

Department shall subtract from the maximum reimbursement amount any reimbursement already approved to be paid to the licensee. The resulting sum shall be the potential additional reimbursement to which the licensee may be entitled. This resulting sum will be adjusted after the approval of claims for work performed through December 31, 2007, to reflect the actual approved costs of work performed through that date.

§ 765.31 [Amended]

■ 6. Section 765.31 is amended by removing paragraph (a) and redesignating paragraphs (b) through (d) as paragraphs (a) through (c).

[FR Doc. 03-13858 Filed 6-2-03; 8:45 am]

BILLING CODE 6450-01-P

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 703 and 742

Investment and Deposit Activities and Regulatory Flexibility Program

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: NCUA is amending its rule regarding the investment activities of Federal Credit Unions (FCUs). The amendments clarify and reformat the rule to make it easier to read and locate information. The amendments expand FCU investment authority to include purchasing equity-linked options for certain purposes and exempt RegFlex eligible FCUs from several investment restrictions. NCUA is also amending the Regulatory Flexibility Program to conform to the revisions to the investment rule.

DATES: The final rule is effective July 3, 2003.

FOR FURTHER INFORMATION CONTACT: Scott Hunt, Senior Investment Officer, Office of Strategic Program Support and Planning (OSPSP) at the above address or telephone (703) 518-6620; Dan Gordon, Senior Investment Officer, OSPSP at the above address or telephone; Kim Iverson, Program Officer, Office of Examination and Insurance, at the above address or telephone (703) 518-6360; or Frank Kressman, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518-6540.

SUPPLEMENTARY INFORMATION:

A. Background

NCUA identified part 703 of its rules as in need of revision. To that end,

NCUA issued an advance notice of proposed rulemaking (ANPR) on October 18, 2001. 66 FR 54168 (October 26, 2001). After considering the comments to the ANPR submitted by 38 commenters, NCUA issued a proposed rule on December 19, 2002. 67 FR 78996 (December 27, 2002). NCUA received 14 comment letters regarding the proposed rule: five from FCUs, one from a State credit union, five from financial services entities, and three from credit union trade organizations. The comments were generally supportive of the proposal.

B. Summary of Comments

1. Broker-dealers and Safekeeping of Investments

Throughout the rulemaking process, NCUA has expressed concern about the purchase of some brokered certificates of deposit (CDs). Deceptive practices or outright fraud on the part of some broker-dealers and safekeepers have caused losses for FCUs. NCUA does not believe, however, that more stringent standards on broker-dealers or safekeepers, such as those contemplated by the ANPR, would prevent losses. NCUA believes continued guidance to FCUs and prudent due diligence by FCUs is the best course of action. Therefore, NCUA is not making any substantive changes to broker-dealer and safekeeping requirements in this regard. The commenters generally supported this position.

The proposed rule permits the use of depository institutions whose broker-dealer activities are regulated by a State regulatory agency. This provides FCUs with greater access to broker-dealers. NCUA also believes additional broker-dealer competition promotes improved service, better execution, and reduced costs. The commenters supported this proposal. The Board adopts this proposed revision in the final rule.

Former § 703.50(c) exempts CD finders from the broker-dealer requirements. It was always NCUA's intent to carry this exemption forward in proposed § 703.8 as indicated in the preamble to the proposed rule. 67 FR 78996, 78996-97 (December 27, 2002). Specifically, if an FCU purchases a CD or share certificate directly from a bank, credit union, or other depository institution that issues the certificate, the FCU will not be bound by the broker-dealer requirements. This exemption was inadvertently omitted in the regulatory language in § 703.8 of the proposed rule through a clerical error. As stated in the proposal's preamble, NCUA indicated it was making no changes to the broker-dealer section of the rule in this regard. Thus, the

inclusion of this exemption in the final rule will not change the requirements pertaining to the use of broker-dealers.

To be consistent with the broker-dealer requirements, the proposed rule added a due diligence requirement that calls for an FCU to review a safekeeper's financial condition, in addition to its registration status, and retain the documentation used to approve a safekeeper. NCUA believes these requirements represent prudent, minimum practices that FCUs should follow when evaluating a safekeeper. In addition, the proposed rule permitted State-regulated trust companies to be safekeepers for FCUs. NCUA recognizes these firms can provide a sound alternative for FCUs.

The commenters overwhelmingly concurred with this aspect of the proposed rule. NCUA adopts this proposal in the final rule.

2. Expanded Investment Authorities

The Federal Credit Union Act (Act) enumerates FCU investment powers. 12 U.S.C. 1757(7), (8), and (15). NCUA has adopted regulatory prohibitions against certain investments and investment activities permitted by the Act on the basis of safety and soundness concerns. In revising the rule, NCUA has explored ways to expand FCU investment powers. Generally, those investments currently prohibited by regulation exhibit high risks or are unsuitable for many FCUs, such as stripped mortgage-backed securities or variable rate investments tied to non-domestic interest rates.

As one means of expanding investment powers, the proposed rule permits some FCUs to purchase commercial mortgage related securities (CMRS), subject to certain restrictions. Specifically, the proposed rule limits the purchase of CMRS, which are not otherwise permitted by § 107(7)(E) of the Act, 12 U.S.C. 1757(7)(E), to RegFlex eligible FCUs. 12 CFR part 742. Further, a RegFlex eligible FCU may purchase CMRS if the CMRS: (1) Are rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization; (2) otherwise meet the definitions of mortgage related security as defined in 15 U.S.C. 78c(a)(41) and CMRS as defined in proposed § 703.2; and (3) have an underlying pool of loans containing more than 50 loans with no one loan representing more than 10 percent of the pool. A RegFlex eligible FCU is limited to purchasing CMRS in an aggregate amount of up to 50 percent of its net worth. Most commenters supported NCUA's proposal to permit RegFlex eligible FCUs to purchase

CMRS with certain limitations. NCUA adopts this proposal as final.

A few commenters suggested NCUA should adopt additional requirements or restrictions to address sound risk management practices for CMRS. NCUA believes no changes are necessary in this regard, but reminds FCUs that former § 703.30 already requires FCUs to develop investment policies that address credit, liquidity, interest rate, and concentration risks. 12 CFR 703.30. The policy must also stipulate the characteristics of any investments that are suitable for the FCU. These requirements carry over to the final rule. Thus, FCUs that purchase CMRS must develop sound risk management policies and construct limits that represent the FCU board's risk tolerance.

NCUA also proposed to permit FCUs to purchase equity options for the sole purpose of offering dividends based on the performance of an equity index. This proposal evolved from the experience gained monitoring an investment pilot program. The pilot program enabled NCUA to review the demands and risks associated with such a program before developing a regulation. Commenters agreed that the proposed regulatory language was prudent and would not pose any undue burden on FCUs. NCUA adopts the proposal.

NCUA has determined that other currently prohibited investments should remain prohibited due to the complexity of the instruments or the difficulty in managing their associated risks. However, NCUA encourages FCUs that believe they possess the skills and resources to manage such investments to apply for a pilot program. The commenters generally supported this approach to expanding investment powers. NCUA remains committed to publishing standards for pilot programs that have been approved to facilitate future applications. These guidelines will be available on the NCUA website or by contacting the appropriate NCUA regional office. Additionally, investment pilot program applicants are encouraged to submit alternative proposals for NCUA's consideration.

3. Discretionary Control of Investments and Investment Advisers

Former § 703.40(c)(6) authorizes an FCU to delegate to an outside third party discretionary control over the purchase and sale of investments, up to 100 percent of the FCU's net capital at the time of delegation. 12 CFR 703.40(c)(6). RegFlex eligible FCUs are exempt from this cap. 12 CFR 742.4.

NCUA proposed that FCUs conduct an annual evaluation of the amount of investments under discretionary control. Further, the proposal required an FCU to notify its board of directors and the appropriate regional director if the amount under discretionary control exceeds the cap at the time of the annual evaluation. An FCU must develop a plan to bring itself into compliance with the cap within a reasonable period of time.

Generally, commenters supported this proposal, although a few commenters suggested that NCUA permit all FCUs to exceed the cap, not just RegFlex eligible FCUs. These commenters stated that FCUs not meeting RegFlex eligibility may benefit most from having an investment professional manage an FCU's investments. NCUA has determined not to lift the cap for FCUs ineligible for RegFlex. NCUA notes that an FCU currently not meeting RegFlex eligibility requirements may petition its regional director for a RegFlex designation. The Board adopts the proposed revisions.

Commenters also questioned whether it was reasonable for an FCU board to be required to notify the appropriate regional director of any violation of the cap within five business days of exceeding the cap. NCUA believes this is reasonable. The regulation stipulates that an FCU only notify its regional director within five business days. An FCU is not required to submit a plan to bring it into compliance within this time frame. An FCU must develop a plan within a reasonable period of time after notification. A reasonable period of time will be decided by the regional director after considering an FCU's circumstances, including the materiality of the breach and the risk to the FCU's earnings and capital.

In response to a commenter's question, NCUA clarifies that mutual funds are not included in the calculation of funds under discretionary control.

As part of the background check of an investment advisor, the proposed rule required that an FCU analyze the background of the firm for whom an investment adviser works, in addition to the investment adviser and his or her associated personnel. No commenters objected to this requirement. This proposed change is adopted in the final rule. Several commenters urged NCUA to clarify the meaning of "associated personnel" as it is used in proposed §§ 703.5 and 703.8. NCUA notes that the proposed rule included a definition for "associated personnel" in proposed § 703.2 and it is adopted in the final.

4. Borrowing Repurchase Transaction

Borrowing repurchase transactions, formerly referred to as reverse repurchase transactions, enable an FCU to sell securities under an agreement to repurchase in order to borrow funds. 12 CFR 703.100(j). Section 703.100(j)(2) prohibits an FCU from purchasing an investment with the proceeds from a reverse repurchase agreement if the purchased investment matures after the maturity of the reverse repurchase agreement. 12 CFR 703.100(j)(2). NCUA proposed to permit RegFlex eligible FCUs to purchase securities with maturities exceeding the maturity of the borrowing repurchase transaction in an amount not to exceed the FCU's net worth.

Most of the commenters supported the proposal. Three commenters objected to the proposed rule because they believed there should be no restrictions on the maturity of any investment purchased by any FCU. These commenters indicated there are no similar restrictions applicable to other types of borrowing. NCUA believes the limitation is prudent and does not unduly impede any FCU's ability to manage its balance sheet and, therefore, adopts the proposed revision in the final rule.

5. Investment Repurchase Transaction

The proposed rule changed the term "repurchase transactions" to "investment repurchase transactions" and revised the requirements for investment repurchase transactions to be consistent with those of securities lending transactions. Other than these revisions, the proposal did not make any substantive amendments in this regard. No commenter objected. NCUA adopts the proposed revisions.

6. Securities Lending Transaction

Former § 703.100(k) addresses securities lending transactions and requires an FCU to take a perfected first priority security interest in all collateral the FCU receives. 12 CFR 703.100(k). Proposed § 703.13 removes the word "perfected", but still requires a first priority security interest through possession or control of the collateral. In addition, the proposed rule clarifies that an FCU's agent may act in its place in these transactions. No commenter objected. NCUA adopts the proposed revisions as final.

7. Recordkeeping and Generally Accepted Accounting Principles

The Act provides that the accounting principles applicable to reports or statements required to be filed with NCUA by insured credit unions, except

those with total assets of less than \$10 million, must be uniform and consistent with generally accepted accounting principles (GAAP). 12 U.S.C. 1782a(a)(6)(C). NCUA proposed to revise part 703 to clarify that FCUs having total assets of \$10 million or more must comply with all GAAP provisions related to the accounting principles applicable to reports or statements required to be filed with NCUA, not just selected ones. While not mandatory for FCUs with total assets of less than \$10 million, NCUA encourages them also to comply with GAAP or to account for their investments consistent with the NCUA Accounting Manual for Federal Credit Unions, which can be found on the NCUA website. No commenters objected. NCUA adopts this amendment.

8. *Net Worth*

To be consistent with changes in the Act and NCUA's rules, NCUA proposed to replace the term "net capital" with "net worth." No commenter objected to this change. NCUA adopts it in the final rule.

9. *Format*

The proposal changed the question and answer format to a more traditional format to make the rule easier to read and more conducive to finding information quickly. Many commenters supported this amendment and no commenters objected to it. NCUA adopts it in the final rule.

10. *State-Chartered Credit Unions*

The proposal changed the question and answer format to a more traditional format to make the rule easier to read and more conducive to finding information quickly. Many commenters supported this amendment and no commenters objected to it. NCUA adopts it in the final rule.

10. *State-Chartered Credit Unions*

One commenter noted that State-chartered credit unions that make investments that are impermissible for FCUs must reserve for those non-conforming investments. 12 CFR 741.3. The commenter questioned whether State-chartered credit unions need to reserve for non-conforming investments that are permissible for RegFlex eligible FCUs. NCUA believes that, if a State-chartered credit union meets all the criteria for RegFlex eligibility as detailed in § 742.2, then it is not required to reserve for non-conforming investments that are permissible for RegFlex eligible FCUs. 12 CFR 742.2. If at any time a State-chartered credit union fails to meet the RegFlex eligibility criteria, then it must reserve for any non-conforming investments it owns.

Another commenter urged NCUA to revise proposed § 703.1, the purpose and scope section, to clarify that State-chartered credit unions, in addition to complying with the reserve requirement for non-conforming investments in § 741.3, must also comply with the

requirements of part 703 concerning transacting business with corporate credit unions, as provided in § 741.219. 12 CFR 741.219. NCUA believes it will be helpful to include this reference in the purpose and scope section and is including it in the final rule as a technical correction.

11. *Other Technical Corrections*

Proposed § 703.16(a) incorrectly references § 703.14(h). The correct and intended reference, reflected in the final rule, is to § 703.14(g).

Proposed § 703.3(g) stated that only "those individuals with investment authority may be voting members of an investment-related committee." (Emphasis added.) The former version of the rule requires that only "officials and employees of the Federal credit union may be voting members of an investment-related committee." (Emphasis added.) This was an unintended change in language. NCUA received no comment on this but wishes to clarify that the prior language in part 703 remains unchanged as intended by the proposal.

Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a proposed rule may have on a substantial number of small credit unions (those under \$1 million in assets). This rule clarifies the investment authority granted to FCUs and conforms the Regulatory Flexibility Program to the investment rule. The final amendments will not have a significant economic impact on a substantial number of small credit unions and, therefore, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

The current Office of Management and Budget control number assigned to part 703 is 3133-0133. NCUA has determined that the final rule would not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on State and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. The final rule would not have substantial direct effects on the States,

on the connection between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. NCUA has determined that this final rule does not constitute a policy that has federalism implications for purposes of the executive order.

The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families

NCUA has determined that this final rule would not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Act of 1996 (Pub. L. 104-121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedure Act. 5 U.S.C. 551. The Office of Management and Budget has determined that this rule is not a major rule for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996.

List of Subjects

12 CFR part 703

Credit unions, Investments.

12 CFR part 742

Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on May 22, 2003.

Becky Baker,

Secretary of the Board.

■ Accordingly, NCUA amends 12 CFR parts 703 and 742 as follows:

PART 703—ORGANIZATION AND OPERATIONS OF FEDERAL CREDIT UNIONS

■ 1. The authority citation for part 703 continues to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15).

■ 2. Revise part 703 to read as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

Sec.
703.1 Purpose and scope.
703.2 Definitions.
703.3 Investment policies.

- 703.4 Recordkeeping and documentation requirements.
- 703.5 Discretionary control over investments and investment advisers.
- 703.6 Credit analysis.
- 703.7 Notice of non-compliant investments.
- 703.8 Broker-dealers.
- 703.9 Safekeeping of investments.
- 703.10 Monitoring non-security investments.
- 703.11 Valuing securities.
- 703.12 Monitoring securities.
- 703.13 Permissible investment activities.
- 703.14 Permissible investments.
- 703.15 Prohibited investment activities.
- 703.16 Prohibited investments.
- 703.17 Conflicts of interest.
- 703.18 Grandfathered investments.
- 703.19 Investment pilot program.

§ 703.1 Purpose and scope.

(a) This part interprets several of the provisions of Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act (Act), 12 U.S.C. 1757(7), 1757(8), 1757(15), which list those securities, deposits, and other obligations in which a Federal credit union may invest. Part 703 identifies certain investments and deposit activities permissible under the Act and prescribes regulations governing those investments and deposit activities on the basis of safety and soundness concerns. Additionally, part 703 identifies and prohibits certain investments and deposit activities that are permissible under the Act and not prohibited or otherwise regulated by part 703 remain permissible for Federal credit unions.

(b) This part does not apply to:

- (1) Investment in loans to members and related activities, which is governed by §§ 701.21, 701.22, 701.23, and part 723 of this chapter;
- (2) The purchase of real estate-secured loans pursuant to Section 107(15)(A) of the Act, which is governed by § 701.23 of this chapter;
- (3) Investment in credit union service organizations, which is governed by part 712 of this chapter;
- (4) Investment in fixed assets, which is governed by § 701.36 of this chapter;
- (5) Investment by corporate credit unions, which is governed by part 704 of this chapter; or
- (6) Investment activity by State-chartered credit unions, except as provided in § 741.3(a)(3) and § 741.219 of this chapter.

§ 703.2 Definitions.

The following definitions apply to this part:

Adjusted trading means selling an investment to a counterparty at a price above its current fair value and simultaneously purchasing or committing to purchase from the

counterparty another investment at a price above its current fair value.

Associated personnel means a person engaged in the investment banking or securities business who is directly or indirectly controlled by a National Association of Securities Dealers (NASD) member, whether or not this person is registered or exempt from registration with NASD. Associated personnel includes every sole proprietor, partner, officer, director, or branch manager of any NASD member.

Banker's acceptance means a time draft that is drawn on and accepted by a bank and that represents an irrevocable obligation of the bank.

Bank note means a direct, unconditional, and unsecured general obligation of a bank that ranks equally with all other senior unsecured indebtedness of the bank, except deposit liabilities and other obligations that are subject to any priorities or preferences.

Borrowing repurchase transaction means a transaction in which the Federal credit union agrees to sell a security to a counterparty and to repurchase the same or an identical security from that counterparty at a specified future date and at a specified price.

Call means an option that gives the holder the right to buy the underlying security at a specified price during a fixed time period.

Collective investment fund means a fund maintained by a national bank under 12 CFR part 9 (Comptroller of the Currency's regulations).

Commercial mortgage related security means a mortgage related security, as defined below, except that it is collateralized entirely by commercial real estate, such as a warehouse or office building, or a multi-family dwelling consisting of more than four units.

Counterparty means the party on the other side of the transaction.

Custodial agreement means a contract in which one party agrees to exercise ordinary care in protecting the securities held in safekeeping for others.

Delivery versus payment means payment for an investment must occur simultaneously with its delivery.

Deposit note means an obligation of a bank that is similar to a certificate of deposit but is rated.

Derivatives means financial instruments or other contracts whose value is based on the performance of an underlying financial asset, index or other investment that have the three following characteristics:

- (1) It has one or more underlyings and one or more notional amounts or payment provisions or both that determine the amount of the settlement

or settlements, and, in some cases, whether or not a settlement is required;

(2) It requires no initial net investment or an initial net investment that is less than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(3) Its terms require or permit net settlement, it can readily be settled net by means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Embedded option means a characteristic of an investment that gives the issuer or holder the right to alter the level and timing of the cash flows of the investment. Embedded options include call and put provisions and interest rate caps and floors. Since a prepayment option in a mortgage is a type of call provision, a mortgage-backed security composed of mortgages that may be prepaid is an example of an investment with an embedded option.

Eurodollar deposit means a U.S. dollar-denominated deposit in a foreign branch of a United States depository institution.

European financial options contract means an option that can be exercised only on its expiration date.

Fair value means the amount at which an instrument could be exchanged in a current, arms-length transaction between willing parties, as opposed to a forced or liquidation sale.

Financial options contract means an agreement to make or take delivery of a standardized financial instrument upon demand by the holder of the contract as specified in the agreement.

Immediate family member means a spouse or other family member living in the same household.

Industry-recognized information provider means an organization that obtains compensation by providing information to investors and receives no compensation for the purchase or sale of investments.

Investment means any security, obligation, account, deposit, or other item authorized for purchase by a Federal credit union under Sections 107(7), 107(8), or 107(15) of the Act, or this part, other than loans to members.

Investment repurchase transaction means a transaction in which an investor agrees to purchase a security from a counterparty and to resell the same or an identical security to that counterparty at a specified future date and at a specified price.

Maturity means the date the last principal amount of a security is

scheduled to come due and does not mean the call date or the weighted average life of a security.

Mortgage related security means a security as defined in Section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)), e.g., a privately-issued security backed by first lien mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure, that is rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization.

Mortgage servicing rights means a contractual obligation to perform mortgage servicing and the right to receive compensation for performing those services. Mortgage servicing is the administration of a mortgage loan, including collecting monthly payments and fees, providing recordkeeping and escrow functions, and, if necessary curing defaults and foreclosing.

Negotiable instrument means an instrument that may be freely transferred from the purchaser to another person or entity by delivery, or endorsement and delivery, with full legal title becoming vested in the transferee.

Net worth means the retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles and as further defined in § 702.2(f) of this chapter.

Official means any member of a Federal credit union's board of directors, credit committee, supervisory committee, or investment-related committee.

Ordinary care means the degree of care, which an ordinarily prudent and competent person engaged in the same line of business or endeavor should exercise under similar circumstances.

Pair-off transaction means an investment purchase transaction that is closed or sold on, or before the settlement date. In a pair-off, an investor commits to purchase an investment, but then pairs-off the purchase with a sale of the same investment before or on the settlement date.

Put means a financial options contract that entitles the holder to sell, entirely at the holder's option, a specified quantity of a security at a specified price at any time until the stated expiration date of the contract.

Registered investment company means an investment company that is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a). Examples of registered

investment companies are mutual funds and unit investment trusts.

Regular way settlement means delivery of a security from a seller to a buyer within the time frame that the securities industry has established for immediate delivery of that type of security. For example, regular way settlement of a Treasury security includes settlement on the trade date (cash), the business day following the trade date (regular way), and the second business day following the trade date (skip day).

Residual interest means the remainder cash flows from collateralized mortgage obligations/real estate mortgage investment conduits (CMOs/REMICs), or other mortgage-backed security transaction, after payments due bondholders and trust administrative expenses have been satisfied.

Securities lending means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return.

Security means a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that:

(1) Either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer;

(2) Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

(3) Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Senior management employee means a Federal credit union's chief executive officer (typically this individual holds the title of President or Treasurer/Manager), an assistant chief executive officer, and the chief financial officer.

Small business related security means a security as defined in Section 3(a)(53) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(53)), e.g., a security that is rated in 1 of the 4 highest rating categories by at least one nationally recognized statistical rating organization, and represents an interest in one or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution, insured credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or a finance company or

leasing company. This definition does not include Small Business Administration securities permissible under § 107(7) of the Act.

Weighted average life means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of principal.

When-issued trading of securities means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

Yankee dollar deposit means a deposit in a United States branch of a foreign bank licensed to do business in the State in which it is located, or a deposit in a State-chartered, foreign controlled bank.

Zero coupon investment means an investment that makes no periodic interest payments but instead is sold at a discount from its face value. The holder of a zero coupon investment realizes the rate of return through the gradual appreciation of the investment, which is redeemed at face value on a specified maturity date.

§ 703.3 Investment policies.

A Federal credit union's board of directors must establish written investment policies consistent with the Act, this part, and other applicable laws and regulations and must review the policy at least annually. These policies may be part of a broader, asset-liability management policy. Written investment policies must address the following:

(a) The purposes and objectives of the Federal credit union's investment activities;

(b) The characteristics of the investments the Federal credit union may make including the issuer, maturity, index, cap, floor, coupon rate, coupon formula, call provision, average life, and interest rate risk;

(c) How the Federal credit union will manage interest rate risk;

(d) How the Federal credit union will manage liquidity risk;

(e) How the Federal credit union will manage credit risk including specifically listing institutions, issuers, and counterparties that may be used, or criteria for their selection, and limits on the amounts that may be invested with each;

(f) How the Federal credit union will manage concentration risk, which can result from dealing with a single or

related issuers, lack of geographic distribution, holding obligations with similar characteristics like maturities and indexes, holding bonds having the same trustee, and holding securitized loans having the same originator, packager, or guarantor;

(g) Who has investment authority and the extent of that authority. Those with authority must be qualified by education or experience to assess the risk characteristics of investments and investment transactions. Only officials or employees of the Federal credit union may be voting members of an investment-related committee;

(h) The broker-dealers the Federal credit union may use;

(i) The safekeepers the Federal credit union may use;

(j) How the Federal credit union will handle an investment that, after purchase, is outside of board policy or fails a requirement of this part; and

(k) How the Federal credit union will conduct investment trading activities, if applicable, including addressing:

(1) Who has purchase and sale authority;

(2) Limits on trading account size;

(3) Allocation of cash flow to trading accounts;

(4) Stop loss or sale provisions;

(5) Dollar size limitations of specific types, quantity and maturity to be purchased;

(6) Limits on the length of time an investment may be inventoried in a trading account; and

(7) Internal controls, including segregation of duties.

§ 703.4 Recordkeeping and documentation requirements.

(a) Federal credit unions with assets of \$10,000,000 or greater must comply with all generally accepted accounting principles applicable to reports or statements required to be filed with NCUA. Federal credit unions with assets less than \$10,000,000 are encouraged to do the same, but are not required to do so. Federal credit unions with assets less than \$10,000,000 may choose to account for their investments consistent with the NCUA Accounting Manual For Federal Credit Unions.

(b) A Federal credit union must maintain documentation for each investment transaction for as long as it holds the investment and until the documentation has been audited in accordance with § 701.12 of this chapter and examined by NCUA. The documentation should include, where applicable, bids and prices at purchase and sale and for periodic updates, relevant disclosure documents or a description of the security from an

industry-recognized information provider, financial data, and tests and reports required by the Federal credit union's investment policy and this part.

(c) A Federal credit union must maintain documentation its board of directors used to approve a broker-dealer or a safekeeper for as long as the broker-dealer or safekeeper is approved and until the documentation has been audited in accordance with § 701.12 of this chapter and examined by NCUA.

(d) A Federal credit union must obtain an individual confirmation statement from each broker-dealer for each investment purchased or sold.

§ 703.5 Discretionary control over investments and investment advisers.

(a) Except as provided in paragraph (b) of this section, a Federal credit union must retain discretionary control over its purchase and sale of investments. A Federal credit union has not delegated discretionary control to an investment adviser when the Federal credit union reviews all recommendations from investment advisers and is required to authorize a recommended purchase or sale transaction before its execution.

(b)(1) A Federal credit union may delegate discretionary control over the purchase and sale of investments to a person other than a Federal credit union official or employee:

(i) Provided the person is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (15 U.S.C. 80b); and

(ii) In an amount up to 100 percent of its net worth in the aggregate at the time of delegation.

(2) At least annually, the Federal credit union must adjust the amount of funds held under discretionary control to comply with the 100 percent of net worth cap. The Federal credit union's board of directors must receive notice as soon as possible, but no later than the next regularly scheduled board meeting, of the amount exceeding the net worth cap and notify in writing the appropriate regional director within 5 days after the board meeting. The credit union must develop a plan to comply with the cap within a reasonable period of time.

(3) Before transacting business with an investment adviser, a Federal credit union must analyze his or her background and information available from State or Federal securities regulators, including any enforcement actions against the adviser, associated personnel, and the firm for which the adviser works.

(c) A Federal credit union may not compensate an investment adviser with

discretionary control over the purchase and sale of investments on a per transaction basis or based on capital gains, capital appreciation, net income, performance relative to an index, or any other incentive basis.

(d) A Federal credit union must obtain a report from its investment adviser at least monthly that details the investments under the adviser's control and their performance.

§ 703.6 Credit analysis.

A Federal credit union must conduct and document a credit analysis on an investment and the issuing entity before purchasing it, except for investments issued or fully guaranteed as to principal and interest by the U.S. government or its agencies, enterprises, or corporations or fully insured (including accumulated interest) by the National Credit Union Administration or the Federal Deposit Insurance Corporation. A Federal credit union must update this analysis at least annually for as long as it holds the investment.

§ 703.7 Notice of non-compliant investments.

A Federal credit union's board of directors must receive notice as soon as possible, but no later than the next regularly scheduled board meeting, of any investment that either is outside of board policy after purchase or has failed a requirement of this part. The board of directors must document its action regarding the investment in the minutes of the board meeting, including a detailed explanation of any decision not to sell it. The Federal credit union must notify in writing the appropriate regional director of an investment that has failed a requirement of this part within 5 days after the board meeting.

§ 703.8 Broker-dealers.

(a) A Federal credit union may purchase and sell investments through a broker-dealer as long as the broker-dealer is registered as a broker-dealer with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) or is a depository institution whose broker-dealer activities are regulated by a Federal or State regulatory agency.

(b) Before purchasing an investment through a broker-dealer, a Federal credit union must analyze and annually update the following:

(1) The background of any sales representative with whom the Federal credit union is doing business;

(2) Information available from State or Federal securities regulators and securities industry self-regulatory

organizations, such as the National Association of Securities Dealers and the North American Securities Administrators Association, about any enforcement actions against the broker-dealer, its affiliates, or associated personnel; and

(3) If the broker-dealer is acting as the Federal credit union's counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfill commitments, as evidenced by capital strength, liquidity, and operating results. The Federal credit union should consider current financial data, annual reports, reports of nationally-recognized statistical rating agencies, relevant disclosure documents, and other sources of financial information.

(c) The requirements of paragraph (a) of this section do not apply when the Federal credit union purchases a certificate of deposit or share certificate directly from a bank, credit union, or other depository institution.

§ 703.9 Safekeeping of investments.

(a) A Federal credit union's purchased investments and repurchase collateral must be in the Federal credit union's possession, recorded as owned by the Federal credit union through the Federal Reserve Book-Entry System, or held by a board-approved safekeeper under a written custodial agreement that requires the safekeeper to exercise, at least, ordinary care.

(b) Any safekeeper used by a Federal credit union must be regulated and supervised by either the Securities and Exchange Commission, a Federal or State depository institution regulatory agency, or a State trust company regulatory agency.

(c) A Federal credit union must obtain and reconcile monthly a statement of purchased investments and repurchase collateral held in safekeeping.

(d) Annually, the Federal credit union must analyze the ability of the safekeeper to fulfill its custodial responsibilities, as evidenced by capital strength, liquidity, and operating results. The Federal credit union should consider current financial data, annual reports, reports of nationally-recognized statistical rating agencies, relevant disclosure documents, and other sources of financial information.

§ 703.10 Monitoring non-security investments.

(a) At least quarterly, a Federal credit union must prepare a written report listing all of its shares and deposits in banks, credit unions, and other depository institutions, that have one or more of the following features:

- (1) Embedded options;

(2) Remaining maturities greater than 3 years; or

(3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

(b) The requirement of paragraph (a) of this section does not apply to shares and deposits that are securities.

(c) If a Federal credit union does not have an investment-related committee, then each member of its board of directors must receive a copy of the report described in paragraph (a) of this section. If a Federal credit union has an investment-related committee, then each member of the committee must receive a copy of the report, and each member of the board must receive a summary of the information in the report.

§ 703.11 Valuing securities.

(a) Before purchasing or selling a security, a Federal credit union must obtain either price quotations on the security from at least two broker-dealers or a price quotation on the security from an industry-recognized information provider. This requirement to obtain price quotations does not apply to new issues purchased at par or at original issue discount.

(b) At least monthly, a Federal credit union must determine the fair value of each security it holds. It may determine fair value by obtaining a price quotation on the security from an industry-recognized information provider, a broker-dealer, or a safekeeper.

(c) At least annually, the Federal credit union's supervisory committee or its external auditor must independently assess the reliability of monthly price quotations received from a broker-dealer or safekeeper. The Federal credit union's supervisory committee or external auditor must follow generally accepted auditing standards, which require either re-computation or reference to market quotations.

(d) If a Federal credit union is unable to obtain a price quotation required by this section for a particular security, then it may obtain a quotation for a security with substantially similar characteristics.

§ 703.12 Monitoring securities.

(a) At least monthly, a Federal credit union must prepare a written report setting forth, for each security held, the fair value and dollar change since the prior month-end, with summary information for the entire portfolio.

(b) At least quarterly, a Federal credit union must prepare a written report setting forth the sum of the fair values of all fixed and variable rate securities

held that have one or more of the following features:

(1) Embedded options;

(2) Remaining maturities greater than 3 years; or

(3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

(c) Where the amount calculated in paragraph (b) of this section is greater than a Federal credit union's net worth, the report described in that paragraph must provide a reasonable and supportable estimate of the potential impact, in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points on:

(1) The fair value of each security in the Federal credit union's portfolio;

(2) The fair value of the Federal credit union's portfolio as a whole; and

(3) The Federal credit union's net worth.

(d) If the Federal credit union does not have an investment-related committee, then each member of its board of directors must receive a copy of the reports described in paragraphs (a) through (c) of this section. If the Federal credit union has an investment-related committee, then each member of the committee must receive copies of the reports, and each member of the board of directors must receive a summary of the information in the reports.

§ 703.13 Permissible investment activities.

(a) *Regular way settlement and delivery versus payment basis.* A Federal credit union may only contract for the purchase or sale of a security as long as the delivery of the security is by regular way settlement and the transaction is accomplished on a delivery versus payment basis.

(b) *Federal funds.* A Federal credit union may sell Federal funds to an institution described in Section 107(8) of the Act and credit unions, as long as the interest or other consideration received from the financial institution is at the market rate for Federal funds transactions.

(c) *Investment repurchase transaction.* A Federal credit union may enter into an investment repurchase transaction so long as:

(1) Any securities the Federal credit union receives are permissible investments for Federal credit unions, the Federal credit union, or its agent, either takes physical possession or control of the repurchase securities or is recorded as owner of them through the Federal Reserve Book Entry Securities Transfer System, the Federal credit union, or its agent, receives a daily

assessment of their market value, including accrued interest, and the Federal credit union maintains adequate margins that reflect a risk assessment of the securities and the term of the transaction; and

(2) The Federal credit union has entered into signed contracts with all approved counterparties.

(d) *Borrowing repurchase transaction.* A Federal credit union may enter into a borrowing repurchase transaction so long as:

(1) The transaction meets the requirements of paragraph (c) of this section;

(2) Any cash the Federal credit union receives is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments the Federal credit union purchases with that cash are permissible for Federal credit unions; and

(3) The investments referenced in paragraph (d)(2) of this section mature no later than the maturity of the borrowing repurchase transaction.

(e) *Securities lending transaction.* A Federal credit union may enter into a securities lending transaction so long as:

(1) The Federal credit union receives written confirmation of the loan;

(2) Any collateral the Federal credit union receives is a legal investment for Federal credit unions, the Federal credit union, or its agent, obtains a first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral through the Federal Reserve Book Entry Securities Transfer System; and the Federal credit union, or its agent, receives a daily assessment of the market value of the collateral, including accrued interest, and maintains adequate margin that reflects a risk assessment of the collateral and the term of the loan;

(3) Any cash the Federal credit union receives is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments the Federal credit union purchases with that cash are permissible for Federal credit unions and mature no later than the maturity of the transaction; and

(4) The Federal credit union has executed a written loan and security agreement with the borrower.

(f)(1) *Trading securities.* A Federal credit union may trade securities, including engaging in when-issued trading and pair-off transactions, so long as the Federal credit union can show that it has sufficient resources, knowledge, systems, and procedures to handle the risks.

(2) A Federal credit union must record any security it purchases or sells

for trading purposes at fair value on the trade date. The trade date is the date the Federal credit union commits, orally or in writing, to purchase or sell a security.

(3) At least monthly, the Federal credit union must give its board of directors or investment-related committee a written report listing all purchase and sale transactions of trading securities and the resulting gain or loss on an individual basis.

§ 703.14 Permissible investments.

(a) *Variable rate investment.* A Federal credit union may invest in a variable rate investment, as long as the index is tied to domestic interest rates and not, for example, to foreign currencies, foreign interest rates, or domestic or foreign commodity prices, equity prices, or inflation rates. For purposes of this part, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is a domestic interest rate.

(b) *Corporate credit union shares or deposits.* A Federal credit union may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified it that the corporate credit union is not operating in compliance with part 704 of this chapter. A Federal credit union's aggregate amount of paid-in capital and membership capital, as defined in part 704 of this chapter, in one corporate credit union is limited to two percent of its assets measured at the time of investment or adjustment. A Federal credit union's aggregate amount of paid-in capital and membership capital in all corporate credit unions is limited to four percent of its assets measured at the time of investment or adjustment.

(c) *Registered investment company.* A Federal credit union may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for Federal credit unions.

(d) *Collateralized mortgage obligation/real estate mortgage investment conduit.* A Federal credit union may invest in a fixed or variable rate collateralized mortgage obligation/real estate mortgage investment conduit.

(e) *Municipal security.* A Federal credit union may purchase and hold a municipal security, as defined in Section 107(7)(K) of the Act, only if a nationally-recognized statistical rating organization has rated it in one of the four highest rating categories.

(f) *Instruments issued by institutions described in Section 107(8) of the Act.* A Federal credit union may invest in the following instruments issued by an

institution described in Section 107(8) of the Act:

- (1) Yankee dollar deposits;
- (2) Eurodollar deposits;
- (3) Banker's acceptances;
- (4) Deposit notes; and
- (5) Bank notes with original weighted average maturities of less than 5 years.

(g) *European financial options contract.* A Federal credit union may purchase a European financial options contract or a series of European financial options contracts only to fund the payment of dividends on member share certificates where the dividend rate is tied to an equity index provided:

(1) The option and dividend rate are based on a domestic equity index;

(2) Proceeds from the options are used only to fund dividends on the equity-linked share certificates;

(3) Dividends on the share certificates are derived solely from the change in the domestic equity index over a specified period;

(4) The options' expiration dates coincide with the maturity date of the share certificate;

(5) The certificate may be redeemed prior to the maturity date only upon the member's death or termination of the corresponding option;

(6) The total costs associated with the purchase of the option is known by the Federal credit union prior to effecting the transaction;

(7) The options are purchased at the same time the certificate is issued to the member.

(8) The counterparty to the transaction is a domestic counterparty and has been approved by the Federal credit union's board of directors;

(9) The counterparty to the transaction:

(i) Has a long-term, senior, unsecured debt rating from a nationally-recognized statistical rating organization of AA – (or equivalent) or better at the time of the transaction, and the contract between the counterparty and the Federal credit union specifies that if the long-term, senior, unsecured debt rating declines below AA – (or equivalent) then the counterparty agrees to post collateral with an independent party in an amount fully securing the value of the option; or

(ii) Posts collateral with an independent party in an amount fully securing the value of the option if the counterparty does not have a long-term, senior unsecured debt rating from a nationally-recognized statistical rating organization.

(10) Any collateral posted by the counterparty is a permissible investment for Federal credit unions and is valued daily by an independent

third party along with the value of the option;

(11) The aggregate amount of equity-linked member share certificates does not exceed the credit union's net worth;

(12) The terms of the share certificate include a guarantee that there can be no loss of principal to the member regardless of changes in the value of the option unless the certificate is redeemed prior to maturity; and

(13) The Federal credit union provides its board of directors with a monthly report detailing at a minimum:

(i) The dollar amount of outstanding equity-linked share certificates;

(ii) Their maturities; and

(iii) The fair value of the options as determined by an independent third party.

§ 703.15 Prohibited investment activities.

Adjusted trading or short sales. A Federal credit union may not engage in adjusted trading or short sales.

§ 703.16 Prohibited investments.

(a) *Derivatives.* A Federal credit union may not purchase or sell financial derivatives, such as futures, options, interest rate swaps, or forward rate agreements, except as permitted under §§ 701.21(i) and 703.14(g) of this chapter;

(b) *Zero coupon investments.* A Federal credit union may not purchase a zero coupon investment with a maturity date that is more than 10 years from the settlement date;

(c) *Mortgage servicing rights.* A Federal credit union may not purchase mortgage servicing rights as an investment but may perform mortgage servicing functions as a financial service for a member as long as the mortgage loan is owned by a member;

(d) A Federal credit union may not purchase a commercial mortgage related security that is not otherwise permitted by Section 107(7)(E) of the Act; and

(e) *Other prohibited investments.* A Federal credit union may not purchase stripped mortgage-backed securities, residual interests in collateralized mortgage obligations/real estate mortgage investment conduits, or small business related securities.

§ 703.17 Conflicts of interest.

(a) A Federal credit union's officials and senior management employees, and their immediate family members, may not receive anything of value in connection with its investment transactions. This prohibition also applies to any other employee, such as an investment officer, if the employee is directly involved in investments, unless the Federal credit union's board of

directors determines that the employee's involvement does not present a conflict of interest. This prohibition does not include compensation for employees.

(b) A Federal credit union's officials and employees must conduct all transactions with business associates or family members that are not specifically prohibited by paragraph (a) of this section at arm's length and in the Federal credit union's best interest.

§ 703.18 Grandfathered investments.

(a) Subject to safety and soundness considerations, a Federal credit union may hold a CMO/REMIC residual, stripped mortgage-backed securities, or zero coupon security with a maturity greater than 10 years, if it purchased the investment:

(1) Before December 2, 1991; or

(2) On or after December 2, 1991, but before January 1, 1998, if for the purpose of reducing interest rate risk and if the Federal credit union meets the following:

(i) The Federal credit union has a monitoring and reporting system in place that provides the documentation necessary to evaluate the expected and actual performance of the investment under different interest rate scenarios;

(ii) The Federal credit union uses the monitoring and reporting system to conduct and document an analysis that shows, before purchase, that the proposed investment will reduce its interest rate risk;

(iii) After purchase, the Federal credit union evaluates the investment at least quarterly to determine whether or not it actually has reduced the interest rate risk; and

(iv) The Federal credit union accounts for the investment consistent with generally accepted accounting principles.

(b) All grandfathered investments are subject to the valuation and monitoring requirements of §§ 703.10, 703.11, and 703.12 of this part.

§ 703.19 Investment pilot program.

(a) Under the investment pilot program, NCUA will permit a limited number of Federal credit unions to engage in investment activities prohibited by this part but permitted by the Act.

(b) Except as provided in paragraph (c) of this section, before a Federal credit union may engage in additional activities it must obtain written approval from NCUA. To obtain approval, a Federal credit union must submit a request to its regional director that addresses the following items:

(1) Certification that the Federal credit union is "well-capitalized" under part 702 of this chapter;

(2) Board policies approving the activities and establishing limits on them;

(3) A complete description of the activities, with specific examples of how they will benefit the Federal credit union and how they will be conducted;

(4) A demonstration of how the activities will affect the Federal credit union's financial performance, risk profile, and asset-liability management strategies;

(5) Examples of reports the Federal credit union will generate to monitor the activities;

(6) Projections of the associated costs of the activities, including personnel, computer, audit, and so forth;

(7) Descriptions of the internal systems that will measure, monitor, and report the activities;

(8) Qualifications of the staff and officials responsible for implementing and overseeing the activities; and

(9) Internal control procedures that will be implemented, including audit requirements.

(c) A third-party seeking approval of an investment pilot program must submit a request to the Director of the Office of Examination and Insurance that addresses the following items:

(1) A complete description of the activities with specific examples of how a credit union will conduct and account for them, and how they will benefit a Federal credit union;

(2) A description of any risks to a Federal credit union from participating in the program; and

(3) Contracts that must be executed by the Federal credit union.

(d) A Federal credit union need not obtain individual written approval to engage in investment activities prohibited by this part but permitted by statute where the activities are part of a third-party investment program that NCUA has approved under this section.

PART 742—REGULATORY FLEXIBILITY PROGRAM

■ 3. The authority citation for part 742 continues to read as follows:

Authority: 12 U.S.C. 1756 and 1766.

■ 4. Revise § 742.4 to read as follows:

§ 742.4 From what NCUA regulations will I be exempt?

(a) RegFlex credit unions are exempt from the provisions of the following NCUA regulations without restrictions or limitations: § 701.25, § 701.32(b) and (c), § 701.36(a), (b) and (c), § 703.5(b)(1)(ii) and (2), § 703.12(c); and § 703.16(b) of this chapter.

(b) RegFlex credit unions are exempt from the provisions of the following

NCUA regulations with certain restrictions or limitations:

(1) Section 703.13(d)(3) of this chapter, provided the value of the investments that mature later than the borrowing repurchase transaction does not exceed 100 percent of the Federal credit union's net worth; and

(2) Section 703.16(d) of this chapter provided:

(i) The issuer of the security is domestic;

(ii) The security is rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization;

(iii) The security meets the definition of mortgage related security as defined in 15 U.S.C. 78c(a)(41) and the definition of commercial mortgage related security as defined in § 703.2 of this chapter;

(iv) The security's underlying pool of loans contains more than 50 loans with no one loan representing more than 10 percent of the pool; and

(v) The aggregate total of commercial mortgage related securities purchased by the Federal credit union does not exceed 50 percent of its net worth.

[FR Doc. 03-13660 Filed 6-2-03; 8:45 am]

BILLING CODE 7535-01-P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 2003-SW-14-AD; Amendment 39-13172; AD 2003-11-13]

RIN 2120-AA64

Airworthiness Directives; Eurocopter France Model AS332C, L, and L1 Helicopters

AGENCY: Federal Aviation Administration, DOT.

ACTION: Final rule; request for comments.

SUMMARY: This amendment adopts a new airworthiness directive (AD) for the specified Eurocopter France (Eurocopter) model helicopters. This action requires replacing a certain elbow adapter (adapter) with an airworthy adapter. This amendment is prompted by reports of a cracked adapter on the hydraulic reservoir resulting in leakage of hydraulic fluid and loss of hydraulic power. This condition, if not corrected, could result in failure of an adapter on the hydraulic reservoir, loss of hydraulic fluid, loss of hydraulic power, and subsequent loss of control of the helicopter.

DATES: Effective June 18, 2003.

Comments for inclusion in the Rules Docket must be received on or before August 4, 2003.

ADDRESSES: Submit comments in triplicate to the Federal Aviation Administration (FAA), Office of the Regional Counsel, Southwest Region, Attention: Rules Docket No. 2003-SW-14-AD, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137. You may also send comments electronically to the Rules Docket at the following address: 9-asw-adcomments@faa.gov.

FOR FURTHER INFORMATION CONTACT: Uday Garadi, Aviation Safety Engineer, FAA, Rotorcraft Directorate, Rotorcraft Standards Staff, Fort Worth, Texas 76193-0110, telephone (817) 222-5123, fax (817) 222-5961.

SUPPLEMENTARY INFORMATION: The Direction Generale De L'Aviation Civile (DGAC), the airworthiness authority for France, notified the FAA that an unsafe condition may exist on Eurocopter Model AS332C, L, and L1 helicopters. The DGAC advises that a right-hand (RH) hydraulic reservoir drained while in service due to a cracked adapter on the hydraulic reservoir. Such a situation could result in the loss of hydraulic power assistance if leakage occurs on both hydraulic systems at the same time.

Eurocopter has issued Alert Service Bulletin No. 67.00.25, dated January 8, 2003 (ASB), which specifies replacing certain adapters, part number (P/N) DHS613-636-43, on the RH hydraulic reservoir to limit the risk of hydraulic fluid leakage, which can result in the loss of hydraulic power assistance in the event of leakage on both hydraulic systems. The DGAC classified this ASB as mandatory and issued AD 2003-101(A), dated March 5, 2003, to ensure the continued airworthiness of these helicopters in France.

These helicopter models are manufactured in France and are type certificated for operation in the United States under the provisions of 14 CFR 21.29 and the applicable bilateral agreement. Pursuant to the applicable bilateral agreement, the DGAC has kept the FAA informed of the situation described above. The FAA has examined the findings of the DGAC, reviewed all available information, and determined that AD action is necessary for products of these type designs that are certificated for operation in the United States.

The previously described unsafe condition is likely to exist or develop on other helicopters of the same type design registered in the United States. Therefore, this AD is being issued to

prevent failure of an adapter on the hydraulic reservoir, loss of hydraulic fluid, loss of hydraulic power, and subsequent loss of control of the helicopter. This AD requires replacing each adapter, P/N DHS613-636-43, with a manufacturing code on the hydraulic reservoir end indicating manufacture before January 1, 2002, and not identified with a yellow mark, with an airworthy adapter, P/N DHS613-636-43, with a manufacturing code on the reservoir end indicating manufacture on or after January 1, 2002. This AD requires that both the RH and left-hand (LH) affected adapters be replaced within 15 days even though the manufacturer's service information and the DGAC AD envisioned replacing the RH adapter only. This was driven apparently by an insufficient number of airworthy replacement adapters at the time their service information was released. Now, since there should be sufficient airworthy replacement adapters, both affected RH and LH adapters must be replaced. The short compliance time involved is required because the previously described critical unsafe condition can adversely affect the controllability of the helicopter. Therefore, this AD requires replacing the previously identified adapter with an airworthy adapter within 15 days, and this AD must be issued immediately.

Since a situation exists that requires the immediate adoption of this regulation, it is found that notice and opportunity for prior public comment hereon are impracticable, and that good cause exists for making this amendment effective in less than 30 days.

On July 10, 2002, the FAA issued a new version of 14 CFR part 39 (67 FR 47997, July 22, 2002), which governs the FAA's AD system. The regulation now includes material that relates to altered products, special flight permits, and alternative methods of compliance. Because we have now included this material in part 39, we are no longer including it in each individual AD.

The FAA estimates that this AD will affect 3 helicopters, and replacing both adapters on each helicopter will take approximately 2 work hours at an average labor rate of \$60 per work hour. Required parts will cost approximately \$184 (2 adapters per helicopter). Based on these figures, the total cost impact of the AD on U.S. operators is \$912.

Comments Invited

Although this action is in the form of a final rule that involves requirements affecting flight safety and, thus, was not preceded by notice and an opportunity for public comment, comments are