Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Conditional Approval #333
November 1999

October 19, 1999

James S. Keller
Chief Regulatory Counsel
PNC Bank Corp.
249 Fifth Avenue
One PNC Plaza, 21st Floor
Pittsburgh, Pennsylvania 15222-2707

Re: Application for approval for PNC Mortgage Corp. of America, a wholly-owned operating subsidiary of PNC Bank, N.A., to hold a non-controlling minority interest in MERSCORP, Inc. Application Control Number: 1999-NE-08-0037

Dear Mr. Keller:

This is in response to your application to the OCC seeking approval to hold through PNC Mortgage Corp. of America ("Subsidiary"), a wholly-owned operating subsidiary of PNC Bank, N.A., Pittsburgh, Pennsylvania ("Bank"), a 2.93% interest in the voting securities of MERSCORP, Inc., McLean, Virginia ("MERS").

On December 20, 1996, the Subsidiary subscribed to a Charter Membership in MERS through an equity contribution and loan commitment to MERS, a limited liability company. In June 1998, MERS was reorganized from a limited liability company into a stock corporation and each dollar of the Subsidiary's capital contribution was converted into one share of Class B Common Stock of MERS. This represents 7.20% of the Class B Common Stock and 2.93% of the total voting shares of MERS, a minority investment interest requiring prior OCC approval.[1]

[1] Minority investments being entered into by operating subsidiaries are generally considered to be "new activities" requiring an application to the OCC under 12 C.F.R. § 5.34(e)(1)(i). The Bank in reviewing its operations discovered that it had not filed an application in connection with this investment. Responding to this oversight, the Bank now seeks OCC approval for the Subsidiary to continue to hold its minority investment in MERS.

For the reasons discussed below, we conclude that the Bank, through the Subsidiary, may hold an investment interest in MERS, subject to the conditions set forth below.

PROPOSAL

The ownership interests of MERS are represented by three classes of Common Stock. The Class A Common Stock may be held only by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Corporation and the Mortgage Bankers Association of America. The Class B Common Stock may be held only by those organizations in the mortgage industry that fund, acquire, lend on the security of, or service mortgage loans that are secured by real property or that guaranty or issue mortgage-backed securities. The Class C Common Stock may be held (a) only by those persons or organizations that are primarily engaged in providing services to the mortgage industry, including, without limitation, mortgage insurance, title insurance, and other mortgage origination services, other than as part of their funding, acquiring, lending or servicing activities; (b) trade associations or similar groups that represent such natural persons and organizations; or (c) those natural persons or entities that the MERS board of directors might approve from time to time.

Each class of common stock votes together as a single class on all matters presented to the stockholders except for the election of directors. The shares may be sold only to entities that satisfy the conditions of ownership, and all sales of shares are subject to a right of first refusal by MERS. An organization shall be eligible to be a holder of Class B Common Stock if an affiliate is eligible to hold such shares.

MERS implements a mortgage industry utility that provides data processing services to financial institutions and others for the purpose of facilitating the transfer of mortgage servicing rights, mortgage ownership and the release of mortgages through an electronic "book-entry" system to register and track mortgages. These are activities related to mortgage lending and servicing, which are part of the business of banking. *See, e.g.*, 12 C.F.R. § 5.34(e)(2)(ii)(L).

ANALYSIS

The OCC has traditionally recognized the authority of national banks to organize and perform any of their lawful activities in a reasonable and convenient manner not prohibited by law. A national bank may engage in activities that are part of or incidental to the business of banking by means of an operating subsidiary. *See* 12 C.F.R. § 5.34(d)(1). Further, the OCC has permitted national banks to own, either directly or indirectly through an operating subsidiary, a non-controlling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or a limited liability company.[2]

[2] *See also* 12 C.F.R. § 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 U.S.C. § 24(Seventh) and other statutes.

In several interpretive letters, the OCC has concluded that national banks are legally permitted to make such a non-controlling investment provided the following four criteria or standards are met:[3]

(1) The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;

(2) The bank must be able to prevent the enterprise or entity 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; and

(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.

Based upon the facts presented, the Bank's proposal satisfies these four standards with respect to the Bank and the Subsidiary.

1. The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.

Our precedents on non-controlling ownership have recognized that the enterprise in which the bank holds an interest must confine its activities to those that are part of, or incidental to, the conduct of the business of banking.[4]

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[3] *See* Interpretive Letter No. 692, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,007 (November 1, 1995), and No. 694, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L.

Rep. (CCH) ¶ 81,009 (December 13, 1995). In other letters, the OCC has permitted national banks to make a non-controlling investment in an enterprise other than an LLC, provided the investment satisfies these four standards. *See, e.g.,* Interpretive Letter No. 697, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,012 (November 15, 1995); Interpretive Letter No. 705, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,020 (October 25, 1995).

[4] *See, e.g.,* Interpretive Letter No. 380, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (December 29, 1986) (because a national bank can provide options clearing services to customers it can purchase stock in a corporation providing options clearing services); Letter from Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (because the operation of an ATM network is a fundamental part of the basic business of banking, an equity investment in a corporation operating such a network is permissible).

MERS provides data processing services that facilitate the transfer of mortgage servicing rights, mortgage ownership and the release of mortgages through an electronic "book-entry" system to register and track mortgage rights. Clearly, registering and tracking mortgages and servicing rights is an integral part of the mortgage lending business, an activity expressly authorized under 12 U.S.C. §§ 24(Seventh) and 371. *See also* 12 C.F.R. § 5.34(e)(2)(ii)(L). Performing and providing permissible activities or services by electronic means is expressly authorized by 12 C.F.R. § 7.1019. Accordingly, we conclude that the activities conducted by MERS are part of, or incidental to, the business of banking and, therefore, the first standard is met.

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.

The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest. This standard may be met if the Bank is able to exercise a veto power over the activities of the enterprise, or is able to dispose of its interest.[5]

In the event that MERS were to engage in activities that are not part of or incidental to the business of banking, the Subsidiary would sell its shares to a nonbank subsidiary of the Bank's parent holding company, to another eligible third party, or to MERS, pursuant to MERS' right of first refusal under the MERS Articles of Incorporation. Under these Articles of Incorporation, an affiliate of the Subsidiary would be eligible to hold MERS Class B Common Stock. If for any reason the MERS shares could not be held by a nonbank subsidiary of the Bank's parent holding company, the Subsidiary would sell the shares to another eligible third party or to MERS at a mutually agreed upon price. By these means, the Subsidiary will be able to ensure that it could withdraw its investment in a timely fashion, thus satisfying the second standard.[6]

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

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[5] *See, e.g.*, Interpretive Letter No. 711, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-026 (February 3, 1996); Interpretive Letter No. 625, *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993).

[6] *See* Conditional Approval No. 289 (October 2, 1998) in which the OCC determined that the ability to divest shares satisfies this condition, even though complete divestiture could take up to two years.

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that the national bank's investment not expose it to unlimited liability. As a legal matter, a corporation is an entity distinct from its shareholders or members, with its own separate rights and liabilities. 1 W. Fletcher, Cyclopedia of the Law of Private Corporations § 25 (rev. perm. ed. 1990). Shareholders are protected by the "corporate veil" from personal liability for the debts of the corporation. The Bank will be well protected in this instance. Not only will it be protected by the "corporate veil" of MERS, but also by the Subsidiary, a separate corporate entity between the Bank and MERS. At all times, the Bank, Subsidiary, and MERS will adhere to corporate and other applicable formalities to ensure that all the entities maintain their corporate existences separate from MERS. Thus, the Bank's and the Subsidiary's loss exposure for the liabilities of MERS will be limited solely to the investment.

b. Loss exposure from an accounting standpoint

The appropriate accounting treatment for the Subsidiary's investment in MERS will be the cost method of accounting. Under the cost method of accounting, the investor records an investment at cost, dividends are the basis for recognition of earnings, and losses recognized by the investor are limited to the extent of the investment (including extensions of credit or guarantees, if any) shown on the investor's books.[7] The Bank's and the Subsidiary's exposure is quantifiable and controllable and they will not have open-ended liability for the liabilities of MERS.

Therefore, for both legal and accounting purposes, the Bank's potential loss exposure relative to MERS should be limited to the amount of the Subsidiary's investment. Thus, the third standard is satisfied.

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

A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank must also satisfy the requirement that the investment have a beneficial connection to the bank's business, *i.e.*, be convenient or useful to the investing bank's business activities, and not constitute a mere passive investment unrelated to that bank's banking business. Twelve U.S.C. § 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful."[8] Our precedents

[7] *See generally*, Accounting Principles Board, Op. 18 ¶ 19 (1971).

[8] *See Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

on bank non-controlling investments have indicated that the investment must be convenient or useful to the bank in conducting *that bank's* business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.[9]

The services to be provided by MERS to Class B Common Stock holders are mortgage banking services related to the electronic registration and tracking of mortgages and servicing rights. At the time of the Subsidiary's initial investment in MERS in 1996, and until MERS' formation as a stock corporation in 1998, only members in MERS could utilize the electronic services. MERS services are not currently limited to Class B Common Stock holders. Being a Class B Common Stock holder, however, allows the Subsidiary to help guide the development of MERS services to address better the Subsidiary's requirements.[10] For these reasons, the investment is convenient and useful to the Bank in carrying out its mortgage banking businesses and is not a passive or speculative investment. Thus, the fourth standard is satisfied.

CONCLUSION

Based upon the information and representations the Bank has provided, and for the reasons discussed above, we conclude that the Bank may continue to hold its indirect non-controlling minority investment in the manner and as described herein, subject to the following conditions:

1. MERS will engage only in activities that are part of, or incidental to, the business of banking;

2. The Bank's Subsidiary will withdraw from MERS in the event it engages in an activity that is inconsistent with condition number one;

3. The Bank will account for its investment in MERS under the cost method of accounting; and

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[9] *See, e.g.*, Interpretive Letter No. 697, *supra*; Interpretive Letter No. 543, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991); Interpretive Letter No. 427, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); Interpretive Letter No. 421, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988); Interpretive Letter No. 380, *supra.*

[10] The Subsidiary will be compensated through the increased value of its share ownership as the MERS electronic registration system serves more customers while providing stockholders the services for which MERS was created. *See* Conditional Approval No. 289, *supra* note 6, in which the owners would be compensated for increased customer base through their share ownership.

4. MERS will be subject to OCC supervision, regulation, and examination.[11]

Please be advised that the conditions of this approval are deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818 and, as such, may be enforced in proceedings under applicable law.

This approval is granted based on a thorough review of all information available, including the representations and commitments made in the application and by Bank representatives.

Sincerely,

/s/

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[11] The agreement between the Subsidiary and MERS, at paragraph 14, provides that "[t]he services being provided by MERS . . . shall be subject to regulation by the federal regulatory authority having jurisdiction over the Member to the same extent as if the services were being provided by the Member itself. The books and records of MERS applicable to the services . . . shall be subject to the federal regulatory authority having jurisdiction over the Member." The Bank's letter in which this information is provided also serves as the notice to the OCC that MERS is subject to the OCC's examination authority under the Bank Service Company Act, 12 U.S.C. § 1867(c).