

# Interpretations—July 1 to September 30, 2002

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# Interpretive Letters

938—January 18, 2001

## 12 USC 84(d)(2)(b)

Dear [ ];

This is in response to your letter of December 11, 2000. You have requested the Office of the Comptroller of the Currency's (OCC's) opinion as to whether certain loans made by [ ] ("bank") to two separate borrowing entities that are related through common ownership would be combined for lending limit purposes. Based on the information you provided in your letter and subsequent e-mails, it is my opinion that the two bank loans may be combinable for purposes of the legal lending limit during the year 2001 for the reasons set forth below.

### I. Facts

The bank has two outstanding credit facilities totaling \$14,620,000 to two limited liability companies managed by [ ] ("Inc."). [ Inc.] is wholly owned by [A], [B], and [C].

The first credit is a \$9,620,000 line of credit to [ ] ("West") for the purposes of land acquisition and site development. The acquired property is 67 acres located on the west side of Rt. [#] in [City, State]. West will develop the site for shopping center lots for sale to retailers. Repayment of the loan is expected from sale of the developed lots to various retailers, including [#1] and [#2]. The owners of West are:

[A]	29.5 percent
[B]	29.5 percent
[C]	29.5 percent
[D]	8 percent
[E]	2.5 percent
[Inc.]	1 percent

The loan is guaranteed by [Inc.], [A], [B], and [C]. West may use [ ] ("Inc. 2"), a wholly owned subsidiary of [Inc.], to perform the site development work.

The second credit is a \$5 million line to [ ] ("East"). The purpose of this loan is to finance the land acquisition and site development phase of a two-phase shopping center development project. The second phase, involving the construction of retail stores on the site, will be financed through a conventional commercial construction loan.

The phase two financing will not be underwritten until a majority of the leases with the major tenants are executed. [Inc.] currently has secured letters of intent from 100 percent of the major tenants (i.e., [#3], [#4], [#5], [#6], and [#7]). The expected source of repayment of the loan will be a take out by the phase two financing. East is owned by:

[A]	24.83 percent
[B]	24.83 percent
[C]	24.83 percent
[D]	22 percent
[E]	2.5 percent
[Inc.]	1.01 percent

The loan is guaranteed by [Inc.], [A], [B], and [C]. East may also use [Inc. 2] to perform the site development work.

The projected cash expenditures for East and West for the development period are as follows (in thousands):

Projected cash expenditures	2000	2001	TOTAL
Land Acquisition	4,709	0	4,709
Site development	1,500	8,700	10,200
Other	876	1,526	2,402
Total	7,085	10,226	17,311

Projected cash expenditures	2000	2001	2002	TOTAL
Land Acquisition	9,302	0	130	9,432
Site development	1,230	1,075	0	2,305
Other	468	419	60	947
Total	11,000	1,494	190	12,684

### II. Legal Analysis

Generally, a national bank's total outstanding loans to one borrower may not exceed 15 percent of the bank's capital and surplus, plus an additional 10 percent of capital and surplus if the amount over the 15 percent general limit is fully secured by readily marketable securities.<sup>1</sup> A "borrower" includes a person who is named a borrower or debtor in a loan or extension of credit.<sup>2</sup> Also, loans

<sup>1</sup> See 12 USC 84(a); 12 CFR 32.2(a).

<sup>2</sup> 12 CFR 32.2(a).

to one borrower will be attributed to another person and both will be considered a borrower (1) when the proceeds are used for the *direct benefit* of the other person, or (2) when a *common enterprise* is deemed to exist between the persons.<sup>3</sup>

The proceeds of a loan to borrower will be deemed to be used for the *direct benefit* of another person and will be attributed to that other person when the proceeds, or assets purchased with such proceeds, are transferred to that other person, other than in a bona fide arm's-length transaction where the proceeds are used to acquire property, goods, or services.<sup>4</sup>

A *common enterprise* is deemed to exist when

- (1) the expected source of repayment for each loan is the same and neither borrower has another source of income from which the loan and the borrower's other obligations can be repaid,
- (2) the borrowers are related through common control and there is substantial financial interdependence between or among the borrowers,
- (3) the borrowers use the loan proceeds to acquire more than 50 percent of a business enterprise, or
- (4) the OCC determines that a common enterprise exists based on the facts and circumstances of particular transactions.<sup>5</sup>

Thus, in determining whether a loan to one borrower should be attributed to another borrower for lending limit purposes, one must apply each of the five loan combination/attribution tests set forth above—the one direct benefit test and the four common enterprise tests—to the specific facts of each loan relationship.<sup>6</sup>

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<sup>3</sup> See 12 CFR 32.5(a). A guarantor is considered a "borrower" only if that guarantor is deemed to be a borrower under the direct benefit or common enterprise tests set forth at 12 CFR 32.5. See 12 CFR 32.2(a).

<sup>4</sup> 12 CFR 32.5(b).

<sup>5</sup> See 12 CFR 32.5(c).

<sup>6</sup> In addition to the general limit on loans to one borrower, there is an additional limit which applies to loans to a corporate group. See 12 CFR 32.5(d). Loans to a corporate group may not exceed 50 percent of a national bank's capital and surplus. 12 CFR 32.5(d)(1). A corporate group is defined as a person and all of its subsidiaries. *Id.* For the purpose of this rule, a corporation or limited liability company is a subsidiary of a person if that person owns more than 50 percent of the voting interests of the corporation or company. *Id.* This limit is independent of the general 15 percent limit on loans to one borrower set forth at 12 USC 84 and 12 CFR 32.3. This special limit applies to a corporate group regardless of whether loans to different members of the corporate group are combined for the general 15 percent limit.

## A. Direct Benefit Test

According to your letter, loan proceeds for both the West and East loans will be used to acquire land and pay for site development costs. Some of those proceeds may be paid to [Inc. 2] for site development work. As long as payments to [Inc. 2] result from bona fide arm's-length transactions, the proceeds of the West and East loans paid to [Inc. 2] will not be attributed to [Inc. 2] under the direct benefit test at 12 CFR 32.5(b).

## B. Common Enterprise Test # 1— Common Expected Source of Repayment

The expected source of repayment on the West loan is the sale of the developed lots to various retailers. The expected source of repayment on the East loan will be the proceeds of the phase two construction loan. Since the expected sources of repayment of the two loans are different, the loans will not be combined for purposes of the lending limit under the common enterprise test at 12 CFR 32.5(c)(1).

## C. Common Enterprise Test # 2— Common Control and Significant Financial Interdependence

As stated above on page three, one way in which a common enterprise is deemed to exist is when:

- (1) the borrowers are related through common control, and
- (2) there is substantial financial interdependence between or among the borrowers.<sup>7</sup>

Borrowers are related through common control when one person or entity controls another, or two or more entities are each controlled by the same person or entity. For the purposes of this combination rule, control is deemed to exist if a person directly or indirectly, or acting through or together with one or more persons either (1) owns or controls 25 percent or more of the voting securities of another person, (2) controls in any manner the election of a majority of the directors or trustees of another person, or (3) has the power to exercise a controlling influence over the management or policies of another person.<sup>8</sup>

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<sup>7</sup> See 12 CFR 32.5(c)(2).

<sup>8</sup> See 12 CFR 32.2(g). The term "person" as used section 32.2(g) means, among other things, a corporation, limited liability company, partnership or a trust. See 12 CFR 32.2(k).

Based on the information in your letter, West, East, [Inc. 2] and [Inc.] are related through the common control of [A], [B], and [C]. The next question, then, is to determine whether substantial financial interdependence exists between or among the control group members. Substantial financial interdependence is deemed to exist when 50 percent or more of one person's annual gross receipts or gross expenditures are derived from transactions with the other person. 12 CFR 32.5(c)(2)(ii). In determining whether substantial financial interdependence exists, we look at the borrower's gross receipts or gross expenditures "on an annual basis." When calculating a borrower's gross receipts or gross expenditures on "an annual basis," the relevant annual period will generally be the fiscal year used by the borrower.<sup>9</sup> Both West and East have a calendar year fiscal period.

Accordingly, if 50 percent or more of West's annual gross receipts or gross expenditures were received from or paid to East, [Inc.2], or [Inc.], then substantial financial interdependence would exist between West and such entity or entities, and loans to West would be attributed to, or combined with loans to, such entity or entities. Similarly, if 50 percent or more of East's annual gross receipts or gross expenditures were received from or paid to West, [Inc. 2], or [Inc.], then substantial financial interdependence would exist between East and such entity or entities, and loans to East would be attributed to, or combined with loans to, such entity or entities. The same analysis would apply to each member of the common control group.

Assuming that all of the site development costs incurred by West and East will be paid to [Inc. 2], those payments to [Inc.2] will represent 85 percent and 72 percent, respectively, of West's and East's gross annual expenditures for the fiscal year 2001.<sup>10</sup> Thus, for the year 2001, there will be substantial financial interdependence between West and [Inc.2] and between East and [Inc.2].<sup>11</sup>

Consequently, for the year 2001 loans to West will be attributed to [Inc. 2] because (1) the two entities are related through common control, and (2) substantial financial interdependence exists between the two entities

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<sup>9</sup> See OCC Interpretive Letter from Jonathan Rushdooney, attorney (December 24, 1986) (unpublished).

<sup>10</sup> West's projected site development costs for 2001 of \$8,700M divided by its total projected expenditures for 2001 of \$10,226M equal 85 percent; East's projected site development costs for 2001 of \$1,075M divided by its total projected expenditures for 2001 of \$1,494M equals 72 percent.

<sup>11</sup> Note that the critical issue here is the percentage of West's and East's gross expenditure paid to [Inc. 2], not whether 100 percent of the site development cost will be paid to [Inc. 2].

for the year 2001. Likewise, for the year 2001, loans to East will be attributed to [Inc. 2] because (1) the two entities are related through common control, and (2) substantial financial interdependence exists between the two entities for the year 2001. Thus, the loans to West and East will be attributed to [Inc 2] during 2001, and therefore are combined for the purpose of the lending limit under 12 CFR 32.5(c)(2).

#### **D. Common Enterprise Test # 3— Borrowing to Acquire Control**

This test is not applicable to the West and East loans.

#### **E. Common Enterprise Test # 4— Facts and Circumstances**

OCC rulings and interpretations reveal that a very strong evidentiary record based upon a number of factors must exist before a common enterprise will be found to exist solely on the basis of the facts and circumstances test.<sup>12</sup> In administrative opinions and interpretive letters, the OCC has considered the following facts and circumstances to be relevant to a common enterprise determination: engaging in supporting lines of business, interchange of goods and services, common ownership of assets, common management, use of common facilities, commingling of assets and liabilities, closely related business activities, similarity in structure, financing and holding, use of same business address, centralized cash management program, likelihood that a financially troubled member of the group would receive financial aid from other members of the group, family relationships among the borrowers, and pledging of assets to support another person's loans.<sup>13</sup>

Based on the information provided in your letter, I am unable to determine with any certainty whether the loans to West and East should be combined for lending limit purposes under the facts and circumstances test.

### **III. Conclusion**

Based on the information provided and the assumption that all of the site development costs will be paid to [Inc. 2], the loans to West and East will be attributed to [Inc. 2] for the year 2001 under the common enterprise test at 12 CFR 32.5(c)(2) and thus combined for purposes

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<sup>12</sup> Interpretive Letter No. 563, reprinted in [1991–1992 Transfer Binder] Fed. Banking L. Rep. ¶83,314, at 71,439 (September 6, 1991).

<sup>13</sup> *Id.*; see also Kenneth C. Rojc, *National Bank Lending Limits—A New Framework*, 40 Bus. Law. 903, 923–24 (1985)(citing various OCC interpretive letters).

of the legal lending limit. If all of the site development costs will not be paid to [Inc. 2], but where payments by West and East to [Inc. 2] during a fiscal period will still represent 50 percent or more of each company's gross expenditures for that period, the same attribution and combination results.

I trust this is responsive to your request. If you have any further questions, please contact me at (312) 360-8805.

Christopher G. Sablich  
Senior Attorney  
Central District Office

## 939—October 15, 2001

### 12 USC 24(7)

Dear [ ]:

This responds to your letter of June 28, 2001, on behalf of [ ] (“the bank”). In your letter, you request confirmation by the Office of the Comptroller of the Currency (OCC) of your view that federal law preempts the laws of Massachusetts and Florida that purport to restrict or prohibit a national bank from establishing deposit-taking automated teller machines (ATMs).<sup>1</sup> For the reasons discussed below, we conclude that federal law would preempt those state laws.

### Background

The bank is considering establishing deposit-taking ATMs in a number of states, including Massachusetts and Florida. The bank has no branches or offices in either state, but contemplates installing unmanned, deposit-taking ATMs in publicly accessible areas of buildings at which certain of its affiliates have operations. The bank's customers will be able to access their accounts through the bank's ATMs or ATMs owned and operated by other financial institutions in the networks, and customers of these other financial institutions will be able to access their accounts through the bank's ATMs.

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<sup>1</sup> As explained below, the issue presented by the bank's request is essentially identical to the issue addressed in *Bank One v. Guttau*, 190 F.3d 844 (8th Cir. 1999). For that reason, the publication and comment requirements of 12 USC 43 are not applicable to the bank's request. See 12 USC 43(c)(1). The OCC provided an opportunity for regulators in the affected states to comment, however, and this letter therefore takes into account comments on the bank's request the OCC received from the Florida Division of Banking and Finance and the Massachusetts Office of Consumer Affairs.

### The Massachusetts Statute

Under Massachusetts law, an out-of-state bank may establish an ATM only if the laws of the state in which it has its main office would permit a bank with its main office in Massachusetts to establish an ATM in that state:

No [non-Massachusetts] financial institution . . . shall purchase, establish, install, operate, lease or use individually or with any financial institution or organization or share with any financial institution or organization any such electronic branch in the commonwealth *unless the financial institution . . . has its main office in one of the states of the United States, and the laws of such state expressly authorize, under conditions no more restrictive than those imposed by this chapter as determined by the commissioner, financial institutions or organizations organized under the laws of the commonwealth to purchase, establish, install, operate, lease, use or share electronic branches in such other state*; provided, however, that any such financial institution . . . shall have applied to and obtained approval of the commissioner prior to engaging in any activity pursuant to this section.

Mass. Gen. Laws Ann. Ch. 167B, §§ 1 and 3 (West 2001) (emphasis added). The Massachusetts Division of Banks enforces this reciprocity statute by requiring an out-of-state bank to “submit a completed application, along with a copy of the relevant statute from the state in which it has its main office, and an affidavit signed by such bank's counsel affirming that such statute would authorize a bank which has its main office in Massachusetts to establish an electronic branch within that state.” Massachusetts Division of Banks Opinion 96-161.

According to your letter, you have been advised by staff at the Massachusetts Division of Banks that the division would enforce the application and reciprocity requirements against a national bank that has its home office outside Massachusetts. The bank's home state of New Jersey prohibits out-of-state financial institutions from establishing ATMs in New Jersey. It has no reciprocity exception to this prohibition. Thus, if the Massachusetts statute applied to the bank, the bank would be prohibited from establishing an ATM in Massachusetts.

### The Florida Statute

Florida's “remote financial service units” statute prohibits an out-of-state bank from establishing and operating a deposit-taking ATM in Florida:

*Any bank which is not authorized to do business in [Florida] or does not have its principal office and place of business in [Florida] is prohibited from using in [Florida] any remote financial service unit or any associated system by which a remote financial service unit is operated.* However, any bank which is not authorized to do business in [Florida] or does not have its principal office and place of business in [Florida] may use in [Florida] any remote financial service unit or any associated system within [Florida] by which such a remote service unit is operated if . . . such bank does not take deposits, either directly or indirectly, from any source whatsoever by use of the remote financial service unit or associated system.

Fla. Stat. Ann. § 658.65 (West 2000) (emphasis added). Although the term “remote financial service unit” is not defined in the Florida statutes or regulations, staff at the Florida Banking Department have opined that the term includes an ATM. According to your letter, department staff also interpret the phrase “authorized to do business” to mean, in the context of an out-of-state bank, a bank that has established a branch in Florida pursuant to Florida’s branching laws.<sup>2</sup> Thus, if applied to the bank, the Florida law would prohibit the bank from establishing deposit-taking ATMs in Florida unless the bank first establishes a branch there.

## Analysis

### Permissibility of the activity

The threshold question in any preemption analysis is whether the activities in question are permissible for a national bank under federal law. If they are not, then there is no preemption issue.

National banks are authorized to establish and operate ATMs.<sup>3</sup> The banking services provided through ATMs represent long-established banking activities: receiving deposits, disbursing cash from bank accounts, and extending credit in the form of cash advances. Each of these activities lies at the heart of national bank authority under 12 USC 24(Seventh), whether as part of the

enumerated national bank power to receive deposits, as part of the authority to engage in the “business of banking,” or as an activity incidental to permissible banking activity.<sup>4</sup> As the OCC has expressly reaffirmed in a recently adopted regulation, 12 CFR 7.4003,<sup>5</sup> the power to deploy and operate ATMs is implicit in the National Bank Act’s authorization of national banks to receive deposits, make loans and carry on the “business of banking.” ATMs and other electronic media simply represent a different means of exercising established banking powers. 12 CFR 7.1019.

Moreover, a national bank’s authority to establish and operate ATMs is unaffected by the federal branching law. Congress has specifically directed that state law will apply, in certain respects, to a national bank’s authority to branch interstate. The McFadden Act, as amended, provides that national banks may establish “branches” only to the extent that state law authorizes state banks to establish branches.<sup>6</sup> However, the McFadden Act, as revised, expressly excludes ATMs from the definition of “branch,” thereby removing national bank ATMs from the reach of state-law-based restrictions.<sup>7</sup> Accordingly, section 7.4003 of the OCC’s rules provides that an ATM is not a branch “and is not subject to state geographic or operational restrictions or licensing laws.”

Based on this analysis, it is clear that the bank’s proposed activities through ATMs in Massachusetts and Florida are permissible under well-settled federal authority.

### Preemptive effect of federal law

In our opinion, federal law preempts the Massachusetts and Florida statutes that purport to restrict or prohibit a national bank’s authority to establish ATMs in those states, because the statutes conflict with federal law authorizing the bank to engage in the activities in question and with the OCC’s exclusive visitorial powers over

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<sup>4</sup>The powers clause of section 24(Seventh) provides that a national bank may “exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking . . .” 12 USC 24(Seventh). See *NationsBank v. Variable Annuity Life Ins. Corp.*, 513 U.S. 251 (1995) (the “business of banking” is not limited to the list of powers enumerated in section 24(Seventh)).

<sup>5</sup>64 Fed. Reg. 60092 (Nov. 4, 1999).

<sup>6</sup>See 12 USC 36(c)–(g).

<sup>7</sup>See Economic Growth and Regulatory Paperwork Reduction Act, Pub. L. No. 104–208, § 2205(a), 110 Stat. 3009–405 (Sept. 30, 1996); see also *Bank One, Utah v. Guttau*, 190 F.3d 844 (8th Cir. 1999), cert. denied sub nom., *Foster v. Bank One, Utah*, 120 S. Ct. 1718 (2000) (Iowa location, registration, and advertising restrictions on national bank ATMs preempted).

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<sup>2</sup>In his letter responding to the OCC’s request for Florida’s comments on the bank’s preemption request, Richard T. Donelan, Jr., the chief counsel of the Florida Division of Banking and Finance, did not address this staff interpretation of the Florida statute. Mr. Donelan did, however, confirm that Florida “provides criminal penalties for the taking of deposits by financial institutions that are not authorized to do business in Florida. . . .”

<sup>3</sup>12 CFR 7.4003.

national banks. These points are addressed in more detail below, following a brief summary of the law governing preemption and the OCC's visitorial powers.

**Preemption and visitorial powers.** When the federal government acts within the sphere of authority conferred upon it by the Constitution, federal law is paramount over, and may preempt, state law.<sup>8</sup> Federal authority over national banks stems from several constitutional sources, including the Necessary and Proper Clause and the Commerce Clause of the United States Constitution.<sup>9</sup>

The U. S. Supreme Court has identified several bases for federal preemption of state law. First, Congress may expressly state that it intends to preempt state law.<sup>10</sup> Second, a federal statute may create a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it."<sup>11</sup> Third, the state law may conflict with a federal law.<sup>12</sup> In *Barnett Bank v. Nelson*,<sup>13</sup> the Supreme Court elaborated on this third test:

Federal law may be in "irreconcilable conflict" with state law. *Rice v. Norman Williams Co.*, 458 U. S. 654, 659 (1982). Compliance with both statutes, for example, may be a "physical impossibility," *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U. S. 132, 142–143 (1963); or, the state law may "stan[d] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U. S. 52, 67 (1941).

The Court in *Barnett* went on to state that

In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases [*i.e.*, national bank preemption cases] take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. To say this is not to deprive States of the power to regulate national banks, where . . . doing so does not prevent or significantly interfere with the national bank's exercise of its powers.<sup>14</sup>

<sup>8</sup> U.S. Const. art. VI, cl. 2 (the Supremacy Clause); *Cohen v. Virginia*, 19 U.S. (6 Wheat.) 264, 414 (1821) (Marshall, C.J.).

<sup>9</sup> U.S. Const. art. I, sec. 8, cl.3, cl. 18; *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 409 (1819).

<sup>10</sup> *E.g.*, *Jones v. Rath Packing Co.*, 430 U.S. 519 (1977).

<sup>11</sup> *Rice v. Norman Williams Co.*, 458 U.S. 654, 659 (1982).

<sup>12</sup> *See, e.g.*, *Franklin National Bank*, 347 U.S. 373 (1954); *Davis v. Elmira Savings Bank*, 161 U.S. 275 (1896).

<sup>13</sup> 517 U.S. 25, 31 (1996).

A conflict between a state law and federal law need not be complete in order for federal law to have preemptive effect. Where a federal grant of authority is unrestricted, for example, state law that attempts to place limits on the scope and exercise of that authority will be preempted.<sup>15</sup> Thus, federal law preempts not only state laws that purport to prohibit a national bank from engaging in an activity permissible under federal law but also state laws that condition or confine the exercise by a national bank of its express or incidental powers. As the Court stated in *Barnett*,

. . . where Congress has not expressly conditioned the grant of "power" upon a grant of state permission, the Court has ordinarily found that no such condition applies. In *Franklin Nat. Bank*, the Court made this point explicit. It held that Congress did not intend to subject national banks' power to local restrictions, because the Federal power-granting statute there in question contained "no indication that Congress [so] intended . . . as it has done *by express language* in several other instances."<sup>16</sup>

Moreover, the preemption may arise because of a conflict between a state law and a federal regulation. As stated by the Supreme Court in *Fidelity Federal Savings and Loan Ass'n v. de la Cuesta*<sup>17</sup>:

Federal regulations have no less pre-emptive effect than federal statutes. Where Congress has directed an administrator to exercise his discretion, his judgments are subject to judicial review only to determine whether he has exceeded his statutory authority or acted arbitrarily. \* \* \* A pre-emptive regulation's force does not depend on express congressional authorization to displace state law; moreover, whether the administrator failed to exercise an option to promulgate regulations which did not disturb state law is not dispositive.

458 U.S. at 153–154 (citations omitted).

Congress vested the OCC with the authority to determine whether a national bank is engaging in permissible activities. Under 12 USC 484 and other federal statutes,<sup>18</sup> the OCC has exclusive visitorial powers over national

<sup>14</sup> *Barnett*, 517 U.S. at 33.

<sup>15</sup> *See, e.g.*, *New York Bankers Association, Inc. v. Levin*, 999 F. Supp. 716 (W.D.N.Y. 1998).

<sup>16</sup> *Barnett*, 517 U.S. at 34 (citations omitted; emphasis in original).

<sup>17</sup> 458 U.S. 141 (1982).

<sup>18</sup> *See, e.g.*, 12 USC 93, 481, and 1818.



banks except as otherwise expressly provided by federal law.<sup>19</sup> These powers include the right to examine a bank, inspect a bank's books and records, regulate and supervise activities authorized or permitted pursuant to federal banking law, and enforce compliance with any applicable federal or state laws concerning those activities.<sup>20</sup>

**Application of federal law to state statutes.** If applied to the bank, the state laws at issue would prohibit the bank from establishing ATMs in Massachusetts and Florida, respectively. Given that the bank's home state has no provision in its banking laws that would satisfy the Massachusetts reciprocity requirement, the laws of Massachusetts would, if applied to the bank, preclude it from establishing ATMs in that state. Similarly, the bank does not have its principal place of business in Florida and is not "authorized to do business" as the Florida Banking Department interprets that term. Thus, the Florida law would prohibit the bank from establishing deposit-taking ATMs in that state.

In *Guttau*, the United States Court of Appeals for the Eighth Circuit considered similar state restrictions imposed in Iowa on a national bank's authority to deploy and operate ATMs. In that case, a national bank operated several ATMs in Iowa but maintained no branches in that state and sought to enjoin the enforcement of Iowa's ATM restrictions. Iowa prohibited the operation of an ATM by any bank without an office in Iowa, required ATM operators to apply for state approval, and prohibited the display of financial institution advertising upon ATM terminals. The Court of Appeals held that the Iowa restrictions were preempted by the National Bank Act:

Congress has made clear in the NBA its intent that ATMs are not to be subject to state regulation, and thus the provisions of the Iowa [law] that would prevent or significantly interfere with Bank One's placement and operation of its ATMs must be held to be preempted.<sup>21</sup>

Like the state laws at issue in *Guttau*, the Massachusetts and Florida laws in question here would prohibit the bank's exercise of its permissible federal powers.

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<sup>19</sup> *Guthrie v. Harkness*, 199 U.S. 148 (1905); *Bank One Texas, N.A. v. Patterson*, No. 3:93-CV-1081-G (N.D. Tex. Sept. 9, 1994), *aff'd* 68 F.3d 469 (5th Cir. 1995).

<sup>20</sup> 12 CFR 7.4000(a)(2). See also *First National Bank of Youngstown v. Hughes*, 6 F. 737, 740-41 (1881).

<sup>21</sup> *Id.* at 850; see also *Metrobank, N.A., et al. v. Foster*, No. 4-01-CV-10226, order at 12, n.7 (S.D. Iowa Aug. 21, 2001) (*Guttau* persuasive in determining that it is appropriate for the district court to address similar question of whether Iowa prohibition on ATM fees is preempted).

For this reason, it is our opinion that the state laws are preempted by federal law.<sup>22</sup>

Nor would the Massachusetts or Florida statutes at issue be immune from preemption under the Electronic Funds Transfer Act<sup>23</sup> ("EFTA"). The EFTA allows states to retain control over electronic transfers:

This subchapter does not annul, alter, or affect the laws of any State relating to electronic funds transfers, except to the extent that those laws are inconsistent with the provisions of this subchapter, and then only to the extent of the inconsistency. A state law is not inconsistent with this subchapter if the protection such law affords any consumer is greater than the protection afforded by this subchapter.<sup>24</sup>

However, as explained by the court in *Guttau*,

this anti-preemption provision is specifically limited to the provisions of the federal EFTA, and nothing therein grants the states any additional authority to regulate national banks. State regulation of national banks is proper where "doing so does not prevent or significantly interfere with the national bank's exercise of its powers." *Barnett Bank*, 116 S. Ct. at 1109. Congress has made clear in the [National Bank Act] its intent that ATMs are not to be subject to state regulation, and thus the provisions of the Iowa EFTA that would prevent or significantly interfere with Bank One's placement and operation of its ATMs must be held to be preempted.<sup>25</sup>

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<sup>22</sup> See *Barnett*, 517 U.S. at 34; 12 CFR 7.4003. Even if the bank were able to satisfy the requirements imposed by Massachusetts and Florida, the barriers to entry presented by these states' laws would constitute an impermissible exercise of visitatorial powers over the bank. As explained above, Congress intended to permit national banks to receive deposits and to have "all such incidental powers as shall be necessary to carry on the business of banking." 12 USC 24(Seventh). Federal regulations expressly interpret this grant to include the authority to use ATMs. 12 CFR 7.4003. Massachusetts provides that an out-of-state bank, including a national bank, must "have applied to and obtained approval of the commissioner prior to" establishing an ATM. Similarly, the Florida statute requires an out-of-state bank, including a national bank, to become "authorized" by the Banking Department before establishing a deposit-taking ATM in Florida. A state requirement that a national bank obtain state approval or license to exercise a power authorized under federal law is an assertion by the state that it has supervisory or regulatory authority over national banks. This is in direct conflict with the federal law providing that the OCC has exclusive visitatorial powers over national banks except as otherwise provided by federal law. 12 USC 484; 12 CFR 7.4000. A state law that purports to vest this authority in a state is preempted.

<sup>23</sup> 15 USC 1693-1693r.

<sup>24</sup> 15 USC 1693q.

<sup>25</sup> *Guttau*, 190 F. 3d at 850.

Thus, the preemption analysis articulated above is unaffected by a state's EFTA.

## Conclusion

Because ATMs are not branches under 12 USC 36(j), state law geographic restrictions are inapplicable to ATMs. Congress has placed no other restrictions upon ATMs in the National Bank Act, and, therefore, a state may not prevent, restrict, or condition a national bank's authority to establish ATMs. Accordingly, we conclude that the Massachusetts reciprocity statute and the Florida prohibition on the establishment of deposit-taking ATMs by out-of-state banks are preempted by federal law.

Julie. L. Williams  
*First Senior Deputy Comptroller and Chief Counsel*

cc: Richard T. Donelan, Jr.  
Chief Banking Counsel  
Office of Comptroller  
Florida Department of Banking and Finance

Thomas J. Curry  
Commissioner of Banks  
Commonwealth of Massachusetts

Jennifer Davis Carey, Director  
Office of Consumer Affairs and Business Regulation  
Commonwealth of Massachusetts

**940—May 24, 2002**

**12 USC 24(7)**

Re: [ ] Investment Management Activities

Dear [ ]:

This is in response to your letter requesting confirmation that [ ] (the "bank") may hold for limited periods of time, limited interests in certain private investment funds for which it serves as investment manager. The bank contends that holding such limited interests is convenient and useful for the bank in order to conduct its investment management business. For the reasons set forth below, we conclude that the bank may hold the interests in the funds in the manner and as described herein.

### A. Background

The bank, which is a subsidiary of [A], is a national bank with powers limited to trust powers. As a national bank,

the bank is exempt from registration as an investment advisor under the Investment Advisers Act of 1940.<sup>1</sup> The bank serves as investment manager for a number of private investment funds organized in the United States (the "funds").<sup>2</sup> The funds invest in a variety of financial instruments, including stocks and bonds, currencies, and commodities. The funds use cash instruments as well as over-the-counter and exchange-traded derivatives. The funds also take both short and long positions in securities. The funds may invest in securities and other financial assets in which a national bank ordinarily is not permitted directly to invest.<sup>3</sup>

The funds are structured as multi-advisor funds. As investment manager, the bank chooses the advisors for each fund, allocates fund assets to each advisor, and sets up stop-loss provisions and other limits for the advisors. The bank also monitors the advisors' performance and processes, re-allocates assets among advisors, and, if necessary, terminates advisors that no longer meet performance or other standards. Certain of the funds are organized as Delaware limited partnerships and others are organized as Delaware limited liability companies. All of the funds are taxed as partnerships. Consistent with this tax treatment, all the losses, gains, fees, and expenses are passed through from the funds to their respective investors.

The funds' investors are primarily high-net-worth individuals who meet the definitions of both accredited investors under the Securities Act of 1933<sup>4</sup> and qualified purchasers under the Investment Company Act of 1940.<sup>5</sup> The funds are marketed primarily by broker-dealers that are affiliates of the bank. These affiliated broker-dealers are registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934.<sup>6</sup> As investment manager, the bank receives both a management fee and a fee for performance for each of the funds. The management fee is a percentage of the assets of each fund. The fee for performance is a percentage of the profits of each fund above a certain hurdle rate.

<sup>1</sup> 15 USC 80b-1 to 80b-21.

<sup>2</sup> In addition to the funds, the bank also serves as investment manager for a number of private investment funds organized outside the United States. This letter does not address the permissibility of the bank's activities with respect to the foreign funds.

<sup>3</sup> The bank plans to invest only in funds that invest primarily in securities. Any non-securities investments will be limited to financial investments, and will not include real estate or tangible personal property.

<sup>4</sup> 15 USC 77a to 77aa.

<sup>5</sup> 15 USC 80a-1 to 80a-64.

<sup>6</sup> 15 USC 77b *et seq.*

The bank represents that it would be to the advantage of U.S. investors in the funds if the bank's compensation for performance were paid as a share of profits, rather than as a fee. To receive a share of the profits, the bank would need to hold an interest in the funds. In the case of funds organized as limited partnerships, the bank would become a special limited partner. As a special limited partner, the bank would not participate in all of the gains and losses of the partnership, but only in the gains equal to the performance fee to which the bank is entitled as investment manager. In the case of funds organized as limited liability companies, the bank would be a special member of those companies, with the same types of rights it would have in the limited partnerships. We refer to the bank's special limited partner and special member interests in the funds as "special interests."

Performance compensation can be a substantial percentage of the funds' respective returns. The bank represents that individual investors, trusts, and investors taxed as partnerships that in turn have individual or trust investors, prefer that investment funds structure performance compensation as an allocation to the investment manager's equity account rather than as a fee. Under U.S. tax law, individual investors must report as income their proportionate share of the gross amount of an investment fund's income and gains *before* deducting investment-related fees and expenses paid by the investment fund. The limit placed by the U.S. tax laws on the deductibility of these fees and expenses may preclude high-income individuals from deducting their full proportionate share of the fees and expenses of the investment funds. If, however, the investment manager is paid in the form of a profit allocation, rather than through a performance fee, the amount so paid is not treated as income to investors who are not recipients of the allocation.

For these reasons, the bank represents that it is an industry practice for investment advisors and managers of certain types of investment funds to receive performance-related compensation as a profit allocation. The bank has provided examples of other, similar private investment funds that its affiliated broker-dealer markets to investors. The similar funds marketed by the broker-dealer are structured to provide payments for advisory services as fund allocations rather than as fees to maximize tax efficiency for investors. Because several nonbank investment managers follow industry practice in structuring performance compensation as an equity interest, the bank believes that the limitation on deductibility on the funds' performance fees as currently

structured (rather than the proposed performance-based equity allocation to the bank as investment manager) is having a significant adverse effect on the bank's ability to compete for this type of advisory business. The bank represents that if it is not able to structure its performance-based compensation using an allocation of income and gains to its equity account, the funds would be significantly disadvantaged in competing for investors' money.

The bank's ownership interest in the funds would be limited. The bank does not propose to make any out-of-pocket investments in the funds, although it will hold a special interest in each fund to enable it to receive its performance-based compensation in the form of a profit allocation as described above. The bank has represented that under the terms of the instruments governing the funds and creating the special interests, the bank will not participate in any losses suffered by the funds. The bank will account for its special interest in the funds under the equity method of accounting. The bank's loss exposure from an accounting perspective will be limited to the amount of profit allocation it expects to receive as compensation. The special interest would not entitle the bank to voting rights. The bank represents that it will receive a special interest in a fund only while the bank provides investment management services to the fund. The bank will withdraw all profit allocations immediately.<sup>7</sup>

The bank proposes to receive a special interest in a fund for which it serves as investment manager only to the extent it is necessary to attract investors into the fund. The bank will hold special interests only in investment funds that hold securities and financial instruments, and will not invest in any fund that includes real estate or tangible personal property. The bank will hold a special interest in a fund containing bank-ineligible investments only while the bank serves as an investment manager to the fund, and only if the terms of the instruments governing the fund allow the bank to sell, redeem, or otherwise dispose of its equity allocation if it no longer services the fund.

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<sup>7</sup>The bank has indicated that it will have a standing request for redemption of all equity allocations from each fund. The bank will receive the redemption proceeds on the same business day that a fund determines the final amount of each allocation. Because the bank will in effect withdraw all profit allocations immediately, the amount of the bank's interest in any fund as a practical matter would, consistent with Interpretive Letter No. 897, *supra*, never exceed 24.99 percent of the total equity of any fund.

## B. Analysis

### 1. *The bank's holding an interest in funds in order to engage in the investment advisory business is incidental to the business of banking.*

The Office of the Comptroller of the Currency (OCC) has long held that a national bank may provide investment management services as part of the business of banking authorized under 12 USC 24(Seventh) and pursuant to their fiduciary powers under 12 USC 92a.<sup>8</sup> Section 24(Seventh) also gives national banks incidental powers to engage in activities that are incidental to enumerated bank powers as well as the broader “business of banking.”<sup>9</sup> Prior to *VALIC*, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in *Arnold Tours*.<sup>10</sup> The *Arnold Tours* standard defined an incidental power as one that is “convenient or useful in connection with the performance of one of the bank’s established activities pursuant to its express powers under the National Bank Act.”<sup>11</sup> Even prior to *VALIC*, the *Arnold Tours* formula represented the narrow interpretation of the “incidental powers” provision of the National Bank Act. The *VALIC* decision, however, has established that the *Arnold Tours* formula should be read to provide that an incidental power includes one that is “convenient” or “useful” to the “business of banking,” as well as a power incidental to the express powers specifically enumerated in 12 USC 24(Seventh). Thus, it would be considered incidental to a permissible bank activity for a national bank to hold interests in an investment fund to which it provides investment management services if, under the circumstances presented, holding the interests is convenient or useful to the clearly bank-permissible investment management activities conducted by the bank.<sup>12</sup>

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<sup>8</sup> See, e.g., Interpretive Letter No. 897 (October 23, 2000) *reprinted in* [2000–2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81–416; Interpretive Letter No. 851 (December 8, 1999) *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,308; Interpretive Letter No. 871 (October 14, 1999) *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,365; Conditional Approval Letter No. 164 (December 9, 1994); Interpretive Letter No. 648 (May 4, 1994) *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶83,557; Interpretive Letter No. 647 (April 15, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶83,558; Interpretive Letter No. 622 (April 9, 1993) *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,557; Interpretive Letter No. 403 (December 9, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,627.

<sup>9</sup> *VALIC*, *supra*, at 258 n. 2.

<sup>10</sup> *Arnold Tours v. Camp*, 472 F.2d 427 (1st Cir. 1972)(“*Arnold Tours*”).

<sup>11</sup> *Id.* at 432.

The OCC recently confirmed that it was legally permissible for an investment advisor that was partly owned by a national bank to hold limited equity interests in certain investment funds to which the investment advisor provided services.<sup>13</sup> In Interpretive Letter No. 897, the OCC noted several reasons in support of limited equity investments in funds by an investment advisor in which a national bank proposed to hold a noncontrolling interest, to: (1) assure that the advisor’s interests were aligned with those of the other investors in the funds; (2) provide a tax-efficient means for the advisor to receive performance-based compensation; and (3) efficiently fund the advisor’s obligations to its staff for performance-based bonuses. These three reasons each constituted reasons why the advisor’s investments in the funds were convenient or useful to the national bank in carrying out its business, and not mere passive investments unrelated to the bank’s business.

In the instant proposal, the bank’s ownership for limited periods of small interests in investment funds it manages is directly related to, and an integral part of, the bank’s activity of providing bank-permissible investment management and administrative services to certain investment funds. The purpose of holding the special interests is to enable the bank to act as an investment manager to the types of investment funds in which this form of ownership by the investment manager is convenient and useful—indeed, necessary. The level of such investments by the bank in any single fund and in the aggregate will be limited. The proposed special interests in the investment funds are not passive or speculative investments on the bank’s part. The investments are made solely to enable the bank to provide investment management services as conducted by its competitors in the investment management industry. As a practical matter, in order to offer the funds it manages, the bank must structure its compensation to hold these investments in this limited manner. They will be held only when, and for so long as, the bank is providing such investment management services.

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<sup>12</sup> See Interpretive Letter No. 897 (October 23, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81–416. See also Interpretive Letter No. 742 (August 19, 1996), *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–106; Interpretive Letter No. 737 (August 19, 1996), *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–101; Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989–90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

<sup>13</sup> Interpretive Letter No. 897 (October 23, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81–416.

Investing in the funds it manages enables the bank to receive its compensation in a manner that provides tax treatment to investors in a fund comparable to that of investors in similar funds. As described above, because performance-based compensation frequently can be a substantial percentage of a private investment fund's returns, the use of a performance-based allocation can have a significant effect on individual investors. As a result, private investment funds traditionally have structured performance compensation as an equity allocation in order to prevent individuals from being disadvantaged by limits on the deductibility of performance-based compensation in the form of fees. Permitting the bank to receive the special interests in the funds enables it to compete more effectively with entities that can offer this tax result to their individual investors.

Accordingly, in the instant case, 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.

2. *Holding an interest in funds in order to engage in the investment advisory business is not prohibited by 12 USC 24(Seventh).*

Section 24(Seventh) addresses the ability of a national bank to underwrite and deal in securities. Specifically, section 24(Seventh) provides that “[t]he business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.”

Here, the bank would not be “dealing” in or “underwriting” securities prohibited for national banks by section 24(Seventh). Although “dealing” and “underwriting” are not defined in section 24(Seventh),<sup>14</sup> “dealing” in securities is generally understood to encompass the purchase of securities as principal for resale to others.<sup>15</sup> “Dealing” is buying and selling as part of a regular business. A dealer typically maintains an inventory of securities and holds itself out to the public as willing to purchase and sell and continuously quote prices.<sup>16</sup> “Underwriting” is generally understood as encompassing the purchase of securities from an issuer for distribution and sale to investors.<sup>17</sup>

Case law confirms that one cannot be an underwriter in the absence of a public offering.<sup>18</sup>

Under the above definitions, the bank receiving the special interests would not constitute “dealing” or “underwriting.” The bank has represented that it will receive the special interests solely for purposes of engaging in the investment management business. The bank will not hold the special interests in order to engage in a regular business of buying and selling them in the secondary market<sup>19</sup> and will not participate in a public offering of the securities to investors.

The ownership by the bank of the special interests would be a type of equity investment, and therefore is not the type of security subject to the limitations placed upon national banks' purchase of investment securities in 12 USC 24(Seventh) or in 12 CFR Part 1. The statutory definition of investment securities includes “marketable obligations evidencing the indebtedness of any person, copartnership, association or corporation in the form of bonds, notes, and/or debentures, commonly known as ‘investment securities’” and gives the Comptroller the authority to define further that term. Accordingly, the OCC issued implementing regulations defining “investment securities” at 12 CFR Part 1. Under part 1, an investment security is defined as “a ‘marketable’ debt obligation that is not predominantly speculative in nature.”<sup>20</sup> Equity securities do not represent debt obligations.

<sup>14</sup> Although the securities laws definitions are not dispositive in determining whether a particular type of securities activity is permitted for banks, these definitions provide a useful starting point for characterizing a bank's securities activities. Under section 3 of the Securities Exchange Act of 1934, a “dealer” is defined as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not part of a regular business.” 15 USC 78c(a)(5). Under the Securities Act of 1933, an “underwriter” includes “any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security.” 15 USC 77(b)(a)(11).

<sup>15</sup> Interpretive Letter No. 393 (July 5, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,617 (national bank with limited market presence not considered a dealer). *See also* Louis Loss, *Securities Regulation* 2983–84 (3d ed. 1990).

<sup>16</sup> *Citicorp, J.P. Morgan & Co. Inc., Banker Trust New York Corporation*, 73 Fed. Res. Bull. 473 n.4 (1987); OCC Interpretive Letter No. 684, *supra*.

<sup>17</sup> Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1998–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; Interpretive Letter No. 329 (March 4, 1985), *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499.

<sup>18</sup> *SIA v. Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

<sup>19</sup> The bank will not act as market maker in the securities by quoting prices continuously on both sides of the market.

<sup>20</sup> 12 CFR 1.2(e).

The language in the fifth sentence of section 24(Seventh)—“nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation”—is not a blanket bar on national bank acquisitions of stock. Rather, as discussed below, that language was intended to make clear that the express authorization contained in the statute permitting banks to invest in “investment securities” does not include an authorization for investments in stock. This proviso does not affect national banks’ authority to hold equities, *if* the holding can qualify as permissible because it is part of or incidental to permissible banking activities.<sup>21</sup>

In the present situation, the bank’s receiving the special interests enables it to engage in permissible banking activities and act as investment manager for investment funds that, in practice, require the manager to take an equity stake. Institutional and sophisticated individual investors in these funds require the manager to structure the payment of performance fees in this fashion. In this connection, these investments permit the bank to offer funds that provide investors with a tax treatment comparable to that of investors in other, similar funds. The bank would be unable to offer these funds on a competitive basis unless it makes these investments. Based on these circumstances, the proposed investments are an integral component of investment management services provided by the bank to the investment funds.

### C. Conclusion

Based upon a review of the information you provided, including the representations and commitments made in your letter, and for the reasons discussed above, we conclude that the bank may receive the special interests in the funds, subject to the following conditions:

- (1) The funds shall constitute “affiliates” of the bank and Citibank, N.A., for purposes of sections 23A and 23B of the Federal Reserve Act.
- (2) Prior to receiving the special interest in the funds, the bank shall adopt and implement an appropriate risk management process, acceptable to the OCC examiner-in-charge, to monitor these interests. The bank’s risk management process shall be comprehensive and shall include:
  - (i) Adoption and implementation of a conflict of interest policy addressing all inherent conflicts associated with the bank’s holding of the special interests in the funds; and

<sup>21</sup> The legislative history of the language in the fifth sentence of section 24 (Seventh) is discussed in detail in Interpretive Letter No. 892 (September 13, 2000).

- (ii) Adoption and implementation of risk management policies and procedures for monitoring the special interests in the funds and the risks associated with those interests, taking into account relevant factors noted in OCC guidance (e.g., OCC Banking Circular 277 (BC 277—October 1993), Supplemental Guidance 1 to BC 277 (January 1999) and the *Handbook for National Bank Examiners*, “Risk Management of Financial Derivatives” (January 1997)).

The bank shall provide the OCC with copies of the policies and procedures described in (i) and (ii) prior to receiving a special interest in the funds it manages.

- (3) The bank shall not receive special interests in the funds other than funds that invest in securities and financial instruments, and the bank shall not invest in any fund that holds real estate or tangible personal property.
- (4) The bank shall make reports and other information in the bank’s possession readily available to OCC supervisory staff as necessary for the OCC to determine compliance with these conditions.
- (5) The bank will account for its special interests in the funds under the equity method of accounting.
- (6) The bank will hold special interests in a fund only when, and only for so long as, it is providing investment management services to the fund.

These conditions are conditions imposed in writing by the OCC in connection with its action on the bank’s request for a legal opinion confirming that its interest in the funds is permissible under 12 USC 24 (Seventh) and, as such, may be enforced in proceedings under applicable law.

Julie L. Williams  
*First Senior Deputy Comptroller and Chief Counsel*

**941—June 11, 2002**

**12 USC 24(7)**

Dear [ ]:

This responds to your request for confirmation that [ ] (“bank”) had authority to acquire preferred stock of [ ] (“company”), a subsidiary of [ ], pursuant to its authority to discount and negotiate evidences of debt. The bank acquired the preferred stock (“preferred stock”)

as partial consideration for the disposition of a loan portfolio to the company. Based on the information and representations you provided, we conclude that the bank had authority to acquire and may continue to hold the preferred stock pursuant to its authority to discount and negotiate evidences of debt. The bank's existing holdings represent less than 5 percent of the bank's capital and surplus and are within applicable limits.

## Background

The bank recently disposed of a portfolio of loans to the company in exchange for cash and preferred stock. The bank had negotiated to dispose of the loan portfolio for cash, but had accepted the company's offer of 90 percent cash and 10 percent preferred stock because the cash portion of the company's offer was significantly higher than other offers the bank received.

The preferred stock was issued in a private placement and is rated above investment grade by two nationally recognized statistical rating organizations. It has a limited life of 20 years and is not otherwise redeemable at the option of the issuer. Dividend payments are cumulative with a fixed dividend of 6.2 percent. Preferred shareholders have a priority over common stockholders upon dissolution of the corporation and have no voting rights other than those required under state law (generally relating to the preferred shareholders' liquidation preference rights). There is a one-year restriction on the sale or transfer of the preferred stock except to the bank's affiliates. After one year, the bank may transfer the preferred stock to a commercial bank, finance company, insurance company, or other financial institution or fund, that is regularly engaged in making, purchasing or investing in loans, and has a tangible net worth in excess of \$100,000,000. You have asked whether the bank had authority to acquire and hold the preferred stock under its authority to discount and negotiate evidences of debt.<sup>1</sup>

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<sup>1</sup> The Office of the Comptroller of the Currency (OCC) has permitted national banks to purchase and hold preferred stock as Type III investment securities if the securities meet the applicable rating and marketability requirements of 12 CFR 1.2. See Interpretive Letter No. 777 (April 8, 1997), reprinted in [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-204. The OCC does not express any view on whether the preferred stock, in this case, meets the marketability requirements of 12 CFR 1.2 or qualifies as a Type III investment security. Regardless of whether it qualifies as a Type III investment security, however, the preferred stock should be reported as a security under Financial Accounting Standards Board Statement No. 115: Accounting for Certain Investments in Debt and Equity Securities. In addition, the preferred stock should be categorized as a security and listed in Schedule B (Securities) in the call report.

## Discussion

### A. Legal Authority to Acquire and Hold the Preferred Stock

National banks may acquire and hold preferred stock under the authority in 12 USC 24(Seventh) to discount and negotiate evidences of debt if the preferred stock is, in substance, a debt obligation of the issuer.

Section 24(Seventh) expressly authorizes national banks to conduct the business of banking, including "by discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt."<sup>2</sup> 12 USC 24(Seventh). This authority has long included the power to acquire and hold a variety of debt and debt-like instruments, including certain instruments denominated as securities.<sup>3</sup>

For example, the OCC concluded that a national bank could acquire privately placed assets-backed securities under its authority to negotiate evidences of debt.<sup>4</sup> In that case, the bank had asked whether the asset-backed securities qualified as investment securities under 12 CFR Part 1. The OCC determined that the securities did not meet the marketability requirements for investment securities, but could be purchased under

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<sup>2</sup> The courts have long held that the term "discount" includes purchases of notes and other evidences of debt. See, e.g., *National Bank v. Johnson*, 104 U.S. 271 (1881); *Steward v. Atlantic National Bank*, 27 F.2d 224, 228 (9th Cir. 1928); *Morris v. Third National Bank*, 142 F. 25 (8th Cir. 1905); *Danforth v. National State Bank of Elizabeth*, 48 F. 271 (3d Cir. 1891). See also 12A *Words and Phrases* 285-95 (West 1954 and Supp. 1986). And negotiation is a form of transfer, disposition or sale. *Black's Law Dictionary* 934 (5th ed. 1979); 28 *Words and Phrases* 758-766 (West 1955 & Supp. 1986). Thus, the OCC has concluded that the authority to discount and negotiate evidences of debt includes the authority to purchase and sell debt and debt-like instruments. See, e.g., OCC Conditional Approval No. 262, *Interpretations and Actions*, Dec. 1997, Vol. 10, No. 12 ("the power to discount and negotiate is the power to purchase and sell, and purchasing and selling as principal defines underwriting and dealing").

<sup>3</sup> See Interpretive Letter No. 833 (July 8, 1998), reprinted in [1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-287; Interpretive Letter No. 834, (July 8, 1998), reprinted in [1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-288; Interpretive Letter No. 600 (July 31, 1992), reprinted in [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,427; Interpretive Letter No. 182 (March 10, 1981), reprinted in [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,263. The OCC has sometimes referred, more broadly, to a national bank's "general lending authority" to purchase debt securities rather than the authority to discount and negotiate evidences of debt. For example, the OCC approved a bank's purchase of participation certificates that represented interests in pools of FHA-insured Title I property improvement loans under its general lending powers. See, e.g., Interpretive Letter No. 579 (March 24, 1992), reprinted in [1991-1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,349. This reference to a bank's general lending authority includes the authority to discount and negotiate evidences of debt.

<sup>4</sup> Interpretive Letter No. 600, *supra*.

the authority to negotiate evidences of debt. The OCC stated that the ability of a national bank to acquire asset-backed securities is not limited by the fact that such investments may not be eligible as investment securities.<sup>5</sup>

The OCC reached the same conclusion in a recent matter involving trust preferred securities.<sup>6</sup> Trust preferred securities are debt-like instruments that are issued by trusts organized by banks or bank holding companies. In a typical structure, the trust sells common securities to the organizing bank or bank holding company and sells preferred securities to third-party investors. The proceeds of the preferred securities issuance are then used to purchase a junior subordinated debenture from the bank or bank holding company. The bank or bank holding company guarantees that the trust will pay its obligations with the cash it has collected from the interest payments on the junior subordinated debt it owns.

The OCC had previously determined that, although trust preferred securities were denominated as securities, they were, in substance, debt obligations.<sup>7</sup> As debt obligations, the trust preferred securities would qualify as investment securities as long as they met the applicable rating and marketability requirements of 12 CFR Part 1. The OCC later concluded that national banks could purchase trust preferred securities under the authority to discount and negotiate evidences of debt even if they did not qualify as investment securities, because the trust preferred securities were debt obligations.<sup>8</sup>

The OCC has considered several factors to determine whether securities with characteristics of both debt and equity have sufficient indicia of debt to qualify as debt obligations.<sup>9</sup> These factors include whether the returns on the investment are fixed or based on the success of the enterprise, the voting rights of the stockholder, the obligation to pay dividends, rights of stockholders in the

event of the failure of the issuer, whether the security has a limited life, and whether it is rated.<sup>10</sup>

These factors distinguish equity securities (or common stock) from debt securities. For example, common stock provides an ownership interest and appreciation of the market value of the issuer and dividends. In contrast, debt securities offer investors periodic interest payments, often in the form of fixed dividend payments, and a principal payment at maturity. In addition, common stock typically is perpetual and has broad voting rights, while debt securities can be perpetual or limited in term and have limited voting rights. In the event of the failure of an issuer, the claims of the common stockholders are subordinate to the holders of debt securities. Finally, rating agencies typically do not rate equity instruments but will assign credit ratings to debt securities.

Relying on these factors, the OCC has determined that national banks may purchase preferred stock as an investment security where the preferred stock can be properly characterized, in substance, as a debt obligation. For example, the OCC concluded that money market preferred stock had sufficient indicia of debt to qualify as an investment security under 12 CFR Part 1.<sup>11</sup> Like debt holders, money market preferred holders did not share in the appreciation or the profits of the issuer, but instead were entitled to dividends determined by a formula established in the prospectus and principal at redemption. Money market preferred holders also had limited voting rights typical of debt holders. Although the money market preferred stock did not have a set maturity date, the OCC viewed it as similar to a series of fixed maturity instruments because dividend rates on the stock were reset every 49 days. Finally, like other debt instruments, the money market preferred stock was given a credit rating by the rating agencies.

In addition, as noted above, the OCC has concluded that trust preferred securities are debt-like instruments that may be purchased as investment securities or under the authority to discount and negotiate evidences of debt.<sup>12</sup>

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<sup>5</sup> *Id.*

<sup>6</sup> Interpretive Letter No. 908, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-433 (April 23, 2001).

<sup>7</sup> Interpretive Letter No. 777, *supra*.

<sup>8</sup> Interpretive Letter No. 908, *supra*.

<sup>9</sup> Some of these decisions addressed whether the securities would qualify as investment securities and did not discuss the authority to discount and negotiate evidences of debt. Nonetheless, these decisions are instructive because the OCC first had to determine whether the securities were debt obligations in order to determine whether they qualified as investment securities. An investment security is, by definition, "a marketable *debt obligation* that is not predominately speculative in nature." 12 CFR 1.2(e).

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<sup>10</sup> *See, e.g.*, Interpretive Letter No. 777 and Interpretive Letter No. 781, both *supra*.

<sup>11</sup> *See* Interpretive Letter No. 781, *supra* (money market preferred stock closely resembles and can be properly characterized in substance as debt).

<sup>12</sup> *See* Interpretive Letter No. 777, *supra* (trust preferred securities are debt-like obligations) and Interpretive Letter No. 908, *supra* (trust preferred securities qualify as debt obligations and may be purchased and held as loans). *See also* OCC Conditional Approval No. 262, *supra* ("trust preferred securities are debt securities representing the long term secured or unsecured debt obligations of the issuing corporation").



Trust preferred securities have many characteristics typically associated with debt obligations including fixed and cumulative dividends, limited voting rights, and limited life.

The preferred stock is analogous in virtually all relevant respects to the preferred stock the OCC has previously concluded are debt obligations and not equity.<sup>13</sup> The preferred stock has characteristics typically associated with debt obligations, such as corporate bonds and municipal revenue bonds. For example, like debt holders, the preferred stockholders do not share in the profits of the issuer, but rather receive fixed dividend payments during the term of the preferred stock and principal at redemption. Also, like holders of debt, the preferred stockholders do not have authority to vote on ownership matters other than in limited situations. And claims of the common stockholders are subordinate to the holders of the preferred stock upon dissolution of the company. In addition, like most debt, the preferred stock is not perpetual. It has a limited life of 20 years. It is also given a credit rating by rating agencies, just as with debt. Thus, because the preferred stock closely resembles and can be properly characterized, in substance, as debt, the bank may acquire and hold it under the authority to discount and negotiate evidences of debt.

Because the preferred stock is, in substance, a debt obligation, the bank's acquisition of the preferred stock does not violate the Glass-Steagall Act's limitation on stock ownership. That provision limits the ownership of the "stock of any corporation" unless "otherwise permitted by law."<sup>14</sup> Here the preferred stock, despite its label, is not, in substance, "stock of any corporation."<sup>15</sup> Functionally, it is a debt obligation. As a debt obligation, its acquisition is "otherwise permitted by law."<sup>16</sup> Specifically, national banks may acquire the preferred stock pursuant to the authority to "discount and negotiate . . . evidences of debt."<sup>17</sup>

## **B. Prudential Standards and Regulatory Limits on Preferred Stock**

Banks that hold debt obligations, such as the preferred stock, are subject to limits on the amount of debt the bank

<sup>13</sup> See, e.g., Interpretive Letter No. 781, Interpretive Letter No. 777, and Interpretive Letter No. 908, all *supra*.

<sup>14</sup> 12 USC 24(Seventh).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

may hold. Most debt obligations are subject to limits of 10 to 15 percent of the bank's capital and surplus.<sup>18</sup> Some debt obligations, such as subordinated, unsecured long-term debt may be subject to stricter limits for safety and soundness reasons. In this case, the preferred stock represents less than 5 percent of the bank's capital and surplus.<sup>19</sup> This amount is within the prudential limits that the OCC would apply to such subordinated unsecured long-term debt.

The bank also must adhere to the prudential requirements in Banking Circular 181 (Rev.).<sup>20</sup> In that regard, the bank should conduct an independent analysis to determine that the acquisition of the preferred stock meets the bank's own internal underwriting standards. The nature and extent of the bank's independent analysis is a function of the type of transaction at issue and the bank's lending policies and procedures. The bank's acceptance of a favorable analysis of the preferred stock by the issuer, a credit rating institution, or another entity does not satisfy the need to conduct an independent credit analysis. The bank may, however, consider analysis by other sources as factors when independently assessing the preferred stock. The bank must maintain its analysis on an ongoing basis and must have continued access to appropriate credit and portfolio performance data as long as it holds the preferred stock.

## **Conclusion**

The bank had authority to acquire and may hold the preferred stock under its authority to discount and negotiate evidences of debt. The bank's existing holdings represent less than 5 percent of the bank's capital and surplus and are within applicable limits. If you have any questions, please contact Beth Kirby, special counsel, at (202) 874-5210.

Ellen Broadman

*Director*

*Securities and Corporate Practices Division*

<sup>18</sup> For example, debt obligations that qualify as Type III investment securities under 12 CFR Part 1 are subject to a 10 percent investment limit. Debt obligations that qualify as loans and other extensions of credit are generally subject to a 15 percent lending limit, under 12 USC 84 and 12 CFR 32. A financed sale of assets is generally exempt from that legal lending limit, however. See 12 CFR 32.2(k)(2)(iii).

<sup>19</sup> The bank acquired \$105 million of preferred stock from the company. This represents 4.64 percent of the bank's total equity capital of \$2,260,849M as of March 31, 2002.

<sup>20</sup> See OCC Banking Circular 181 (Rev.) (August 2, 1984), *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 63-506.

12 CFR 32.7

Subject: Pilot program for residential real estate loans and small business loans, 12 CFR 32.7

Dear [ ]:

This letter responds to your letters of April 12, 2002, and May 8, 2002, regarding the applicability of the two special limits in the lending limit pilot program (pilot program or program), 12 CFR 32.7, to loans made to finance land development or property construction.

The pilot program provides new special lending limits for residential real estate loans and small business loans under certain conditions.<sup>1</sup> A residential real estate loan is defined as a loan or extension of credit that is secured by 1–4-family residential real estate. 12 CFR 32.2(p). Such loan must be secured by a perfected first-lien security interest in 1–4-family real estate in an amount that does not exceed 80 percent of the appraised value of the collateral at the time the loan is made.<sup>2</sup> A small business loan is defined as a loan or extension of credit “‘secured by nonfarm nonresidential properties’<sup>3</sup> or ‘a commercial or industrial loan’ as defined in the instructions for preparation of the Consolidated Report of Condition and Income” (call report instructions).<sup>4</sup> 12 CFR 32.2(r). A bank must apply for approval to use the special limits in the program and must meet certain requirements for eligibility. As you note, [“bank”] has been approved to participate in the pilot program.

A loan secured by real estate made to finance land development or property construction cannot qualify for the special limit for small business loans because the loan is excluded from the category of loans “secured by nonfarm nonresidential properties” and from the category of “commercial and industrial loans.” Instead, the call report instructions provide that such construction and land development loans are reported as a separate category of loan, namely, “Construction, land development, and other land loans.”<sup>5</sup> For these reasons, the special limit for small business loans does not extend to a loan secured

by real estate to finance land development or property construction.<sup>6</sup>

A bank cannot avoid this result by making a construction or land development loan without taking a security interest in the real estate. It is true that not taking a security interest in the real estate would remove the loan from the “Construction, land development, and other land loans” category in the call report instructions, and potentially put it into the “commercial or industrial loan” category, depending upon its other characteristics. However, as you correctly point out in both your letters, making such a construction or land development loan on an unsecured basis would “not appear to be consistent with prudent banking practices.” The basic purpose of the lending limit regulation is to “protect the safety and soundness of national banks” by preventing excessive loans to one borrower and promoting diversification of loans.<sup>7</sup> The pilot program itself stresses that the higher limits being made available in specified circumstances must be used in a manner that is “consistent with safety and soundness.”<sup>8</sup>

Finally, a loan made to finance land development or property construction will also not generally qualify for the special limit for residential real estate loans. This is because a residential real estate loan must be secured by an existing, completed 1–4-family residence. A loan to finance land development or property construction will not generally meet this requirement.<sup>9</sup>

I trust this letter is responsive to your inquiry.

Ray Natter  
*Deputy Chief Counsel*

<sup>6</sup>As noted in the preamble to the final rule, the OCC chose to restrict the categories of loans to which the program would apply with the expectation that our experience with the program would be the basis for considering whether more categories of loans should be added at a later date. *See* 66 *Fed. Reg.* 31114, 31116 (Jun. 11, 2001) (final rule).

<sup>7</sup>12 CFR 32.1(b).

<sup>8</sup>*See* 66 *Fed. Reg.* 31114, 31117 (Jun. 11, 2001) (final rule).

<sup>9</sup>I include the qualification “generally” since there may be a rare situation in which a bank’s customer is able to borrow under the program to finance land development or property construction and provide collateral in the form of a first-lien security interest in an existing, completed residence. The bank’s customer might be either an owner-occupier or a developer. If the borrower is a developer, the OCC requires as a prudential matter that the bank ensure that the security interest is taken in a residence that the developer has “pre-sold” to an unaffiliated third party under a binding purchase and sale agreement and that the loan is made on that same “pre-sold” basis and in conformity with OCC guidance regarding residential construction lending conducted on that basis. *See Comptroller’s Handbook*, “Commercial Real Estate and Construction Lending” (Nov. 1995) at 17–18.

<sup>1</sup> *See* 66 *Fed. Reg.* 31114 (Jun. 11, 2001) (final rule) and 66 *Fed. Reg.* 55071 (Nov. 1, 2001) (correction).

<sup>2</sup> 12 CFR 32.7(a)(1).

<sup>3</sup> There is no requirement that the property be owner-occupied.

<sup>4</sup> The call report instructions are available at <http://www.ffiec.gov>.

<sup>5</sup> *See* RC-C-3 (3-01).

12 USC 24(7)

Dear [ ]:

This responds to your letter of April 12, 2002, as supplemented by your letter of May 7, 2002, requesting confirmation that [ ] (“bank”), may lawfully acquire and hold a one-third non-controlling equity interest in [ ] (“company”), a [State] limited liability company that will own and operate a single small airplane. For the reasons set forth below, the bank may acquire and hold the interest in the company, in the manner and as described herein.

**A. Background**

The bank proposes to make a non-controlling investment in the company, which will own and operate a plane that the bank will use in its conduct of business. The two other owners also plan to utilize the aircraft for their own respective business and personal purposes. The plane will not be used for chartering purposes or to generate income unrelated to the usage of the owners themselves. The bank has almost 50 offices spread across [State1, State2] and [State3], and will use the plane to facilitate bank management’s air travel to these various offices. The bank represents that since its offices are located in geographic areas served by small airports offering infrequent commercial flights, reliance upon commercial air-carriers has not been practical or convenient. Thus, this investment will provide the bank with access to an airplane that will permit management to better serve the bank’s numerous offices spread across three states.

**B. Analysis**

A national bank may engage in activities that are part of or incidental to the business of banking. In a variety of circumstances, the Office of the Comptroller of the Currency (OCC) has permitted national banks to own, either directly, or indirectly through an operating subsidiary, a non-controlling interest in an enterprise.<sup>1</sup> The OCC has concluded that national banks are legally permitted to make a non-controlling investment in a company provided four criteria or standards are met.<sup>2</sup> These standards, which have been distilled from our

previous decisions in the area of permissible non-controlling investments for national banks and their subsidiaries, are:

- (1) The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking (or otherwise authorized for a national bank).
- (2) The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.
- (3) The bank’s loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.
- (4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank’s banking business.

We conclude, as discussed below, that the bank’s investment in the company will satisfy these four criteria.

1. *The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking (or otherwise authorized for a national bank).*

The National Bank Act, in relevant part, provides that national banks shall have the power:

[t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes. . . .

The Supreme Court has held that this powers clause of 12 USC 24(Seventh) is a broad grant of power to engage in the business of banking, which is not limited to the five enumerated powers. Further, national banks are authorized to engage in an activity if it is incidental to the performance of the enumerated powers in section 24(Seventh) *or* if it is incidental to the performance of an activity that is part of the business of banking.<sup>3</sup>

<sup>3</sup> *NationsBank of North Carolina, N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 215 (1995).

<sup>1</sup> See, e.g., Conditional Approval Letter No. 219 (July, 15, 1996).

<sup>2</sup> See, e.g., Interpretive Letter No. 692, reprinted in [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,007 (Nov. 1, 1995); Interpretive Letter No. 694, reprinted in [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,005 (Dec. 13, 1995).

The company will own and operate a single airplane, the use of which will permit bank management to better serve the bank's numerous offices spread across three states. The bank's ownership interest in and operation of an airplane for use in its business is legally permissible under 12 USC 24(Seventh) as part of or incidental to the business of banking.

Its decision to be a one-third owner of the plane (through the company) is based upon projected need and usage by the bank. It requires access to an airplane, but not so much as to justify purchasing one outright. The other two owners will use the airplane for their proportionate share, to the mutual benefit of all three owners. The first standard is satisfied.

2. *The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.*

This is an obvious corollary to the first standard. It is not sufficient that the entity's activities are permissible at the time a bank initially acquires its interest; they must also remain permissible for as long as the bank retains an ownership interest.

The bank has the ability and the intention to divest itself of its investment in the company should the company engage in any activities that are impermissible for a national bank. Article XIV of the proposed LLC Operating Agreement that you have submitted for our review stipulates that the company shall be dissolved upon the direction of any LLC member. This ability to divest and the stated intention to do so, if necessary, appear adequate to permit the bank to withdraw its investment in the company should the company undertake impermissible activities. The second standard is thus satisfied.

3. *The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.*

a. *Loss exposure from a legal standpoint.*

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that the national bank's investment not expose it to unlimited liability.

The company is a [State] limited liability company. As a legal matter, investors in a [State] limited liability

company do not incur liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the company.<sup>4</sup> Furthermore, the proposed LLC Operating Agreement includes a provision stating that the members of the company shall have no liability or obligation for any debts, liabilities, or obligations of the company beyond the members' respective capital contributions or obligations to make a capital contribution, except as expressly required by the agreement or applicable law. See Agreement at Article XIX.

Thus, the bank's loss exposure for the liabilities of the company will be limited.

b. *Loss exposure from an accounting standpoint.*

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's minority investment in a corporate entity is to report it as an unconsolidated entity under the equity or cost method of accounting. You have represented that the bank will account for its ownership interest in the company according to the equity method of accounting. Under the equity method of accounting, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances shown on the investor's books.

Therefore, for both legal and accounting purposes, the bank's potential loss exposure arising from its investment in the company should be limited to the amount of its investment. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

4. *The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.*

A national bank's investment in an enterprise or entity must also satisfy the requirement that the investment have a beneficial connection to the bank's business, *i.e.*, be convenient or useful to the investing bank's business activities, and not constitute a mere passive investment unrelated to that bank's banking business. Twelve USC 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking.

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<sup>4</sup> See [State] Code Ann. § [ ].

“Necessary” has been judicially construed to mean “convenient or useful.”<sup>5</sup> Our precedents on bank non-controlling investments have indicated that the investment must be convenient or useful to the bank in conducting *that bank’s* business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.<sup>6</sup>

In this instance, the bank’s ownership interest in the company is neither passive nor speculative, and this ownership interest will be convenient and useful for the bank. The bank has almost 50 offices spread across [State1, State2] and [State3]. As a result of its investment in the company, the bank will have access to an airplane to facilitate bank management’s air travel to these various offices. The bank represents that since its offices are located in geographic areas served by small airports offering infrequent commercial flights, reliance upon commercial air-carriers is neither practical nor convenient. Access to the aircraft owned and operated by the company will permit the bank’s management to better serve the bank’s numerous offices spread across three states. Thus, the investment is not a mere passive investment unrelated to the bank’s banking business.

Accordingly, the fourth standard is satisfied.

## C. Conclusion

Based upon a thorough review of the information you provided, including the representations and commitments made in your letters, and for the reasons discussed above, it is my opinion that the bank may acquire a non-controlling equity investment in the company, subject to the following conditions:

- (1) The company will engage only in activities that are permissible for a national bank;
- (2) In the event that the company engages in an activity that is inconsistent with condition number one, the bank will divest its interest in the company in accord with the bank’s letter of May 7, 2002;
- (3) The bank will account for its investment in the company under the equity method of accounting; and

<sup>5</sup> See *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

<sup>6</sup> See, e.g., Interpretive Letter No. 543, reprinted in [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (Feb. 13, 1991); Interpretive Letter No. 427, reprinted in [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); Interpretive Letter No. 421, reprinted in [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (Mar. 14, 1988).

- (4) The company will be subject to OCC supervision and examination, subject to the limitations and requirements of 12 USC 1820a and 1831v.

These conditions are conditions imposed in writing by the OCC in connection with this opinion letter stating that the bank’s investment in the company is permissible under 12 USC 24(Seventh). As such, these conditions may be enforced in proceedings under applicable law.

If you have any questions, please contact Counsel June Hinson Allen at (404) 588-4520.

Brenda Curry  
District Counsel  
Southeastern District

## 944—August 12, 2002

### 12 USC 24(7)

Subject: Proposed Loss Notification and Credit Monitoring Services

Dear [ ]:

This is in response to your letter, transmitted via e-mail on June 27, 2002 to Richard Erb, licensing manager, Large Bank Supervision, regarding the proposal of [ ], [City, State] (“bank”) to engage in certain loss notification and credit monitoring services. In particular, you seek the OCC’s concurrence with your view that the proposed activities are incidental to the business of banking under 12 USC 24(Seventh) and therefore permissible for a national bank.

## Facts

The bank, which specializes in the issuance of retail and business credit cards, proposes to add loss notification and credit monitoring services to its product offerings. Initially these services would be offered solely to the bank’s cardholders. At some later time, the bank may also offer these services to cardholders of other issuers and to the general public. Customers would pay a monthly charge for each service. In the case of the bank’s own cardholders, such charges would appear on the regular monthly billing statement.

Customers who purchase the bank’s loss notification services would be able to register all their credit, debit, ATM, and telephone calling cards with the bank.

Participating customers whose cards were lost or stolen would then be able to notify the bank of the loss or theft and the bank would then (a) notify the issuers of all the lost or stolen cards and (b) request that the cards be canceled or reissued. Through this process, the customers would receive full protection from their respective card issuers for fraudulent charges. They would also be eligible for emergency cash advances.

Customers who purchase the bank's credit monitoring services would also be able to obtain, at any time, the following products or services:

- (a) A merged triple credit bureau report (*i.e.*, from the three major credit bureaus);
- (b) A current credit score;
- (c) Monthly monitoring of their credit record for new accounts, inquiries, and derogatory or adverse information;
- (d) Access to their Social Security account to confirm accurate Social Security deductions by past and present employers;
- (e) Access to medical information about them on file at the Medical Information Bureau, including health information used by insurance companies;<sup>1</sup>
- (f) Access to records of their motor vehicle violations, including points and dates by which points should be removed from their drivers license records; and
- (g) Access to credit advisory consultants.

The bank currently offers these services, provided by nonaffiliates, to its own cardholders pursuant to its authority to act as a finder under 12 CFR 7.1002. However, the bank would like to bring these services in-house.

## Analysis

The OCC has traditionally recognized the authority of national banks to organize and perform any of their lawful activities in a reasonable and convenient manner

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<sup>1</sup>The Medical Information Bureau is a non-stock, not-for-profit membership association, organized under Delaware law, of approximately 600 U.S. and Canadian insurance companies. According to its Web site ([www.mib.com](http://www.mib.com)), its purpose is to "detect and deter attempts by applicants of life, health, disability or long-term insurance who would omit or misrepresent facts." It maintains a database that assigns codes to a wide variety of medical conditions and other factors, such as adverse driving records and participation in hazardous sports, that might affect an individual's insurability. Member companies report to the bureau information they obtain about any insured person or insurance applicant that is considered significant to the person's risk classifications, and often check the bureau's database before approving an insurance application.

not prohibited by law. A national bank may engage in all activities that are part of or incidental to the business of banking. 12 USC 24(Seventh). In *NationsBank of North Carolina, N.A., v. Variable Life Annuity Co.*, 513 U.S. 251 (1995), the Supreme Court held that the "business of banking" is not limited to the enumerated powers in 12 USC 24(Seventh), but rather encompasses activities that are part of the business of banking. *Id.* at 258. The Court further established that banks may engage in activities that are incidental to the enumerated powers as well as the broader "business of banking."

The OCC determined a number of years ago that loss notification services such as those proposed by the bank are incidental to banking.<sup>2</sup> Since the issuance of credit cards has long been determined to be a proper activity for national banks, ancillary activities such as loss notification and providing emergency loans are a logical outgrowth of those services.

The OCC has also consistently stated for many years that the operation of a credit bureau is incidental to banking and thus permissible for national banks.<sup>3</sup> In addition, it has determined that providing credit verification incidental to the issuance of credit cards is permissible.<sup>4</sup> If it is permissible for a national bank to operate a credit bureau, then it is clearly also permissible for the bank to provide directly to its customers those services that are performed by a credit bureau or are a logical outgrowth of credit bureau activities, *i.e.*, credit reports, credit scores, and monitoring of credit records. Providing access to credit advisory consultants is well within a national bank's longstanding authority to offer financial counseling. 12 CFR 5.34(e)(5)(v)(I); OCC Interpretive Letter No. 137, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,218 (December 27, 1979).

While the other services proposed to be offered by the bank (providing customers with access to their Social Security, medical, and motor vehicle records) are not viewed as strictly banking, financial, or related economic information, the inclusion of these services along with the other credit monitoring services is permissible. The OCC has long held that, under their incidental powers, national

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<sup>2</sup>See letter from Jonathan L. Levin, senior attorney (March 15, 1985) (unpublished); letter from John E. Shockey, deputy chief counsel (Sept. 18, 1975) (unpublished).

<sup>3</sup>See, *e.g.*, OCC Conditional Approval No. 336 (Nov. 2, 1999); OCC Conditional Approval No. 276 (May 8, 1998); letter from John E. Shockey, deputy chief counsel (May 18, 1976) (unpublished).

<sup>4</sup>See letter from Richard V. Fitzgerald, director, Legal Advisory Services Division (Jan. 25, 1979) (unpublished).

banks may sell non-banking products and services when reasonably necessary to provide banking products on a competitive basis by creating a package of related services needed to satisfy consumer demand, meet market competition, and enable the national bank successfully to market its services. *See, e.g.*, OCC Interpretive Letter No. 928, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-453 (December 24, 2001).<sup>5</sup> In this case, the inclusion of these other records as part of the credit monitoring services to be offered by the bank will make the overall package more attractive and useful to

customers by providing them with a single convenient source through which to gain access to a wide variety of personal, financial, and other files.

## **Conclusion**

The loss notification and credit monitoring activities described in your letter are permissible under 12 USC 24(Seventh) because they are part of or incidental to the business of banking.

Sue E. Auerbach

*Counsel*

*Bank Activities and Structure Division*

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<sup>5</sup> *See also* OCC Interpretive Letter No. 653, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (Dec. 22, 1994)