



Comptroller of the Currency  
Administrator of National Banks

Washington, DC 20219

**Interpretive Letter #1135**  
**February 2012**

January 20, 2012

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Subject: Purchase of Auction Rate Securities

Dear [ ]:

This is in response to your request to confirm the authority of [ ] (“Bank”), a federal savings association, to purchase and hold through a wholly owned operating subsidiary shares of auction rate securities (“ARS”).<sup>1</sup> The proposed acquisitions by [ ] (“OpSub”), the operating subsidiary, include: (1) municipal ARS, (2) student loan-backed ARS, and (3) auction rate preferred securities (“ARPS”), as described below.<sup>2</sup> For the following reasons, and based on the representations and subject to the conditions set forth herein, the OCC hereby confirms that the Bank through [OpSub] may purchase the ARS and ARPS (collectively, “the ARS”) from current and former customers and hold them for up to 120 days from the date of purchase.

<sup>1</sup> An ARS typically is a debt instrument with a long-term nominal maturity for which the interest rate is regularly reset through a Dutch auction.

<sup>2</sup> The Bank represents that the ARPS primarily were issued by closed-end investment funds, are rated investment grade and generally fall into four categories with respect to their underlying assets: (1) those backed exclusively by municipal obligations; (2) those backed exclusively by corporate securities; (3) those backed by a mixture of corporate securities and government obligations; and (4) those backed by a mixture of corporate securities, municipal obligations, and mortgage-backed securities.

## Background<sup>3</sup>

[OpSub], a registered broker-dealer, sold ARS to customers before the ARS market froze in 2008.<sup>4</sup> Following the failure of the ARS market, federal and state regulators and the Financial Institutions Regulatory Authority (“FINRA”) commenced a series of enforcement actions against various types of market participants, including issuers, marketers, auction participants, and “downstream sellers” of ARS to require financial institutions to provide liquidity to investors in ARS.<sup>5</sup> As part of a consent order with the Colorado Division of Securities<sup>6</sup> and the North American Securities Administrators Association (“NASAA”), [OpSub] would repurchase the ARS from its current and former customers<sup>7</sup> nationwide at par value.<sup>8</sup>

The Bank represents that it has reviewed the prospectuses for each of the ARS currently held by a customer of [ OpSub ], and conducted a thorough review of the securities, cash, loans, and other assets that serve as collateral for some of the ARS.<sup>9</sup> The Bank represents that all of the ARS are rated investment grade and that the issuer of each ARS has an adequate capacity to meet the financial commitments under the security for the projected life of the investment.<sup>10</sup> The

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<sup>3</sup> These facts are based upon the Bank’s representations.

<sup>4</sup> At the time of these sales [OpSub] was a subsidiary of [ ] (“Corp”), the savings and loan holding company parent of the Bank. However, in 2009 [Corp] reorganized by making Securities an operating subsidiary of the Bank.

<sup>5</sup> The Bank represents that Securities had a limited role in connection with the sale of ARS, and was not an issuer, underwriter, dealer, or market-maker. Rather, [OpSub] processed ARS orders for a limited number of customers through a platform made available by [ Company ].

<sup>6</sup> [OpSub] is registered as a broker-dealer with the Colorado Division of Securities.

<sup>7</sup> The Bank represents that if a former customer submits an ARS for purchase that is not already known to [OpSub], [OpSub] would conduct a thorough review of each such ARS to ensure that it is eligible for purchase by [OpSub] and consult with OCC if there was any issue with respect to permissibility.

<sup>8</sup> Par value is currently higher than fair value. As an alternative to purchasing and holding the ARS, [OpSub] may purchase the ARS from customers in a riskless principal transaction with a simultaneous sale to a third-party. A federal savings association may engage in riskless principal transactions regardless of whether the securities are eligible for the federal savings association to hold for its own account. See Memorandum to Office of District Banks from FHLBB Deputy General Counsel (January 15, 1988).

<sup>9</sup> The Bank has included in its submission detailed representations about each ARS held by a current customer, including principal amount outstanding, credit rating (if rated), maturity date (unless perpetual), and voting rights (if any). For ARS backed by collateral, these representations include information concerning the initial ratio of collateral to securities issued, the current ratio of collateral to securities issued, the percentage of portfolio assets that are investment grade, and the ratio of thrift-permissible assets to securities issued.

<sup>10</sup> Current regulations require that many types of securities have an investment grade rating. E.g., 12 C.F.R. § 160.40(a)(2)(ii) (corporate debt securities). As required by section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, Section 939A, 124 Stat. 1376, 1887 (July 21, 2010), the OCC has proposed to replace references to credit ratings in its regulations with alternative standards of creditworthiness, which would require that the issuer of each ARS has an adequate capacity to meet the financial commitments under the security for the projected life of the investment. An issuer has an adequate capacity to meet financial

Bank requests confirmation that [*OpSub*] may hold the purchased ARS for a limited period of time (up to 120 days) until they could be sold in an orderly manner at fair value. [ ] (“*Corp*”), Bank’s holding company, has committed to purchase from [ *OpSub* ] any of the ARS remaining unsold to third-party customers at the end of that period at a price equal to the greater of the ARS’ fair value or the amount that [ *OpSub* ] paid the customer to buy back the ARS.

## Discussion

### Municipal ARS

The Bank proposes to purchase a municipal ARS held by [*OpSub*] current customers that is a general obligation of a state or municipality. A federal savings association has the authority to purchase this type of municipal ARS for its own account when the obligation is guaranteed by the full faith and credit of a state or political subdivision that has the power to tax.<sup>11</sup>

The Bank also seeks to purchase revenue bond municipal securities and a certificate of participation ARS<sup>12</sup> which all have investment grade ratings.<sup>13</sup> These municipal ARS that [*OpSub*] would purchase also are permissible, subject to a per-issuer limitation of ten percent of total capital.<sup>14</sup>

### Student Loan ARS

The Bank seeks to purchase a single investment-grade rated ARS issued by a trust and backed by student loans, which currently is held by [ *OpSub* ] customers.<sup>15</sup> A federal savings association has authority to securitize and sell any loans that it is authorized to originate and purchase and

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commitments if the probability of default by the obligor is low and the full and timely repayment of principal and interest is expected. 76 Fed. Reg. 73,526,73,532-33 (Nov. 29, 2011); 76 Fed. Reg. 73,526 (Nov. 29, 2011). The bank has represented that the purchase of ARS would meet the revised standard, as proposed.

<sup>11</sup> 12 U.S.C. § 1464(c)(1)(H); 12 C.F.R. § 160.42(a)(1) and (c).

<sup>12</sup> The Bank represents that a certificate of participation is similar to a revenue bond. A municipality creates a bond issue to fund construction of a capital project or facility. During construction of the facility, the municipality leases the facility and makes lease payments instead of owning the facility outright. When the lease payment schedule is completed, the municipality assumes ownership of the completed facility. Holders of the certificate of participation are entitled to a return based on the lease payments made by the municipality.

<sup>13</sup> The municipal ARS the Bank proposes to purchase are current in their regular interest and dividend payments. The Bank has determined that the issuers of the ARS have an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. The Bank does not seek approval to purchase municipal ARS that are not rated investment grade or are unrated.

<sup>14</sup> 12 U.S.C. § 1464(c)(1)(H); 12 C.F.R. § 160.42(a)(2).

<sup>15</sup> This ARS also meets proposed creditworthiness standards. See 76 Fed. Reg. 73,526 (Nov. 29, 2011).

may invest in such asset-backed securities.<sup>16</sup> Accordingly, purchase of the student loan ARS is permissible because the student loans that back this ARS are authorized investments for a federal savings association.<sup>17</sup>

### ARPS With Characteristics of Debt Obligations

The Bank proposes to purchase ARPS with characteristics commonly associated with debt obligations using its lending authority. Certain substantive characteristics distinguish common stock and debt securities. Common stock usually is perpetual with broad voting rights, while debt securities generally have a limited life and few, if any, voting rights. Common stock provides an ownership interest and appreciation in the market value of the issuer and dividends. In contrast, debt securities offer investors periodic interest payments that may be fixed or fluctuate as provided in the debt instrument, and a principal payment at maturity. With debt securities, if the issuer should fail, the claims of the common stockholders are subordinate to the debt holders. Rating agencies may assign credit ratings to debt securities, but typically do not rate equity instruments.

Here the ARPS have the characteristics of debt obligations. In this instance, because the interest rates are set in a Dutch auction, they are not within the control of [ *OpSub* ] or the Bank. Further, the Bank represents that [ *OpSub* ] will exercise no voting rights during the limited period in which [ *OpSub* ] would hold the ARPS.<sup>18</sup> Although the ARPS are perpetual, the Bank represents that [ *OpSub* ] would hold the ARPS for no longer than 120 days, at which point [ *Corp* ] would purchase any unsold ARPS. In addition, the ARPS are senior to common stock, and dividends are cumulative. Rating agencies have assigned the ARPS investment grade ratings.

The OCC previously has recognized that ARPS may possess many characteristics commonly associated with debt obligations, and thus permitted national banks to purchase certain ARPS as Type III investment securities.<sup>19</sup> The OCC has opined that the National Bank Act and its implementing regulations authorize national banks to purchase preferred securities under a bank's lending authority.<sup>20</sup> Section 24(Seventh) of the National Bank Act 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>21</sup> This authority has

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<sup>16</sup> Op. OTS Chief Counsel (September 14, 2004).

<sup>17</sup> 12 U.S.C. § 1464(c)(1)(U); 12 C.F.R. § 160.30.

<sup>18</sup> A commitment to limit exercise of voting rights may be sufficient to qualify a security as a permissible debt security. *See, e.g.*, OCC Interpretive Letter No. 1126 (March 8, 2010); OCC Interpretive Letter No. 1115 (April 3, 2009).

<sup>19</sup> *See, e.g.*, OCC Interpretive Letter No. 1126 (March 8, 2010); OCC Interpretive Letter No. 1124 (November 3, 2009); OCC Interpretive Letter No. 1115 (April 3, 2009).

<sup>20</sup> *See, e.g.*, OCC Interpretive Letter No. 1027 (May 3, 2005); OCC Interpretive Letter No. 941 (June 11, 2002).

<sup>21</sup> 12 U.S.C. § 24(Seventh).

long included the power to purchase and hold debt securities as loans, consistent with safety and soundness considerations.<sup>22</sup>

While federal savings associations have been permitted to invest in trust preferred securities (nominally equity securities that are in substance corporate debt securities), the OCC has not previously addressed the authority of a federal savings association to purchase and hold an ARPS using lending authority.<sup>23</sup> The ARPS have the same characteristics whether purchased and held by a national bank or a federal savings association. Thus, the same rationale supporting purchase of certain ARPS as the equivalent of debt obligations for a national bank applies to federal savings associations.<sup>24</sup> The ARPS pay an interest rate not under control of the Bank; the Bank has committed not to exercise any voting rights; and the ARPS rank senior to common stock in the event of liquidation, and are cumulative. Although national banks and federal savings associations have different charters and powers, both have lending powers. Existing OCC guidance recognizes federal savings associations may use lending authority to purchase certain securities rated investment grade.<sup>25</sup> Because the ARPS are the equivalent of debt securities, the Bank may purchase them pursuant to lending authority.<sup>26</sup>

When national banks rely on lending authority to purchase debt securities, the OCC requires that the bank conduct an independent analysis and complete review of relevant credit information and determine that purchases meet the bank's own internal loan underwriting standards and comply with applicable lending standards.<sup>27</sup> The bank must have continued access to appropriate credit and portfolio performance data as long as the bank holds the securities. In addition, the bank must maintain the analysis undertaken at the time that the bank acquired the ARPS and on an ongoing basis as part of the bank's fully documented loan files.<sup>28</sup> The prudential concerns that

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<sup>22</sup> See, e.g., OCC Interpretive Letter No. 908 (April 23, 2001).

<sup>23</sup> Federal savings associations have been permitted to make limited investments in trust preferred securities under either authority to own corporate debt securities (12 C.F.R. § 160.40) or pass-through investment authority (12 C.F.R. § 160.32). See OTS Thrift Bulletin 73a (December 18, 2001), at 6.

<sup>24</sup> Federal savings associations' incidental authority provides another basis for finding federal savings associations may purchase certain ARPS with characteristics of debt securities. See, e.g., OTS Op. Chief Counsel P-2006-1 (March 6, 2006); OTS Op. Chief Counsel P-2006-7 (November 28, 2006).

<sup>25</sup> See Thrift Bulletin 73a, *Investing in Complex Securities*, at 7-8 (December 18, 2001)(advising savings associations that lending authority is limited to securities that are investment grade due to prohibitions in 12 U.S.C. § 1831e(d)(1), which apply to savings associations, but not national banks).

<sup>26</sup> A federal savings association may designate under which of several applicable lending or investment authorities, the federal savings association is making the loan or investment, such as a purchase of securities with the characteristics of debt. 12 C.F.R. § 160.31(a).

<sup>27</sup> The bank must comply with the lending limit restrictions in 12 U.S.C. § 84 and generally may not purchase them in an amount exceeding 15 percent of the bank's capital and surplus. OCC Interpretive Letter No. 930 (March 11, 2002),

<sup>28</sup> See OCC Interpretive Letter No. 941 (June 11, 2002); OCC Banking Circular 181 (Rev.) (August 2, 1984).

underlie this policy are as relevant to the exercise of lending authority by a federal savings association as to that of a national bank. Here the Bank has represented that purchases of ARPS pursuant to its lending authority will comply with these standards. The Bank also represents that it will comply with all applicable lending and investment limits.

## **Conclusion**

The Bank through its operating subsidiary [*OpSub*] may repurchase from customers and former customers up to an aggregate of \$[ ] million of ARS. The Bank through [*OpSub*] may acquire the ARPS under general lending authority if the acquisition is consistent with Banking Circular 181(Rev.) and within the applicable limits of 12 U.S.C. § 1464(c) and 12 C.F.R. § 160.93 and safety and soundness limitations. The Bank through [*OpSub*] may purchase the municipal ARS pursuant to its authority in 12 U.S.C. § 1464(c)(1)(H) and 12 C.F.R. §§ 160.40 (a)(1) & (2) & (c), and may purchase the student loan ARS pursuant to 12 U.S.C. § 1464(c)(1)(U) and 12 C.F.R. § 160.30.

The Bank's acquisition of the ARS through [*OpSub*] is subject to the following enforceable conditions:

1. If, for any reason, the Bank through [*OpSub*] has not sold or otherwise disposed of the purchased ARS as described within 120 days after the date of purchase, the Bank will sell the ARS to [*Corp*] for cash at a price equal to the greater of the ARS' fair value or the amount that [*OpSub*] paid the customer to buy back the ARS; and
2. If a customer were to tender for payment an ARS that is not eligible for the Bank through [*OpSub*] to purchase and for which a buyer could not be found, the Bank would have [*Corp*] purchase the ineligible ARS from [*OpSub*] on a same-day basis in a riskless principal transaction.

These conditions of approval are conditions "imposed in writing by a Federal banking agency in connection with any action on any application, notice or other request" within the meaning of, and enforceable under, 12 U.S.C. § 1818.

Our conclusions herein specifically are based on the Bank's representations and written submissions describing the facts and circumstances of the subject transactions. Any change in the facts or circumstances could result in different conclusions.

This approval and the activities and communications by OCC employees in connection with this approval do not constitute a contract, express or implied, or any other obligation binding upon the OCC, the United States, any agency or entity of the United States, or any officer or employee of the United States, and do not affect the ability of the OCC to exercise its supervisory, regulatory, and examination authorities under applicable law and regulations. The OCC may modify, suspend, or rescind this approval if a material change in the information on which the OCC relied occurs prior to the date of the transactions to which this decision pertains. The foregoing may not be waived or modified by any employee or agent of the OCC or the United States.

If you have any questions concerning this letter, please contact Martha Vestal Clarke, Counsel, Securities and Corporate and Practices Division, at (202) 874-5210.

Sincerely,

*Julie L. Williams*

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First Senior Deputy Comptroller and Chief Counsel