



BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE  
TO THE BOARD

October 3, 2005

Ignacio Alvarez, Esq.  
Pietrantonio Mendez & Alvarez LLP  
Banco Popular Center – Suite 1901  
209 MuZoz Rivera Avenue  
San Juan, Puerto Rico 00918

Dear Mr. Alvarez:

This is in response to the request by Banco Popular de Puerto Rico, San Juan, Puerto Rico (“Banco Popular”), for an exemption from the quantitative limits of section 23A of the Federal Reserve Act and the Board’s Regulation W for extensions of credit (the “Proposed Credits”) by Banco Popular to unaffiliated customers that are secured, in whole or in part, by shares of two investment fund affiliates of the bank (“Fund” or collectively the “Funds”).<sup>1</sup>

The Funds whose shares would serve as collateral for the Proposed Credits are (i) the Popular Total Return Fund, an investment fund that seeks to invest 50 to 80 percent of its assets in equity securities (with the remaining assets invested in fixed-income securities); and (ii) the Popular High Grade Fixed-Income Fund, an investment fund that seeks to invest at least 90 percent of its assets in fixed-income securities. Banco Popular serves as investment adviser, transfer agent, custodian, and administrative agent for each Fund. The bank’s securities affiliate, Popular Securities, Inc., serves as the distributor of each Fund.

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<sup>1</sup> 12 U.S.C. § 371c; 12 C.F.R. Part 223. Banco Popular also has requested a broader exemption that would apply to any substantially similar funds that it may form in the future.

Section 23A and Regulation W limit the aggregate amount of “covered transactions” between a bank and any single affiliate to 10 percent of the bank’s capital stock and surplus and limit the aggregate amount of covered transactions with all affiliates to 20 percent of the bank’s capital stock and surplus.<sup>2</sup> “Covered transactions” include, among other things, the extension of credit by a bank to an affiliate and “the acceptance of a security issued by the affiliate as collateral for an extension of credit to any person or company.”<sup>3</sup> “Affiliates” include, among other entities, any investment company for which the bank or any affiliate serves as an investment adviser.<sup>4</sup> Accordingly, each of the Proposed Credits would be a covered transaction under section 23A and Regulation W and would be subject to the quantitative limits of the statute and rule.

Section 23A and Regulation W specifically authorize the Board to exempt, at its discretion, transactions or relationships from the requirements of the statute and rule if the Board finds the exemption to be in the public interest and consistent with the purposes of section 23A.<sup>5</sup> Banco Popular has requested the exemption to enhance its ability to provide the Proposed Credits. The Board believes that exempting the Proposed Credits from the quantitative limits of section 23A and Regulation W would be appropriate for the reasons discussed below.

The Board has granted by rule an exemption in analogous situations for transactions involving certain U.S. mutual funds. Regulation W provides an exemption from the quantitative limits of section 23A and the rule for extensions of credit by a bank to customers that are secured by eligible affiliated mutual fund securities (the “Mutual Fund Exemption”). A bank’s eligible affiliated mutual fund securities are securities issued by an affiliated open-end investment company registered with the Securities and Exchange Commission (“SEC”) under the

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<sup>2</sup> 12 U.S.C. § 371c(a)(1) and 12 C.F.R. 223.11 and 223.12.

<sup>3</sup> 12 U.S.C. § 371c(b)(7) and 12 C.F.R. 223.3(h).

<sup>4</sup> 12 U.S.C. § 371c(b)(1)(D)(ii) and 12 C.F.R. 223.2(a)(6)(i).

<sup>5</sup> 12 U.S.C. § 371c(f)(2); 12 C.F.R. 223.43.

Investment Company Act of 1940 (“Investment Company Act”)<sup>6</sup> if (i) the securities have a publicly available price and (ii) the bank and its affiliates own 5 percent or less of the fund’s shares.<sup>7</sup> The Board adopted the Mutual Fund Exemption in Regulation W principally because (i) transactions that qualify for the exemption do not involve direct bank funding of an affiliate and are unlikely to involve indirect bank funding of an affiliate; (ii) tracking transactions that involve loans secured by shares of specific mutual funds is highly burdensome; (iii) the assets of the affiliated mutual funds generally are shares of nonaffiliates; and (iv) mutual funds are highly regulated, their shares are liquid, and they are required by law to have boards of directors that are largely independent of the bank and its affiliates.<sup>8</sup>

The shares issued by the Funds that would serve as collateral for the Proposed Credits meet the public-price requirement of the Mutual Fund Exemption, and each Fund is an open-end investment company<sup>9</sup> that satisfies the 5 percent-ownership limit of the Exemption. The Proposed Credits would automatically qualify for the Mutual Fund Exemption if the Funds were registered with the SEC under the Investment Company Act.<sup>10</sup>

Although the Funds are not registered with the SEC under the Investment Company Act, the Funds are registered with the Securities Division of the Office of the Commissioner of Financial Institutions of the Commonwealth of

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<sup>6</sup> 15 U.S.C. § 80a-1 et seq.

<sup>7</sup> 12 C.F.R. 223.24(c).

<sup>8</sup> See 67 Federal Register 76,583 (Dec. 12, 2002).

<sup>9</sup> Although not required to do so by Puerto Rican law, Banco Popular has represented that each Fund will sell and redeem its shares consistent with the requirements imposed on open-end investment companies by sections 2(a)(32) and 22(e) of the Investment Company Act and SEC Rule 22c-1 thereunder. See 15 U.S.C. §§ 80a-2(a)(32) and 80a-22(e); 17 C.F.R. 270.22c-1.

<sup>10</sup> As investment companies that are organized under the laws of Puerto Rico and offer and sell interests only to residents of Puerto Rico, the Funds qualify for an exemption from SEC registration under section 6(a)(1) of the Investment Company Act. 15 U.S.C. § 80a-6(a)(1).

Puerto Rico (“Puerto Rico Commissioner”) as open-end investment companies under the Investment Companies Act of Puerto Rico. In analyzing the exemption request, the Board has considered the nature and scope of the system of mutual fund regulation in Puerto Rico and the mutual fund supervisory and examination practices of the Puerto Rico Commissioner. Through discussions with you and the Puerto Rico Commissioner, the Board understands that the offering and redemption of the shares of common stock of the Funds and the operation of the Funds are subject to comprehensive regulation by the Puerto Rico Commissioner.<sup>11</sup> Under Puerto Rican law and regulation, through commitments to the Puerto Rico Commissioner, and by contract with shareholders, the Funds are subject to restrictions similar to those imposed on SEC-registered mutual funds. In fact, each Fund has received a no-action letter from SEC staff confirming that the Fund would be treated as an SEC-registered mutual fund for purposes of SEC Rule 11d-2 under the Securities Exchange Act of 1934 (“1934 Act”).<sup>12</sup>

In addition to the regulatory environment, the Funds are similar to SEC-registered mutual funds in their operation and liquidity. The shares of each Fund are held by thousands of investors in Puerto Rico. Each Fund has adopted a policy of redeeming its shares on each business day at a price per share equal to the Fund’s net asset value per share determined at the close of business on the redemption date and calculated generally in the same manner as SEC-registered mutual funds. Information concerning each Fund’s share price is published each business day in a newspaper of general circulation in Puerto Rico. In addition, as with most SEC-registered mutual funds, a majority of the board of directors of

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<sup>11</sup> In addition, Popular Securities, the distributor of the Funds, is an SEC-registered broker-dealer and a member of the NASD and, accordingly, is subject to supervision and regulation by the SEC and NASD.

<sup>12</sup> Section 11(d)(1) of the 1934 Act prohibits a broker-dealer from extending, maintaining, or arranging for credit to a customer with respect to any security within 30 days of its underwriting if the broker-dealer was part of the selling syndicate for the security. See 15 U.S.C. § 78k(d)(1). SEC Rule 11d1-2 provides an exception to the prohibition in section 11(d)(1) for securities issued by an SEC-registered open-end investment company (provided the person to whom credit is being extended has owned the fund shares for 30 days or more). See 17 C.F.R. 240.11d1-2.

each Fund, consistent with a requirement of the Puerto Rico Commissioner, must be individuals who are not employed by or otherwise associated with Banco Popular or its affiliates. Moreover, as with SEC-registered mutual funds, the financial statements of the Funds are kept in accordance with U.S. generally accepted accounting principles and are audited annually by an independent certified public accounting firm in accordance with U.S. generally accepted auditing standards.

To help safeguard against misuse of the exemption to provide funding to affiliates, Banco Popular has agreed that (i) Fund shares securing a Proposed Credit must have been held by the borrower for more than 30 days before the borrower may receive any loan proceeds; and (ii) Banco Popular must not know or have reason to know that the loan proceeds will be used for the benefit of, or will be transferred to, an affiliate of the bank.<sup>13</sup> In addition, no more than 10 percent of the assets of a particular Fund will be (i) obligations or securities issued by an affiliate of bank or (ii) assets purchased by the Fund from an affiliate of the bank. Moreover, the Funds will not own more than 10 percent of a class of voting securities of any affiliate of Banco Popular. Furthermore, the exemption would not apply to credit extended to directors or executive officers of Banco Popular or its affiliates.

Banco Popular also has committed to the Board that the aggregate amount of the Proposed Credits will not exceed 25 percent of the aggregate net assets of each Fund. In addition, Banco Popular has stated that the maximum loan-to-value ratio for the Proposed Credits will be 50 percent for loans secured by shares of the Popular Total Return Fund (and any other equity-based funds), and 70 percent for loans secured by shares of the Popular High Grade Fixed-Income Fund (and any other fixed-income funds).

Granting the requested exemption would have the public benefit of increasing the eligible collateral set for potential borrowers from Banco Popular in a manner that does not impose safety and soundness risks to the bank. The Board notes that Banco Popular would continue to be subject to the market terms

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<sup>13</sup> This condition is designed to ensure that the Proposed Credits do not trigger the attribution rule in section 23A and Regulation W. See 12 U.S.C. § 371c(a)(2); 12 C.F.R. 223.16(a) and 223.24(c)(1).

requirement of section 23B of the Federal Reserve Act with respect to the Proposed Credits. Section 23B requires that the Proposed Credits be on terms that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable credit transactions secured by nonaffiliate collateral.<sup>14</sup>

For the reasons stated above, and in light of all the facts of record, including the unique circumstances and regulatory framework in Puerto Rico, granting the proposed exemption, subject to the limitations and conditions noted in this letter and your correspondence, appears to be consistent with safe and sound banking practices and the purposes of section 23A. Accordingly, the Board hereby grants the requested exemption. The Board also grants your request that any funds that Banco Popular may form in the future that are substantially similar to the Funds may rely on this exemption, subject to the same limitations and conditions imposed on the Funds.

This determination is specifically conditioned on compliance by Banco Popular with all the commitments and representations made in connection with the exemption request. These commitments and representations are deemed to be conditions imposed in writing by the Board in connection with granting the request and, as such, may be enforced in proceedings under applicable law. Any material change in the facts or circumstances described in your correspondence and this letter or any failure by Banco Popular to observe any of its commitments or representations may result in a different view or in a revocation of the exemption.

Sincerely yours,

Robert deV. Frierson  
Deputy Secretary of the Board

cc: Jay Bernstein  
Federal Reserve Bank of New York  
Federal Deposit Insurance Corporation

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<sup>14</sup> See 12 U.S.C. 371c-1(a)(1); 12 C.F.R. 223.51.