Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #897
November 2000
12 USC 24(7)

October 23, 2000

Dear **[ ]**:

This is in response to your letter of September 18, 2000, requesting confirmation that **[ ]** (the "Bank") may acquire a 24.9 percent non-controlling interest in **[ ]** (the "Advisor"), a Delaware limited liability company that provides investment advisory and related services. For the reasons set forth below, the Bank may acquire and hold the interest in the Advisor, in the manner and as described herein.

A. Background

The Bank proposes to make a minority, non-controlling investment in the Advisor, an investment advisor registered as such with the U.S. Securities and Exchange Commission ("SEC"). The Advisor provides investment advisory and related services to its clients, which include private investment funds, high net worth individuals and their related interests, and institutional customers.

As part of its business, the Advisor owns limited equity interests in private investment funds for which it serves as investment manager, and may in the future own limited equity interests in public investment funds for which it serves as investment manager. The Bank has represented that the Advisor is compelled to make these investments in order to compete effectively in the investment advisory business due to (1) the demands of investors and the practices of competing investment advisors, (2) the structures required to provide tax treatment for investors comparable to that of investors in similar funds, and (3) the compensation arrangements required to attract and retain qualified staff. The investment funds may be organized as limited liability companies, corporations, or business trusts.[1] Certain of the investment funds for which the Advisor serves as

[1] As described below, the Advisor has indicated that it intends to continue to serve as general partner to eight existing private investment funds established in limited partnership form. The Advisor will not, however, serve as general partner to any newly-created funds. The existing private funds organized as limited partnerships do not employ leverage or derivatives, do not own controlling interests in any businesses, and do not own real property or other assets that are likely to generate liabilities.

investment advisor may invest in securities and other financial assets in which a national bank ordinarily is not permitted directly to invest.[2]

The Advisor proposes to own interests in funds it advises or subadvises only if the investment is necessary to attract investors into the investment fund and to structure tax-efficient performance compensation arrangements. Investments made for these purposes may also be used to provide performance-based compensation to investment management staff of the Advisor. The Advisor will invest only in funds that hold securities and financial instruments, and will not invest in any fund that includes real estate or tangible personal property. The Advisor further proposes that it will hold an interest in funds containing bank ineligible investments only while the Advisor serves as an investment manager or subadvisor to the fund, and only if the terms of the instruments governing the fund allow the Advisor to sell, redeem or otherwise dispose of its investment if it no longer services the fund.

The Advisor will limit the amount of its equity contributions to the funds in a variety of ways. The maximum investment by the Advisor in any one new fund that contains bank-ineligible assets will not exceed five percent of a class of voting securities of the fund or 24.99 percent of the total equity of the fund, and will not exceed one percent of the equity capital of the fund at the time the Advisor initially makes an investment.[3] The aggregate investment by the Advisor, measured at the time of the investment, in all such funds generally would be no greater than an amount equal to 10 percent of the Bank’s capital. In addition, the Advisor will not invest more than an amount equal to the Advisor’s net equity capital minus the aggregate amount of the Advisor’s investment in plant, property and equipment and working capital. The Bank has represented that it will not guarantee the Advisor’s obligations or extend credit to the Advisor.

1. Industry practice and competitive need

The Bank represents that in order to perform the approved investment management and administrative activities described with respect to certain types of funds, investment advisors, as a practical matter, are compelled to take small stakes in the funds they manage. Many institutional and sophisticated individual investors expect and require the manager to invest to assure that the investment manager's interests are aligned with those of investors in the fund. These investors believe that such investment by the fund manager improves the quality of the

[2] The Advisor plans to invest only in funds that invest primarily in securities. Any non-securities investments will be limited to financial investments, will not include real estate or tangible personal property, and will not make significant use of leverage or derivatives.

[3] As a result of unrealized gains allocated to the Advisor’s equity account for performance, the percentage of the equity of a fund attributable to the Advisor’s capital account may in some unusual cases, for a brief period, exceed the percentages set forth above. The Advisor’s interest in the fund will be brought within the percentages within no more than six months.

service received by the fund from the investment manager. Thus, the Bank states that it is now a standard industry practice for investment managers to invest in certain funds that they manage.[4]

As a result of amendments to the Federal Reserve's Regulation Y, investment management firms that are nonbank subsidiaries of bank holding companies are now permitted to own up to five percent of the voting shares of investment funds that the firm manages. These amendments, adopted by the Board of Governors of the Federal Reserve System in 1997, removed a prior restriction on such investments by a bank holding company or its nonbank subsidiaries that was originally adopted in 1972.[5] Due to the 1997 amendments, the Bank's competitors that are subsidiaries of bank holding companies are permitted to make the types of investments for which the Bank is seeking authorization.

In a recent interpretive letter (issued before the Gramm-Leach-Bliley Act[6] expanded the powers of holding companies), the Federal Reserve permitted a bank holding company to invest as principal in shares of investment funds serviced by the bank holding company in analogous circumstances.[7] The Federal Reserve permitted the investment (which was as much as 100 percent of the initial capitalization of a series mutual fund, provided that amount was decreased to 24.9 percent within six months) on the theory that the purpose of the investment is "to facilitate [the bank holding company's] primary activity of providing investment advice and other services to the mutual funds, which is a permissible activity for bank affiliates under the Glass-Steagall Act."[8]

Other investment managers -- including managers that are not bank affiliates, as well as investment managers that are subsidiaries of bank holding companies or of foreign banks -- are permitted to make these investments, and do so. Many of the investment managers that directly compete with the Advisor invest as principal in funds that those competitors manage and

---

[4] *See* Letter from **[ ]** (September 18, 2000)(citing Bank's experience as investment manager and administrator of private "funds of funds," *i.e.*, funds that invest in multiple private funds that in turn invest in venture capital investments and private equity investments); Federal Reserve Interpretive Letter dated June 24, 1999 (First Union investment as principal in registered investment companies managed by subsidiary). *See also*, Robert Dunn, *Negotiations on Terms Become More Balanced*, Buyouts (December 7, 1998)(investment managers of large buyout funds Aconsistently have been contributing larger sums to recent funds--largely based upon limited partner demands that the interests of the funds= management and its investors be aligned@); Debra Lau and Josh Kosman, *PSERS Plays Hardball, But Tries to Stay in Game*, Buyouts (April 20, 1998)(Pennsylvania Public Schools Employee Retirement System invests only in private funds in which the investment manager invests in at least 5 percent of the total because Athere is a higher probability that they will pay attention to the fund@); James Robinson, *JLW Bows to Client Pressure to Coinvest*, Estates Gazette (July 25, 1998)(investment management principal quoted as saying Awe are not seeking to co-invest, but we listen to the requirements of our clients@).

[5] 62 Fed. Reg. 9290, 9303, 9343 (Feb. 28, 1997); 37 Fed. Reg. 1464 (Jan. 29, 1972), codified as amended at 12 C.F.R. § 225.125.

[6] Public L. No. 106-102 (1999)("GLBA").

[7] Letter dated June 24, 1999 from Jennifer J. Johnson, Secretary of the Board of Governors of the Federal Reserve System to H. Rodgin Cohen.

[8] *Id.*

administer. The Bank and the Advisor believe that in order to offer the intended investment advisory and administrative activity and to compete effectively in its investment management business, the Advisor must, as an incident to that activity, continue to invest as principal to a limited extent in the investment funds it advises. Bank represents that the Advisor will be at a severe competitive disadvantage -- both in terms of attracting and retaining investment management staff, and in attracting investors to its private investment funds -- if it is not permitted to continue making these investments. Thus, to assure the other investors that the Advisor's interests are aligned with their own, the Advisor as a competitive matter needs to make small investments in funds it advises.

2. Tax-efficient means to receive performance-based allocations

The Bank also represents that in order to compete effectively in the investment management business, Advisor must be able to offer the investors in its funds the maximum after tax total returns possible. As described below, one means for the Advisor to maximize these returns is for the Advisor to structure the way it receives compensation for its services in a manner that is tax-efficient for its investors. The Advisor believes that in order to receive its compensation in a tax-efficient manner, it is necessary for it to own at least a small initial investment in the funds it advises.[9]

The Advisor receives performance-based compensation calculated as a percentage of a fund's total return. Performance-based compensation of investment advisers is a long-standing and common industry practice, particularly for institutional and high net worth clients, private investment funds and specialized investment companies. In 1996, Congress amended the Investment Advisers Act to simplify the regulation of these arrangements and liberalize former restrictions, particularly in the context of non-U.S. clients, "qualifying client" funds, and "qualified purchaser" funds.[10] The SEC has expanded upon the statutory liberalization through amendments to Advisers Act Rule 205-3 (17 C.F.R. § 275.205-3).[11] In proposing the revised rule, the SEC noted that the former restrictions "inhibit flexibility of advisers and their clients in establishing performance fee arrangements beneficial to both parties."[12] The SEC noted that:

[P]roponents of performance fees have argued that these arrangements may benefit both parties to the advisory contract because linking advisory compensation to performance may result in a closer alignment of the goals of the adviser and the client. If the goals of both parties coincide,

---

[9] The U.S. Department of the Treasury and the Tax Court have not yet addressed whether, under the Internal Revenue Code (the "Code"), a manager of a private investment fund is required to make a cash investment in the fund in order for the manager to receive its compensation in a manner that is tax-efficient for the other investors in the fund. In the absence of dispositive guidance from the tax authorities, the Bank's counsel has advised the Bank that it would be prudent from a tax point of view for the Advisor to make investments in the funds it manages. The Bank represents that many tax practitioners have given their investment manager clients similar advice.

[10] National Securities Markets Improvement Act of 1996 § 210, 1041, Cong., 2d Sess. (1996).

[11] SEC Rel. No. IA - 1731 (July 15, 1998).

[12] SEC Rel. No. IA - 1682 (Nov. 13, 1997).

then the benefits of performance arrangements would include fewer conflicts of interest in advisory relationships. Better alignment of the goals of the adviser and the client might also result in more efficient investment and allocation of capital. Proponents also claim that performance fees may encourage better performance by rewarding good performance rather than linking compensation and assets under management as in more traditional arrangements. Thus, such arrangements may produce more cost-effective results than arrangements with more traditional fee structures.[13]

Performance compensation of a private investment fund's investment managers typically can be structured in either of two forms: (1) a fee based upon performance or (2) a performance-based allocation of income and gains to the equity account of the investment manager or its affiliate.

Most institutional investors in a private investment fund are indifferent as to whether performance-based compensation is structured as a performance fee or as an allocation to an equity account. In contrast, higher income individual investors, trusts, and investors taxed as partnerships that in turn have individual or trust investors, prefer that performance compensation be structured as an allocation to the investment manager's equity account. Individual investors must report as income their proportionate share of the gross amount of a fund's income and gains before deducting investment-related fees and expenses paid by a private investment fund. However, there are limits on the deductibility by individuals and trusts of investment related fees and expenses that may preclude higher income individuals from deducting their full proportionate share of the fund's fees and expenses. Thus, the investor's *taxable* income attributable to the fund may be greater than the investor's proportionate share of the *net* income of the fund. By contrast, performance compensation in the form of a profit allocation by a fund is not required to be reported as income by investors who are not the recipients of the allocation, and thus investors' reportable income and gains exclude the share of the fund's profits allocated to the fund's advisor or manager.

Because performance compensation frequently is a substantial percent of the fund's returns, the limitation on deductibility can have a significantly adverse effect on individual investors in a private investment fund that uses a performance fee rather than a performance-based equity allocation to the investment manager. As a result, private investment funds traditionally have structured performance compensation as an equity allocation in order to be tax-efficient for individual investors. The Advisor competes with nonbank investment managers that structure their performance compensation in this way. In order to compete effectively for investors for its private investment funds, the Advisor wishes to be able to continue to structure performance compensation for investment funds as an allocation to the Advisor's equity interest in each fund.

3. Performance-based compensation of employees

Like many investment managers and securities firms, the Advisor currently pays out a substantial part of its gross revenues to key staff members as performance-based compensation. Such compensation arrangements allow investment management firms to attract and retain staff

[13] *Id*. (citations omitted).

members with compensation tied to performance. This also aligns the staff member's interests with those of the Advisor and its clients. The Advisor plans to pay its principal and investment management team annual bonuses that are a substantial percentage of the gross performance fees and allocations received by the Advisor. If the Advisor were not able to pay substantial performance-based compensation to its key investment management staff members, the Bank represents that the Advisor would have difficulty attracting and retaining qualified staff. Investment management employees with experience and an established track record in managing high-tech and small cap equity portfolios are very much in demand. To compete in this sector, the Advisor must be able to pay staff members meaningful bonuses based upon successful investment performance.

To pay performance-based bonuses to its own staff, the Advisor as a practical matter must receive performance-based compensation from its clients. To receive performance-based compensation in a manner that is tax-efficient to its taxable non-corporate clients, the Advisor as a practical matter must own an equity investment in an investment fund in which such investors invest and receive a performance-based income allocation from the fund. Thus, ownership of equity interests in the investment funds managed by staff members can serve as an effective way for an investment management firm to fund obligations to employees under annual bonus arrangements, or under non-qualified employee benefit plans under which the amount of an employee's deferred compensation is indexed to the increase or decrease in the value of interests in the fund.

B. Analysis

In a variety of circumstances, the OCC has permitted national banks to own, either directly or indirectly through an operating subsidiary, a noncontrolling interest in an enterprise.[14] The OCC has concluded that national banks are legally permitted to make such a noncontrolling investment provided four criteria or standards are met.[15] These standards, which have been distilled from our previous decisions in the area of permissible noncontrolling 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.

---

[14] *See, e.g.,* Conditional Approval Letter No. 219 (July 15, 1996).

[15] *See* Interpretive Letter No. 692 (November 1, 1995); Interpretive Letter No. 694 (December 13, 1995).

(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 Advisor 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).

In the present case, the Bank proposes to make a non-controlling investment in a firm engaged in investment advisory activities. Thus, the Advisor's activities must be analyzed to determine if they are part of, or incidental to, the business of banking. It is well recognized that national banks may engage in investment advisory activities as part of the business of banking. The Advisor's basic activities clearly satisfy the first criterion. The Advisor's limited investments in the funds it advises also meet the first criterion because they are useful and convenient in conducting its bank-permissible investment advisory activities. The proposed investments assure the fund's other investors that the investment advisor's interests are aligned with their own, provide tax treatment for investors that is comparable to that of investors in other similar funds, and provide the investment advisor with a mechanism for funding the performance-based compensation required by the investment advisor's key employees and staff. Investing in the funds is thus incidental to the business of banking. Moreover, as described below, the proposed investments are not prohibited by 12 U.S.C. 24(Seventh).

a. The Advisor's activities are part of and incidental to the business of banking.

As noted above, we analyze the Advisor's activities to determine if they would be permissible for a national bank as part of, or incidental to, the business of banking. The OCC has long held that a national bank may provide investment advice as part of the business of banking authorized under 12 U.S.C. § 24(Seventh) and pursuant to their fiduciary powers under 12 U.S.C. § 92a, including acting as an investment adviser to an investment company.[16] These activities also are expressly permitted for an operating subsidiary of a national bank under 12 C.F.R. § 5.34(e)(5)(v)(I), and for non-controlling by a national bank under 12 C.F.R. § 5.36(e).

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."[17] Prior to

[16] *See*, *e.g.*, 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.

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*.[18] 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."[19] 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 U.S.C. § 24(Seventh). Thus, it would be considered incidental to a permissible bank activity for a national bank to invest in a fund to which it provides investment advice if, under the circumstances presented, that activity is confined to investments that are convenient or useful to the clearly bank-permissible investment advisory activities conducted by the Advisor.[20]

In the context of the instant proposal, the ownership by the Advisor of small interests in investment funds it manages is directly related to, and an essential part of, the Advisor's activity of providing bank-permissible investment management and administrative services to the investment fund. The purpose of the proposed investments is to enable the Advisor to act as an investment manager to the types of investment funds in which an ownership stake by the investment manager is necessary. The level of such investments by the Advisor in any single fund and in the aggregate will be limited, and any income from these small investments would be overshadowed by revenues generated by the Advisor's investment advisory and management activities. The proposed investments are not passive or speculative investments on the Advisor's part; they are made solely to enable the Advisor to provide investment management services as conducted by the Advisor's competitors in the investment management industry, and will be held only when, and for so long as Advisor is providing those services.

The Bank has stated that institutional and sophisticated individual investors in private investment funds require that the manager invest in the fund as a means of assuring outside investors that the manager's interests are aligned with those of the outside investors. These investors believe that such investment by the fund manager improves the quality of the investment management services received by the fund from the investment manager. The Bank has stated that, as a practical matter, in order to offer the funds it advises, the Advisor must make these investments.

---

[17] *VALIC*, *supra,* at 258 n. 2.

[18] *Arnold Tours v. Camp,* 472 F.2d 427 (1st Cir. 1972)('*Arnold Tours*").

[19] *Id*. at 432.

[20] *See* Letter from Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, to **[ ]** (Oct. 1, 1999, unpublished)(expressing no objection to an investment advisor making small investments in funds it advises where such investments were necessary to conduct permissible advisory activities). *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.

Investing in the funds it advises enables the Advisor 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 is a substantial percentage of a fund's returns, the use of a performance-based allocation can have a significant effect on individual investors in a private investment fund. 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 Advisor to invest in the funds enables the bank to compete more effectively with entities that can offer this tax result to their individual investors.

Further, the Advisor's investment in funds also enables it to offer competitive compensation to key staff members. A private investment fund manager typically must pay a substantial part of its gross revenues to the manager's key staff members as performance-based compensation. Such compensation arrangements are required for the investment managers to attract and retain high quality staff. The Bank has indicated that the Advisor plans to pay its investment management staff annual bonuses that are a substantial percentage of the gross performance-based compensation received by the Advisor. The Bank has indicated that, as a practical matter, in order to fund the payment of performance-based bonuses to its staff, the Advisor must charge its customers performance-based compensation. As described above, to charge performance based-compensation in a manner that is tax-efficient, the Advisor must receive a performance-based allocation from the funds it manages.

In this regard, the OCC has approved various plans for funding employee compensation and benefit obligations through the acquisition of bank eligible and ineligible assets. For example, a national bank may hold investment funds, including funds that hold investment that otherwise would be impermissible, in order to hedge its obligations under a deferred employee compensation program.[21] Under the deferred compensation program, employees were allowed to defer receiving a portion of their bonuses to a future date and use the change in value of certain indices or investments to benchmark the distribution value. The bank would purchase investments in funds that would match the benchmarks, and some of the funds would make investments that would not be permissible for a national bank.[22] In addition, a national bank may establish a "rabbi trust" to provide reasonable deferred compensation for its officers and

---

[21] *See* Interpretive Letter No. 878 (December 22, 1999), *reprinted in* [1999-2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,375. *Cf*. Federal Reserve Board Staff Letter to Anthony J. Horan, Chemical Banking Corporation, 1994 WL 904318 (Federal Reserve Bulletin)(July 22, 1994)(permitting such investments by a bank holding company at time Regulation Y prohibited investment by bank holding company in proprietary investment companies), Interpretive Letter No. 848 (November 23. 1998), *reprinted in* [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,303 (same result in context of national bank investment in insurance products to hedge obligations under deferred compensation plans).

[22] *See* Interpretive Letter No. 878, *supra*.

employees consistent with safety and soundness considerations.[23] The rabbi trust may hold investments beyond those allowed for national banks without violating Section 24(Seventh).[24]

Accordingly, in the instant case, because the Advisor'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 of the Advisor.

b. Holding an interest in funds in order to engage in the investment advisory business is not prohibited by 12 U.S.C. 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 Advisor would not be "dealing" in or "underwriting" securities prohibited for national banks by Section 24(Seventh). Although Adealing@ and Aunderwriting@ are not defined in Section 24(Seventh)[25] "dealing" in securities is generally understood to encompass the purchase of securities as principal for resale to others.[26] 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.[27] "Underwriting" is generally understood as encompassing the purchase of securities from an issuer for distribution and sale to

---

[23] *See* Letter from Ellen Broadman, Director, Securities and Corporate Practices Division (January 19, 1995)(Unpublished).

[24] *Id*.

[25] 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 U.S.C. § 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 U.S.C. § 77(b)(a)(11).

[26] 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).

[27] *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*.

investors.[28] Case law confirms that one cannot be an underwriter in the absence of a public offering.[29]

Under the above definitions, the purchase by the Advisor of interests in the funds it advises would not constitute "dealing" or "underwriting." The Bank has represented that the Advisor will invest in the funds solely for purposes of engaging in the investment advisory business. The Advisor will not hold the interest in the funds in order to engage in a regular business of buying and selling them in the secondary market[30] and will not participate in a public offering of the securities to investors.

The ownership by the Advisor of a small interest in the funds it advises 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 U.S.C. § 24(Seventh) or in 12 C.F.R. 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 C.F.R. Part 1. Under Part 1, an investment security is defined as "a 'marketable' debt obligation that is not predominantly speculative in nature."[31] Equity securities do not represent debt obligations.

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 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.[32]

In the present situation, the Advisor's proposed non-controlling investment 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. The Bank has stated that institutional and sophisticated individual investors in these funds require that the manager make the investments.

---

[28] 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.

[29] *SIA v. Board of Governors,* 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

[30] The Bank will not act as market maker in the securities by quoting prices continuously on both sides of the market.

[31] 12 C.F.R. § 1.2(e).

[32] The legislative history of the language in the fifth sentence of Section 24(Seventh) is discussed in detail in Interpretive Letter 892 (September 13, 2000).

In this connection, these investments enable the Advisor to assure investors in its funds that the Advisor's interests are aligned with their own, permit the Advisor to offer funds that provide investors with a tax treatment comparable to that of investors in other, similar funds, and provide a means for the Advisor to compensate its key staff on a competitive basis. The Bank has stated that the Advisor would be unable to offer these funds on a competitive basis unless the Advisor makes these investments. Based on these circumstances, the proposed investments are an essential component of investment management services provided by the Advisor to the investment funds. Therefore, 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 represented that, under the terms of the Advisor's operating agreement (the "Operating Agreement"), the Bank has the ability to prevent the Advisor from engaging in impermissible activities. The Operating Agreement will limit the Advisor's activities to those that are part of, or incidental to, the business of banking and that are permissible activities for a national bank. In addition, the Operating Agreement will provide that the Advisor will not engage in any new business activity disapproved by the Bank. Thus, the Bank, while holding a noncontrolling interest in the Advisor, will nonetheless be able to prevent the Advisor from engaging in any activity that is not permissible for a national bank.[33] Accordingly, the second standard is 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 subject 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 the bank to unlimited liability. As a legal matter, an investor in a Delaware limited liability company will not incur liability with respect to the liabilities or obligations of a limited liability company solely by reason of being a member or manager of the company.[34] The Bank's loss exposure for the liabilities of the Advisor will be limited to the amount of its investment.

---

[33] The Bank has also represented that the Advisor will invest as principal in an investment fund that invests in bank-ineligible assets only if the terms of the instruments governing the fund permit the Advisor to withdraw, transfer or sell its investment within a reasonable period after such time that Advisor resigns or is removed as an investment manager to the fund. Thus, the manner in which the Advisor uses its investments in the funds will remain consistent with activities that are part of the business of banking.

[34] *See* Del. Code Ann. Title 6, § 18-303 (1999).

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 banks 20-50 percent ownership share in a limited liability company is to report it on an unconsolidated basis. Under the equity method of accounting, unless the bank has extended a loan to the entity, guaranteed any of its liabilities or has other financial obligations to the entity, losses are generally limited to the amount of the investment shown on the investor's books.[35] The Bank has represented that it will not guarantee any obligation of, or extend credit to, the Advisor. The Bank will account for its noncontrolling investment in the Advisor under the equity method of accounting.[36] The Bank's loss exposure from an accounting perspective will be limited to the amount of its investment.

Therefore, for both legal and accounting purposes, the Bank's potential loss exposure arising from its investment in the Advisor should be limited to the amount of the investment.[37] 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 business.

---

[35] *See generally* Interpretive Letter No. 692 (November 1, 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep (CCH) ¶ 81,007.

[36] Under the equity method of accounting, the Bank's financial statements will reflect its investment *in* the Advisor. Investments made *by* the Advisor are not consolidated with assets held by the Bank on the Bank's financial statements.

[37] The Bank also has represented that the Advisor's loss exposure would be limited by the legal structure of the funds in which it would invest. The new funds in which the Advisor proposes to invest will be limited liability companies, corporations, business trusts, or other similar limited liability entities in which the risk of loss will be limited to the amount of the Advisor's equity investment. The Advisor will not invest in any new fund as to which investors have unlimited liability. The Advisor will not invest in a fund that will be consolidated with the Advisor for accounting purposes. Accordingly, the Advisor's loss exposure also will be limited as a legal and accounting matter. As described above, the Advisor plans to continue to serve as general partner in a small number of existing private investment funds established in limited partnership form. The Adviser has represented that it will not, however, serve as general partner to any newly-created funds. National banks are not permitted to be partners in general partnerships due to the potential unlimited liability for the acts of other partners within the scope of the partnership. *Merchants National Bank v. Wehrmann*, 202 U.S. 295 (1906). In the case of the existing private investment funds, the Advisor would be the sole general partner. Thus, there would be no other partners for whom the Advisor would be liable. Moreover, national banks may enter into general partnerships that engage in bank-permissible activities because the corporate veil of the subsidiary corporation protects the bank from the potentially open-ended exposure associated with a direct partnership investment. Corporate Decision No. 2000-07 (May 10, 2000); Interpretive Letter No. 697 *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,012 (Nov. 15, 1995); Interpretive Letter No. 289 *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,453 (May 15, 1984). In this case, the Bank would not be the general partner in the existing private investment funds organized as limited partnerships, but would merely own an interest in the Advisor, which would be the entity acting as general partner. Because the partnership interest is not held by the Bank, but rather by the Advisor which would be a separate limited liability company, the Bank should be shielded from unlimited liability.

The Bank represents that its investment in the Advisor is convenient and useful to the Bank as an extension of the investment management business that is conducted in the Bank. The investment is convenient and useful to the Bank in providing the Bank with access to the Advisor's expertise in the management of growth-equity, technology and small cap investments, private investment fund management, and in providing the Bank with access to high net worth individuals and families. In this connection, the Bank is establishing a representative office at the Advisor's location and will seek introductions to clients of the Advisor. The Advisor will serve as a subadvisor for a family of new private investment funds for which the Bank acts as manager and advisor, and for which an affiliate of the Bank acts custodian. The principal of the Advisor will become a senior advisor to the Bank and will seek to introduce clients to the Bank for trust and investment management services. For these reasons, the investment in the Advisor is convenient and useful to the Bank in carrying out its business and not a mere passive investment. The proposed investments are thus directly related to the Bank's investment management 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 letter, and for the reasons discussed above, we conclude that the Bank may make a non-controlling equity investment in the Advisor, subject to the following conditions:

(1) If the Bank's capital falls below the level required for it to be "well-capitalized" as determined by the OCC, the Advisor may maintain its investments in existing funds it advises or subadvises but shall not invest in any new funds.

(2) The Bank, the Advisor and the Bank's subsidiaries shall be deemed "affiliates" of any investment company advised or subadvised by the Bank or the Advisor for purposes of Sections 23A and 23B of the Federal Reserve Act.

(3) The Bank shall not extend credit to the Advisor. The Bank shall not make loans to any persons to fund investments in the investment funds advised or subadvised by the Advisor. The Bank's aggregate advances to the funds advised by the Bank or the Advisor shall not exceed an amount equal to the Bank's legal lending limit.

(4) Prior to making the proposed investment in the Advisor, the Bank shall adopt and implement an appropriate risk management process to monitor principal investments made by the Advisor in funds advised or subadvised by the Advisor. 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 purchases and sales by the Advisor in funds it advises or subadvises;

(ii) Adoption and implementation of risk management policies and procedures for monitoring the investments made by the Advisor in the funds it advises or subadvises and the risks associated with those investments, 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)); and

(iii) Obtaining periodic reports from the Advisor on the investments in funds it advises or subadvises, including information on the Advisor's risk management policies and procedures.

The Bank shall provide the OCC with copies of the policies and procedures described in (i) and (ii) prior to making the proposed investment in the Advisor.

(5) The Bank shall ensure that the Advisor adopts and adheres to the following limits for the Advisor's investments in new funds it advises or subadvises that contain bank-ineligible assets:

(i) *Individual fund basis* - the Advisor's maximum investment in a fund it advises or subadvises shall not exceed five percent of a class of voting securities or 24.99% of total equity of the fund, and shall not exceed 1% of the equity capital of the fund measured at the time the Advisor makes the investment;[38]

(ii) *Aggregate funds basis* - the Advisor's maximum aggregate investment, measured at the time of the investment, in all such funds shall not exceed an amount equal to 10% of the Bank's capital;

(iii) *Types of funds* - the Advisor shall not invest in funds it advises or subadvises other than those that invest in securities and financial instruments, and the Advisor shall not invest in any fund that holds real estate or tangible personal property; and

(iv) *Funds organized as partnerships* - the Advisor shall not invest as principal in any funds it advises or subadvises that are established in limited partnership form other than the existing funds described in the letter from David F. Freeman, Jr. dated September 18, 2000 (the "Existing Funds").

(6) The Bank shall ensure that the Advisor shall not invest additional amounts in the Existing Funds.

---

[38] As a result of unrealized gains allocated to the Advisor's equity account for performance, the percentage of the equity of a fund attributable to the Advisor's capital account may in some unusual cases, for a brief period, exceed the percentages set forth above. The Advisor's interest in the fund will be brought within the percentages within no more than six months.

(7) The Bank shall obtain reports from the Advisor as necessary for the Bank to determine compliance with these imposed conditions and to evaluate the risks and effectiveness of risk management associated with the Bank's arrangement with the Advisor. The Bank shall make such 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 imposed conditions and to evaluate the risks and the effectiveness of risk management associated with the Bank's arrangement with the Advisor. The Advisor shall be subject to OCC supervision and examination, subject to the limitations contained in 12 U.S.C. §1831v.

(8) The Advisor shall engage only in activities that are part of, or incidental to, the business of banking.

(9) The Bank shall have, in some fashion, and exercise veto power over any activities and major decisions of the Advisor that are inconsistent with condition (8) above, or, in the alternative, shall withdraw from the Advisor in the event that the Advisor engages in an activity that is inconsistent with condition (8).

(10) The Bank will account for its investment in the Advisor under the equity method of accounting.

(11) The Bank shall not acquire a majority interest in the Advisor without submitting an application to the OCC and obtaining prior approval.

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 investment is permissible under 12 U.S.C. § 24 (Seventh) and, as such, may be enforced in proceedings under applicable law.

Sincerely,

-signed-

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel