Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #911
August 2001
12 USC 24(7)

June 4, 2001

Re: [ ] ("Bank")
Managed Loan Fund

Dear [ ]:

This is in response to your letter requesting an opinion from the Office of the Comptroller of the Currency ("OCC") that national banks may acquire for their own account beneficial interests in a privately offered investment fund that would invest in loans, cash and cash equivalents, and an offshore fund that invests solely in loans. We conclude that if certain standards are met, it would be legally permissible for national banks to acquire such interests as securities, subject to a 5 percent aggregate investment limit and safe and sound banking practices, or as loan participations, subject to the requirements of Banking Circular No. 181 (Rev.) (August 2, 1984) ("BC-181").

Background

The Bank established the [ ] ("Fund") as a vehicle for investment in bank loans. The Fund also may invest temporarily in cash and cash equivalents, and in an offshore fund managed by the Bank that invests solely in bank loans. The Bank is the investment manager of both the Fund and the offshore fund. The Fund holds approximately $30 million in assets, all of which have been provided by investors that qualify as "accredited investors" and "qualified purchasers" under the federal securities laws. The minimum investment in the Fund is $10 million. Interests in the Fund qualify for an exemption from registration as securities under

section 4(2) of the Securities Act of 1933 because they are sold through private placements.[1] The Fund is not subject to registration under the Investment Company Act of 1940 because its investors must be qualified purchasers.[2]

The Fund is organized as a [*State*] limited liability company. The Fund's governing instrument, the Limited Liability Company Agreement ("Agreement"), provides that upon dissolution of the Fund each beneficial owner will receive a dollar amount equal to its *pro rata* interest in the Fund's net assets. The Agreement limits the Fund's activities to participation in the primary and secondary bank loan markets, and cash and cash equivalents. Investors in the Fund are shielded from personal liability for the acts and obligations of the Fund since their liability as owners of beneficial interests in the Fund is limited to the value of their interests.

The Fund will hold loans from a variety of industries. The Fund will invest no more than 10 percent of its portfolio in loans to any one business sector. Other restrictions include limitations on loans to one borrower, limitations on loans to non-U.S. borrowers, and limitations on loans purchased from the Bank or any of its affiliates. The Fund values its loans monthly at market value using third-party pricing sources. In the event it is not possible to determine market value using third party sources, the investment manager values the loans at fair value, which is intended to approximate market value.[3]

Investors in the Fund receive information regarding the composition, credit quality, and performance of the loans in the Fund's portfolio. This information includes a list of each loan held in the Fund as of a specified date, the loan's credit rating, and information about the Fund's credit underwriting standards. Investors also are able to consult with the Bank concerning the Fund's investment decision-making. On a quarterly basis, investors receive information about the Fund's performance and changes in its composition. The information about portfolio composition and underwriting standards is provided to investors whether the Fund has invested directly in such loans or whether the investment is through the offshore fund.

After holding their initial purchase for six months, investors may liquidate their Fund holdings on a quarterly basis and are required to provide at least 30 days prior notice of any redemption.

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[1] *See* 15 U.S.C. § 77d(2).

[2] *See* 15 U.S.C. § 80a-3(c)(7).

[3] The Bank states that in valuing loans at "fair value," it will consider relevant factors such as: (1) the existence of bona fide, non-distressed transactions on the bank loans, if available; (2) data such as costs, size, current interest rate, period until next interest rate reset, maturity and base lending rate of the loans, the terms and conditions of the loans and any related agreements, and the position of the loans in the borrower's debt structure; (3) the nature, adequacy, and value of the collateral, including the investment manager's rights, remedies, and interests with respect to the collateral; (4) the creditworthiness of the borrower's business, cash flows, capital structure, and future prospects; (5) reliable price quotations for and trading in bank loans and interests in similar loans and the market environment and investor attitudes towards the bank loan investments and interests in similar loans; (6) the reputation and financial condition of the borrower, shareholders of the borrower, and/or the agent and any intermediary in the bank loans; and (7) general economic market conditions affecting the fair value of the bank loans.

Redemptions will be paid in an amount based on the market value of the Fund's portfolio as of the redemption date.

Discussion

National Bank Authority to Purchase Investment Securities

National banks may purchase investment securities subject to the limits of 12 U.S.C. § 24(Seventh) and 12 C.F.R. Part 1. The OCC defines "investment security" as a "marketable debt obligation that is not predominantly speculative in nature."[4] A security is not "predominantly speculative in nature if it is rated investment grade."[5] When a security is not rated, it must be the credit equivalent of one that is rated investment grade.[6] The term "marketable" is defined to include a security that "[c]an be sold with reasonable promptness at a price that corresponds reasonably to its fair value."[7] The OCC, however, also states in its regulations that notwithstanding the definitions of investment security and investment grade, "a national bank may treat a debt security as an investment security for purposes of [Part 1] if the bank concludes, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to satisfy its obligations under that security, and the bank believes that the security may be sold with reasonable promptness at a price that corresponds reasonably to its fair value."[8] Such securities are subject to a 5 percent aggregate investment limit.[9] Banks purchasing securities permitted under Part 1 must adhere to safe and sound banking practices and consider, as appropriate, interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risk.[10]

The OCC permits national banks to purchase for their own accounts investment company shares, provided that the investment company's portfolio consists exclusively of assets that a national bank could purchase directly.[11] The OCC may permit a national bank to invest in an entity that is exempt from registration as an investment company, provided that the portfolio of the

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[4] 12 C.F.R. § 1.2(e).

[5] *Id.*

[6] *See id.*

[7] *Id.* at § 1.2(f)(4).

[8] *Id.* at § 1.3(i)(1).

[9] *See id.* at § 1.3(i)(2). This limit is 5% for *all* securities, in the aggregate, acquired pursuant to reliable estimates authority.

[10] *See id.* at § 1.5(a).

[11] *See id.* at § 1.3(h)(1).

company consists exclusively of assets that a national bank may purchase and sell for its own account.[12] The OCC has permitted national banks to invest in limited partnerships and unregistered investment companies.[13]

A crucial factor in the OCC's regulations on investment in investment company shares and in its prior interpretations is whether the investment company's underlying assets consist of bank-eligible investments. Among the activities that make up the business of banking are the discounting and negotiating of promissory notes, drafts, bills of exchange, and other evidences of debt, loaning money on personal security, and obtaining, issuing, and circulating notes.[14] These powers are merely illustrative, however, and the list of bank powers contained in Section 24(Seventh) does not constitute the full scope of the "business of banking."[15]

National Bank Authority to Purchase Loan Participations

National banks may purchase participation interests in pooled loans under their general lending power.[16] Purchases of interests as loan participations merely constitute another way for national banks to engage in activities that long have been permissible for them. Under this analysis, the purchase of the interests is viewed as a purchase of a share of the assets that they represent. The OCC has issued extensive guidance on national bank purchases of loans and loan participations.[17] National banks that purchase debt securities as loans must comply with the lending limit restrictions in 12 U.S.C. § 84 and may not purchase them in an amount exceeding

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[12] *See id.* at § 1.3(h). Banking Circular No. 220 (November 21, 1986) ("BC-220") states that the investment company must be registered with the SEC under the Investment Company Act of 1940 and Securities Act of 1933 or be a privately offered fund sponsored by an affiliated commercial bank. The proposed Fund is privately offered, but not from an affiliated bank. The OCC, however, has permitted exceptions to the BC-220 requirements. *See, e.g.*, 12 C.F.R. § 1.3(h)(2). The Fund at issue here is exempt from registration under the Investment Company Act of 1940 because its investors must be "qualified purchasers." *See* 12 U.S.C. § 80a-3(c)(7). The proposed Fund would also qualify as an exception to BC-220 because its portfolio consists exclusively of assets that a national bank may purchase and sell for its own account, and it is exempt from registration under the Investment Company Act of 1940. The fact that the exemption is provided under 12 U.S.C. § 80a-3(c)(7), and not under § 80a-3(c)(1), is immaterial. While section 3(c)(7) does not restrict participation to 100 or fewer investors, it does require a more sophisticated investor, *i.e.*, a "qualified purchaser," than under section 3(c)(1).

[13] *See* Interpretive Letter No. 617 (March 4, 1993), *reprinted in* [1992-93 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,457; and Interpretive Letter No. 435 (June 30, 1988), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,659.

[14] *See* 12 U.S.C. § 24(Seventh).

[15] *See Nations Bank v. Variable Annuity Life Insurance Company*, 513 U.S. 251 (1995).

[16] *See* Interpretive Letter No. 579 (March 24, 1992), *reprinted in* [1991-92 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,349.

[17] *See* Banking Circular No. 181 (Rev.) (August 2, 1984). The OCC currently is contemplating issuing a revision to Banking Circular No. 181 (Rev.). Banks must conform their activities to the guidance contained in Banking Circular No. 181 (Rev.) and all subsequent revisions, both when purchasing and when continuing to hold interests in loan funds.

15 percent of the bank's capital and surplus.[18] Bank purchasers also must adhere to the prudential requirements of OCC Banking Circular No. 181 (Rev.), including the requirement that they perform an independent credit analysis of the loan pool to satisfy themselves that the underlying credits meet their own credit standards.[19] The OCC requires banks to implement "satisfactory controls" over loan participations, including: (1) written lending policies and procedures governing those transactions; (2) an independent analysis of credit quality by the purchasing bank; (3) agreement by the obligor to make full credit information available to the selling bank; (4) agreement by the selling bank to provide available information on the obligor to the purchaser; and (5) written documentation of recourse arrangements outlining the rights and obligations of each party.[20]

Purchases of Interests in the Fund

National banks may purchase interests in the Fund as securities, subject to a 5 percent aggregate investment limit, or as loan participations. Part 1 provides for national bank investments in unregistered investment companies so long as the underlying instruments in the portfolio are permissible investments for national banks. Part 1 does not require that the underlying assets of investment companies be limited to instruments labeled "securities."[21] Making loans is part of the business of banking, and national banks may hold shares of investment companies that invest in loans.[22]

Part 1 requires that an investment security be rated investment grade or the credit equivalent thereof.[23] Interests in the Fund would not qualify under Part 1 as "investment securities" if the credit quality of the portfolio of loans in which the Fund invests were below investment grade. Even if interests in the Fund do not qualify as "investment securities," however, national banks may purchase limited quantities of interests in the Fund if they are able to conclude: (1) that the obligor could satisfy its obligations under the security (based on reliable estimates); and (2) that the security could be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

In the instant situation, national banks would need to demonstrate that, due to the Fund's diversification and its investment standards, the Fund would perform in a manner consistent with

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[18] *See* Interpretive Letter No. 834 (July 8, 1998), *reprinted in* [1998-99 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-288; Interpretive Letter No. 833 (July 8, 1998), *reprinted in* [1998-99 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-287; and Interpretive Letter No. 579, *supra*.

[19] *See* Interpretive Letter No. 663 (June 8, 1995), *reprinted in* [1994-95 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,611; and Interpretive Letter No. 579, *supra*.

[20] *See* Banking Circular No. 181, *supra*.

[21] *See* 12 C.F.R. § 1.3(h); Interpretive Letter No. 687, *supra*.

[22] *See* 12 U.S.C. § 24(Seventh).

[23] *See* 12 C.F.R. § 1.2(e).

the reliable estimates standard. That determination would require an analysis of the performance of the Fund's loans. The Fund's diversification should help ensure its overall performance. Investors in the Fund also should be able to sell their holdings with "reasonable promptness" at a "price that corresponds reasonably" to their fair value because redemptions can be made quarterly based on the interests' market value at the time of redemption. National banks would also need to consider risk factors enumerated in Part 1, such as liquidity risk, credit risk, compliance risk, and reputation risk, and satisfy themselves that they can manage such risks and that the investment is appropriate for them.[24]

In addition to purchasing interests in the Fund as securities under Part 1, national banks also may purchase such interests as loans or loans participations in an amount not exceeding 15 percent of the bank's capital and surplus. In order to rely on this authority, national banks would need to have sufficient information available to them to make the independent credit analysis required by BC-181. The nature and extent of the required independent credit analysis is a function of the particular transaction. Banks investing in the Fund would receive data from the Bank on the Fund's underwriting standards, and the principal terms, credit quality, and performance of loans in the Fund's portfolio. Investors would also be able to consult with the Bank concerning the Fund's investment decision-making, and obtain information on the Fund's performance and composition.

Conclusion

National banks as a legal matter may be able to purchase interests in the Fund either as securities under the reliable estimates standard of Part 1, subject to a 5 percent aggregate investment limit for all securities purchased under this authority, or as loan participations, subject to a 15 percent limit. Investments made under Part 1 are subject to the prudential considerations set forth in the rule. National banks contemplating investment in the Fund through the purchase of interests as loan participations must undertake an independent credit analysis as discussed above and must establish that the Fund's investment strategy and portfolio of loans are consistent with their credit underwriting standards prior to making the investment. If you have any questions, please do not hesitate to contact Donald N. Lamson, Assistant Director, or Paul Vogel, Senior Attorney, Securities & Corporate Practices Division at 202/ 874-5210.

Sincerely,

-signed-

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[24] *See generally* 12 C.F.R. § 1.5(a).