** Federal thrift may retain its existing CDC investments provided that they qualify as public welfare investments under 12 CFR 24 without a separate filing under 12 CFR 24. The OCC will review the CDC investments in connection with the

conversion application and will determine whether the investment is approved in connection with the conversion decision. Corporate Decision 2002-7 (June 16, 2001).

- **Stock in Life Insurance Underwriter.** National bank may accept and retain stock in a life insurance underwriter that it received as a result of being a policyholder of the company, which was converting from mutual to stock form ("demutualization"). OCC Interpretive Letter No. 901 (June 29, 2000).

- **Structured Finance Transaction.** A national bank may acquire an interest in an operating subsidiary in which a financial services company chartered and operating in the United Kingdom also will have an interest. The operating subsidiary was created for the purpose of facilitating a complex structured finance transaction by which the national bank will lend money to the financial services company. Corporate Decision Letter No. 646 (June 28, 2004).

- **Tax Credits.** A national bank may make a noncontrolling investment in a limited liability company (LLC) in order to generate new markets tax credits. The LLC may engage in activities not permissible for national banks as long as the bank's investment in a series of membership units is segregated from all other investments and used only for bank permissible purposes. OCC Interpretive Letter No. 996 (July 6, 2004).

- **Transitional Housing.** A national bank may invest, through its subsidiary community development corporation (CDC), in the acquisition and rehabilitation of a single-family dwelling to provide transitional housing for the homeless. The CDC will own and manage the property and residents of the facility will receive case management support from an established nonprofit social services provider. After successful completion of the transitional housing program, for a term of one to two years, qualified residents would be provided an option to purchase the dwelling. Approval of Bank's Self-Certification (April 26, 2004).

- **Trust Bank Stock.** National banks may establish operating subsidiaries to serve as a general partner in a partnership that will own a trust company. National banks may acquire a minority interest in a limited purpose trust bank. OCC Interpretive Letter Nos. 697, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,012 (November 15, 1995), 831, reprinted in [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,285 (June 8, 1998).

- **Trust Preferred Securities Purchased as Investment Securities.** National banks may invest in trust preferred securities that meet applicable rating and marketability requirements as Type III investment securities under 12 CFR 1. OCC Interpretive Letter No. 777, reprinted in [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,204 (April 8, 1997).

- **Trust Preferred Securities Purchased Under Lending Authority.** A national bank may purchase under its lending authority, trust preferred securities that are not marketable and thus do not qualify as investment securities under Part I, subject to the

lending limits of 12 USC 84 and the requirements of Banking Circular 181 (REV). OCC Interpretive Letter No. 908 (April 23, 2001).

- **U.S. Government-Sponsored Corporation Securities.** National banks may invest, without limitation, in obligations of Fannie Mae, Ginnie Mae, Freddie Mac, Sallie Mae, FHLBanks, Federal Finance Bank, and Farmer Mac 12 USC 24(Seventh). National banks may purchase preferred stock of Freddie Mac and Sallie Mae. OCC Interpretive Letter (December 3, 1992); OCC Interpretive Letter No. 577, reprinted in [1991-1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,347 (April 6, 1992). National banks may invest in the stock of FHLB, in excess of minimum membership requirements. OCC Interpretive Letter No. 755, reprinted in [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,119 (October 3, 1996). National banks may purchase stock of Fanner Mac, OCC Interpretive Letter No. 427 reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 7, 1988), and Fannie Mae, 12 USC 1718(f). In addition, national banks may invest in obligations of the TVA, Postal Service, and various international development banks, provided investments in any one of these latter entities do not exceed 10 percent of capital and surplus. 12 USC 24(Seventh); 12 CFR 1.20. National bank may hold up to 5 percent of its capital and surplus in stock of state housing corporations. 12 USC 24(Seventh).

- **U.S., State, and Local Government Securities.** National banks may invest in securities issued or guaranteed by the United States or any agency of the United States, as well as general obligations of any state or political subdivision thereof and the Washington Metropolitan Area Transit Authority. 12 USC 24(Seventh); 12 CFR Part 1.

- **Use of New Markets Tax Credits.** National bank may invest in wholly owned subsidiary that, in turn, makes an investment in a fund that is certified by the U.S. Department of the Treasury as a "community development entity." The fund will provide debt and equity financing for retail, office, commercial, distribution, industrial mixed-use, and community facility projects in targeted low- and moderate-income areas. The fund is anticipated to earn federal new markets tax credits that will be usable by the bank and other investors. Approval of Bank's Self-Certification (August 28, 2002), National Bank Community Development Investments 2002 Directory.

- **Various Activities of CDC Subsidiary.** A national bank's community development corporation (CDC) subsidiary may conduct various community and economic development activities that primarily benefit low- and moderate-income individuals, low- and moderate-income areas, or other areas targeted for redevelopment by local, state, federal, or tribal governments. The approved activities of the CDC include: 1) providing financing to a corporation that owns and operates a charter school, funded by the state, that educates "at-risk" students, who are primarily low- and moderate-income and have exhibited behavioral or drug problems in other schools; 2) providing financing at reduced rates to low- and moderate-income families that received subsidies under state and federal government programs for the purchase of their first homes; 3) investing in an entity that renovated a commercial building leased to a state government agency that provides training to unemployed low- and moderate-income individuals and assists them

in finding employment; 4) financing the education of a medical student who had committed to work after graduation for a facility that provides medical services to low-income families; 5) providing working capital for a convenience and hardware store in a low- and moderate-income community; and 6) investing in a fund that provides financing for developing and operating affordable housing and is anticipated to earn federal low-income housing tax credits that will be usable by the bank. Approval of Bank's Prior Approval Requests and Self-Certifications (April 16, 2002; May 3, 2002; May 3, 2002; July 18, 2002; September 23, 2002; and September 23, 2002), National Bank Community Development Investments 2002 Directory.

- **Warrants for Common Stock.** National banks may establish operating subsidiaries to acquire warrants for common stock. Conditional Approval No. 319 (July 26, 1999).

Community Development

- **Fund Comprising SBA Guaranteed Loans.** A national bank may make an investment in a fund which invests in the federally guaranteed portion of Small Business Administration 7(a) loans. Publication pending (February 8, 2006).

- **Fund for Construction of Agricultural Facilities.** A national bank may make an investment in a community and economic development entity that funds construction of agricultural-product receiving bins, which will increase the tax base and produce jobs in a low- and moderate-income area. Community Development Investment Letter 2009-2 (January 6, 2009).

- **Fund for Construction of Rent-to-Own Affordable Rental Housing.** A national bank may make an investment in a community and economic development entity which will use new markets tax credits, for the construction of a rent-to-own affordable housing complex in a low- and moderate-income area. Community Development Investment Letter 2009-5 (June 17, 2009).

- **Fund to Construct an Industrial Facility on Indian Reservation.** A national bank may make an investment in a community and economic development entity that constructs an industrial facility that will produce jobs on an Indian reservation in a low- and moderate-income area. Community Development Investment Letter 2009-3 (March 9, 2009).

- **Fund to Renovate and Lease a Residential Drug and Alcohol Treatment Center.** A national bank may make an investment in a community and economic development entity, which uses new markets tax credits, for the renovation and lease of a residential drug and alcohol treatment center in a low- and moderate income area. Community Development Investment Letter 2009-4 (June 17 2009).

- **Fund to Provide Low-Cost Products and Services.** A national bank may make an investment in community and economic development entities that have a dedicated adherence to provide low-cost financial products and services for underbanked and low-

to-moderate income consumers. Community Development Investment Letter [No. pending] (April 5, 2011).

- **Investment in Fund to Install Photovoltaic System in Low-Income Housing Tax Credit Project.** A national bank may make an investment in a Community and Economic Development Entity that will install photovoltaic systems in low income housing tax credit projects. These systems will qualify for renewable energy tax credits. Community Development Investment Letter No. 2009-6 (December 16, 2009).

- **Investment in Fund for Solar–Energy-Producing Facilities.** A national bank may make an equity investment to acquire a membership interest in a fund (the company) established as a limited liability company that will sign a master lease for a solar-energy project financed by the company. The managing member of the company is a renewable-energy utility company that designed, insured, and maintained customized solar systems for industrial, commercial, and municipal enterprises. The investment primarily benefits low- and moderate-income areas Community Development Precedent Letter 2009-01 (February 17, 2009).

- **Investment in the Construction and Sale of Single Family Properties.** A national bank's subsidiary community development corporation may invest in the construction of single family homes, which are then resold, located in low- or moderate-income communities. Community Development Investment Letter 2007-2 (October 11, 2007).

- **Investment in the Renovation and Resale of Single Family Properties.** A national bank's subsidiary community development corporation may invest in the acquisition and renovation of single family homes, which are then resold, located in low- or moderate-income communities. Community Development Investment Letter 2007-1 (August 17, 2007).

- **Stabilizing Communities.** National banks may use a variety of funding and financing tools, such as the Department of Housing and Urban Development's Neighborhood Stabilization Program and the new markets and low-income housing tax credit programs to facilitate the sale of foreclosed properties. Stabilization activities may qualify for consideration under the Community Reinvestment Act. "Property Disposition: Exploring Different Approaches for Preserving Affordable Housing Opportunities," Community Developments Insights (March 2009).

Other Investments

- **Additional Expenditures on Other Real Estate Owned (OREO) Property.** National banks, under some conditions, may make additional expenditures on OREO property in order to facilitate the disposal of the OREO. Banks cannot make additional expenditures on OREO property for speculative purposes, such as ground-up construction and sale of completed residences in order to achieve greater return. 12 CFR 34.86(a). OCC Interpretive Letter 1129 (February 3, 2011).

APPENDIX B

Comptroller of the Currency
Administrator of National Banks

Investment Securities

Comptroller's Handbook (Section 203)

Narrative and Procedures - March 1990

A

Assets

Investment Securities (Section 203)

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Investment Securities (Section 203)

Introduction

This section discusses money market investments and securities purchased by the bank for its own account. Securities purchased primarily for resale to customers, i.e., trading account securities, are discussed in a separate section of this handbook.

The term "money market" generally refers to the markets for short- term credit instruments, such as commercial paper, bankers' acceptances, negotiable certificates of deposit, repurchase agreements, and federal funds. Although not carried in the investment account, such instruments generally are handled by the investment officer. The highly liquid nature of such investments allows the bank to employ temporarily idle funds in interest bearing assets that usually can be converted quickly into cash. The speed of conversion, however, depends on the quality of the investment. Quality can be monitored through credit analysis, emphasizing a review of current financial information, the use of specializing rating services, and frequent collateral valuation. Since money market transactions generally involve a large volume of funds, deficiencies in credit or administrative policies can quickly result in serious problems. The investment policy should include limitations on authority of personnel, restrictions regarding asset type, and amount and established credit standards. Compliance with policy guidelines should be assured through adequate internal controls, audit coverage, and internal supervisory review.

Investment securities, representing obligations purchased for the bank's own account, may include United States government obligations; various Federal agency bonds; state, county, and municipal issues, special revenue bonds; industrial revenue bonds; and certain corporate debt securities. Securities included in the investment account should provide a reasonable rate of return commensurate with safety, which must take precedence. Investment considerations should come into play only after provision for all cash needs and reasonable loan demands have been met. Accordingly, an investment account should contain some securities that may be quickly converted into cash by immediate sale or by bonds maturing. Hence, liquidity and marketability are of the utmost importance. A bond is a liquid asset if its maturity is short and if there is assurance that it will be paid at maturity. It is marketable if it may be sold quickly at a price commensurate with its yield and quality. The highest quality bonds have those two desirable qualities.

Investments, like loans, are extensions of credit involving risks that carry commensurate rewards. However, risks in the investment portfolio should be minimized to ensure that liquidity and marketability are maintained. Bank management must recognize that the investment account is primarily a secondary reserve for liquidity rather than a vehicle to generate speculative profits. Speculation in marginal securities to generate more favorable yields is an unsound banking practice.

Occasionally, examiners will have difficulty distinguishing between a loan and a security. Loans result from direct negotiations between a borrower and a lender. A bank will refuse to grant a loan unless the borrower agrees to its terms. A security, on the other hand, is usually acquired through a third party, a broker or dealer in securities. Most securities have standardized terms that can be compared to the terms of other market offerings. Because the terms of most loans do not lend themselves to such comparison, the average investor may not accept the terms of the lending arrangement. Thus, an individual loan cannot be regarded as a readily marketable security.

Limitations and Restrictions on National Banks' Holdings

National banks are governed in their security investments by the seventh paragraph of 12 USC 24 and by the investment securities regulation of the Comptroller of the Currency (12 CFR 1). The investment securities regulation defines investment securities; political subdivision; general obligation; and Type I, II, and III securities, and establishes limitations on the bank's investment in those securities. The law, 12 USC 24, requires that for a security to qualify as an investment security, it be marketable and not predominantly speculative.

For its own account, a bank may purchase Type I securities, which are obligations of the U.S. government or its agencies and general obligations of states and political subdivisions (see 12 USC 24(7)), subject to no limitations, other than the exercise of prudent banking judgment. The purchase of Type II and III securities (see 12 CFR 1.3(d) and (e)) is limited to 10 percent of capital and surplus for each obligor when the purchase is based on adequate evidence of the maker's ability to perform. That limitation is reduced to 5 percent of capital and surplus for all obligors in the aggregate where the purchase judgment is predicated on "reliable estimates." The term "reliable estimates"

refers to projections of income and debt service requirements or conditional ratings when factual credit information is not available and when the obligor does not have a record of performance. Securities purchased subject to the 5 percent limitation may, in fact, become eligible for the 10 percent limitation once a satisfactory financial record has been established. There are additional limitations on specific securities ruled eligible for investment by the OCC that are detailed in 12 CFR 1.3. The par value, not the book value or purchase price, of the security is the basis for computing the limitations. However, the limitations do not apply to securities acquired through debts previously contracted.

When a bank purchases an investment security that is convertible into stock or has stock purchase warrants attached, entries must be made by the bank at the time of the purchase to write down the cost of the security to an amount representing the investment value of the security exclusive of the conversion feature or the attached stock purchase warrants. The purchase of securities convertible into stock at the option of the issuer is prohibited (12 CFR 1.10).

Mortgage Backed Securities

Most mortgage backed securities (MBS) pass-through obligations are issued by or obligations of GNMA, FNMA, or FHLMC. Accordingly, banks may invest in them in unlimited amounts.

The Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) amended 12 USC 24(7) and allows national banks to purchase and hold "mortgage related securities" without any statutory limitation. Collateralized Mortgage Obligations (CMO's) and Real Estate Mortgage Investment Conduits (REMIC's) are "mortgage related securities" for the purposes of SMMEA if they are offered and sold pursuant to Section 4 (5) of the Securities Act of 1933 (15 USC 77d(5)); or are mortgage related securities as that term is defined in Section 3(a) (41) of the Securities Exchange Act of 1934 (15 USC 78c(a) (41)).

Information as to when a "mortgage related security" is covered by SMMEA is usually found in the security's prospectus or offering circular. Look in the index of the prospectus under SMMEA or legal matters. A privately issued MBS that is not fully collateralized by U.S. government or Federal agency obligations must be supported by a credible opinion that it is covered by SMMEA. In the absence of such an opinion, this type of security may be subject to a Type III investment limit or, depending upon the facts, considered ineligible for national bank

investment. Interest Only (IOs) portions and Residual interests in any of the above listed securities are not unconditional obligations of the issuer, and, accordingly, these derivative products are not eligible for the same holding limitations.

Private Placements

The absence of a public market for securities which are "privately placed" makes them ineligible as investments for national bank investment portfolios. Refer to handbook section 411 for a more complete discussion of private placements.

Mutual Funds and Investment Companies

A national bank may purchase for its own account without limitation shares of investment companies as long as the portfolios of such companies consist solely of obligations that are eligible for purchase without limitation by national banks for their own account pursuant to the provisions of paragraph Seventh of 12 USC 24. Shares of investment companies whose portfolios contain investments subject to the limits of 12 USC 24 or 84 may only be held in an amount not to exceed 10 percent of capital and surplus. That is, a bank may invest only an amount not to exceed 10 percent of its capital and surplus in each such investment company. Also, to be eligible for national bank investment, the investment company must be registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and Securities Act of 1933 or be a privately offered fund sponsored by an affiliated commercial bank. This can be determined by a review of the fund's prospectus.

Banks that invest in such investment companies must be aware of the possibility that a bank may violate the 10 percent limitation because of the cumulative holdings of a particular security in the portfolios of more than one investment company or in combination with the bank's direct holdings. Accordingly, a bank that has invested in shares of more than one investment company must determine that its pro rata share of any security in the fund portfolio subject to the 10 percent limitation does not exceed it by being combined with the bank's pro rata share of that security held by all other funds in which the bank has invested and with the Bank's own direct investment portfolio holdings. Therefore, the holdings of investment companies whose shares are held by the bank must be reviewed quarterly.

The bank's investment policy as formally approved by its board of directors should: (1) provide specifically for such investments; (2) require that for initial investments in specific investment companies prior approval of the board of directors be obtained and recorded in the official board minutes; and (3) ensure that procedures, standards, and controls for managing such investments are implemented prior to making the investment.

A bank's investment in shares of investment companies that use futures, forward placement and options contracts, repurchase agreements, and securities lending arrangements as part of their portfolio management strategies is permitted, provided that those instruments would be considered acceptable for use in a national bank's own investment portfolio.

In addition to considering the types of instruments used for each investment company and applicable investment limits, national bank portfolio managers should weigh the practical liquidity of holdings of investment company shares. Mutual Funds Shares and Unit Investment Trust (UIT) units are much less marketable generally than many types of "investment securities," particularly U.S. government and federal agency issues. Indeed, certain investment company fee structures, such as "deferred contingency" fees (declining rear-end load fees), may actually impede marketability. Most municipal authorities will not accept mutual fund shares as collateral for pledge against uninsured public deposits or for other pledging purposes. Units of closed-end tax exempt UITs may present particular liquidity problems because they may not be readily redeemable nor have a secondary market.

Generally Accepted Accounting Principles and the instructions for the quarterly Reports of Condition require that bank holdings of investment company shares be reported at the lower of the aggregate cost or market value. The market value of "open-end" investment company shares reported should be based on net asset value rather than offering price; shares in "closed-end" investment companies should be marked to the bid price. In no case should the carrying value of investment company holdings be increased above their aggregate cost as a result of net unrealized gains. Net unrealized losses on marketable equity securities and subsequent recoveries of those losses should be excluded from the income statement and be reported instead (reduced by the applicable income tax effect) as an adjustment to "Undivided Profits and Capital Reserves." A loss other than a temporary one on an individual investment held by the fund should be changed to noninterest expense on the income statement.

As part of the market value determination, mutual funds sales fees, both "front-end load" and "deferred contingency," must be deducted to reflect more accurately the current value of fund shares. Consequently, unless the market value of such shares increases sufficiently to offset those fees, their amount must be reflected at the end of the first reporting period as unrealized losses and charged against "Undivided Profits and Capital Reserves."

Generally, banks are prohibited from investing in stocks. However, detailed below are a number of exceptions to that rule:

Permitted Stock Holdings by National Banks

Type of stock	*Authorizing statute and limitation*
Federal Reserve Bank	12 USC 282—Subscription *must* equal 6 percent of the bank's capital and surplus, 3 percent paid in. (Regulation I, Federal Reserve Board; 12 CFR 209)
Safe deposit corporation	12 USC 24—15 percent of capital and surplus.
Corporation holding bank premises	12 USC 371(d)—100 percent of capital. Limitation includes total direct and indirect investment in bank premises in any form. Maximum limitation may be exceeded with permission of the District Deputy Comptroller (12 CFR 7.3100).
Small business investment company	15 USC 682(b)—5 percent of capital and surplus. After January 10, 1968, national banks are prohibited from acquiring shares of such a corporation if, upon making the acquisition: • The aggregate amount of shares in small business investment companies then held by the bank would exceed 5 percent of its capital and surplus.
Banking service corporation	12 USC 1861 and 1862—10 percent of capital and surplus. Limitation includes total direct and indirect investment in any form. Also, corporation must be owned by one or more banks.
Foreign banking corporation	12 USC 601 and 618—10 percent of capital and surplus with the provision that capital and surplus must be $1 million or more.
Corporation authorized under Title IX of the Housing and Urban Development Act of1968 (amendments not included)	12 USC 1718(f)—No limit.
Federal National Mortgage Association	12 USC 1718(f)—No limit.
Bank's own stock	12 USC 83—Shares of the bank's own stock may not be acquired or taken as security for loans, except as necessary to prevent loss from a debt previously contracted in good faith. Stock, so acquired, must be disposed of within 6 months of

Type of stock	*Authorizing statute and limitation*
	the date of acquisition.
Corporate Stock acquired through debts previously contracted (DPC) transaction.	Case law has established that stock of any corporation may be acquired to prevent loss from a debt previously contracted in good faith. However, if the stock is not disposed of within a reasonable time period, it loses its status as a DPC transaction and becomes a prohibited holding under 12 USC 24(7). The maximum time such stock can be retained generally is regarded to be 5 years. The maximum time limit for stock of affiliates acquired through a DPC transaction, and not held within the limitations of specific statutes, is 2 years.
Corporate stock acquired as a dividend from a small business investment company (SBIC)	12 CFR 7.7535—No limit. Stock of any corporation may be acquired and retained, if received as a dividend on SBIC stock.
Operating subsidiaries	12 CFR 7.10—No limit. Stock of any operating subsidiary corporation, the functions or activities of which are limited to those authorized to a national bank, may be acquired and held without limitation, provided that at least 80 percent of the voting stock of the subsidiary is owned by the bank. The establishment of an operating subsidiary requires the prior approval of the OCC (12 CFR 7.7378 through 7.7380).
State Housing Corporation incorporated in the state in which the association is located	12 USC 24—5 percent of its capital stock, paid in and unimpaired plus 5 percent of its unimpaired surplus fund when considered together with loans and commitments made to the corporation.
Agricultural Credit Corporation	12 USC 24—20 percent of capital and surplus unless the association owns over 80 percent. No limit if association owns 80 percent or more.
Government National Mortgage Association	12 USC 24—No limit.
Student Loan Marketing Association	12 USC 24—No limit.
Minibank Capital Corporation	12 CFR 7.7480—2 percent of capital and surplus. Aggregate investment in all such projects should not exceed 5 percent of capital and surplus.
Charitable foundations	12 CFR 7.7445—Contribution in any one year not to exceed income tax deduction.
Community development corporation	12 CFR 7.7480—2 percent of capital and surplus. Aggregate investments in such projects should not exceed 5 percent of capital and surplus
Bankers' banks	12 USC 24—10 percent of capital stock and paid in and unimpaired surplus. Bankers' bank must be insured by the FDIC, owned exclusively by other banks, and engaged solely in providing banking services to other banks and their officers, directors, or employees. Ownership shall not result in any bank acquiring more than 5 percent of any class of voting securities of the bankers' bank.