Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

February 25, 2000

Corporate Decision #2000-02
March 2000

Martin D. Werner
Werner & Blank Co., L.P.A.
7205 West Central Avenue
Toledo, Ohio 43617

Re: Application of Capital Bank, N.A., Sylvania, Ohio, to Establish an Operating Subsidiary to Provide, as Agent, Private Placement and Related Advisory Services
Application Control No. 1998-CE-08-0032

Dear Mr. Werner:

This is in response to the application filed by Capital Bank, National Association, Sylvania, Ohio ("Bank"), pursuant to 12 C.F.R. § 5.34, to establish an operating subsidiary to be known as Capital Securities, Inc. ("Subsidiary"). The Subsidiary will assist customers in the issuance of debt and equity securities by providing private placement services as agent. Also, the subsidiary will provide financial and transactional advice to customers and assist customers in structuring, arranging, and executing various financial transactions, as agent, in connection with its private placement activities.[1] The Bank indicates that the Subsidiary may, in some cases, accept as sole or partial compensation for its services a share in the customer's profit, income, or earnings. The proposed compensation would be in the form of stock warrants, or in the form of contractual arrangements between the Subsidiary and the customer whereby a share of the customer's profit, income, or earnings would be paid to the Subsidiary (hereinafter "performance-linked compensation"). For the reasons given below, we conclude that the proposed activities are permissible and, pursuant to 12 C.F.R. § 5.34, approve the operating subsidiary application.

I. DISCUSSION

A. Legal Analysis

[1] The Bank intends to register the Subsidiary as a broker-dealer with the Securities and Exchange Commission.

National banks may engage in activities that are part of or incidental to the business of banking by means of an operating subsidiary.[2]

1. Private Placement Activity and Related Advisory Services

The OCC has long held that a national bank is authorized to privately place debt and equity securities, as agent, and that such activity does not constitute securities dealing or underwriting in violation of the Glass-Steagall Act.[3] The OCC also has opined that national banks are authorized under 12 U.S.C. § 24(Seventh) to provide financial and transactional advice to customers.[4] Accordingly, the Bank may establish the Subsidiary to privately place debt and equity securities, as agent, for its customers and to provide financial and transactional advice to its customers.

2. Acceptance of Performance-Linked Compensation

A national bank may accept warrants or performance-linked compensation as the sole form of compensation for its private placement activities, provided that such compensation would not change the fundamental nature of the bank's activity into something impermissible for a national bank. If the performance-linked compensation is in the form of warrants, consistent with 12 U.S.C. §24(Seventh) ("Section 24(Seventh)") and OCC precedent, the national bank must not exercise the warrants.

a. A National Bank May Receive Performance-Linked Compensation, Including Warrants, as Compensation For Permissible Banking Services as Part of or Incidental to The Business Of Banking

The first sentence of Section 24(Seventh) specifies the powers that a national bank may exercise. It states that national banks shall have the power:

> [T]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes. . . .[5]

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[2] 12 C.F.R. § 5.34(c).

[3] *See* Interpretive Letter No. 463, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,686 (Dec. 27, 1988); Interpretive Letter No. 212, *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,107 (July 2, 1981).

[4] *See, e.g.*, Interpretive Letter No. 389, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,613 (July 7, 1987).

[5] 12 U.S.C. § 24(Seventh).

The Supreme Court has held that this sentence provides a broad grant of power to engage in the business of banking, including but not limited to the enumerated powers and the business of banking as a whole.[6] This provision also authorizes national banks to engage in activities that are incidental to the business of banking.[7] Prior to *VALIC*, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in *Arnold Tours, Inc. v. Camp*.[8] The *Arnold Tours* standard defined an incidental power as one that is "convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act."[9] Even prior to *VALIC*, the *Arnold Tours* formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act.[10] The *VALIC* decision, however, has established that an incidental power includes one that is convenient and useful to the express powers specifically enumerated in 12 U.S.C. § 24(Seventh), as well as the broader "business of banking."

As part of the business of banking, a national bank may price products and services as appropriate to achieve its marketing and profitability objectives, provided such pricing is not otherwise contrary to law or an unsafe or unsound banking practice. Indeed, OCC regulation and precedent on the form and basis of compensation for products and services support this proposition.[11] These regulations and

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[6] *See NationsBank of North Carolina, N.A. v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("*VALIC*").

[7] *See VALIC*, 513 U.S. at 258 n.2.

[8] 472 F.2d 427 (1st Cir. 1972).

[9] *Id.* at 432.

[10] *See* Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

[11] *See, e.g.*, 12 C.F.R. § 7.4002(b) (a national bank reasonably establishes non-interest charges and fees when it considers: (1) the cost incurred by the bank in providing the service, (2) the deterrence of misuse of services by customers, (3) the enhancement of the competitive position of the bank in accordance with the bank's marketing strategy, and (4) the maintenance of the bank's safety and soundness); 12 C.F.R. § 7.1006 (acceptance of stock warrants in lieu of interest on loans); Letter from Elizabeth H. Corey, Attorney (May 18, 1989) (unpublished) (acceptance of a percentage of the commission as compensation for referring customers to insurance agents); Interpretive Letter No. 274, *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,438 (lease of bank space on a percentage-lease basis) (December 2, 1983); Interpretive Letter of Patrick Parise, Regional Counsel (Oct. 16, 1970) (unpublished) (citing Paragraph 7312 of the *Comptroller's Manual for National Banks*); Interpretive Letter of Robert Bloom, Chief Counsel (May 26, 1969) (unpublished).

precedents do not impose any limitation on the bank's compensation, other than it not be otherwise prohibited by law or contrary to safe and sound banking practice.

There is longstanding OCC precedent allowing a national bank to accept warrants as compensation. In 1969, the staff of the OCC first issued an opinion letter stating that a national bank may accept warrants in lieu of interest on a loan as a form of participation in the profits of a borrower.[12] Since that time, in a series of interpretive letters with the most recent issued in 1990, the OCC staff have consistently permitted national banks to accept warrants in the context of loans.[13] As a body of precedent, these letters indicate that a national bank's acceptance of warrants in lieu of interest on a loan does not violate Section 24(Seventh). In this connection, it should be noted that the letters explicitly rely on the condition that the national bank not exercise the warrants.[14]

In 1996, the OCC codified the advice regarding warrants that previously had been contained in the interpretive letters. This was accomplished by adding references to warrants to the OCC's long-standing ruling permitting a national bank to take a share in the profit of a business enterprise in lieu of interest on a loan.[15] The OCC staff's most recent interpretive letter on the subject of warrants expanded the application of the participatory financing advice beyond the context of national banks making loans. Specifically, the OCC stated that it was permissible for a national bank to accept warrants as a supplement to reasonable monetary compensation in the context of the bank providing investment advisory services.[16]

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[12] Letter from Thomas G. DeShazo, Deputy Comptroller (July 11, 1969).

[13] *See, e.g.*, Interpretive Letter 517, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶83,228 (Aug. 16, 1990); Letter from Peter Liebesman, Assistant Director, Legal Advisory Services Division, (May 4, 1983); Letter from Richard V. Fitzgerald, Assistant Director, Legal Advisory Services Division (Jan. 13, 1976); Letter from Thomas G. DeShazo, Deputy Comptroller, (June 26, 1974); Letter from Patrick Parise, Regional Counsel, (Oct. 16, 1970).

[14] The 1990 letter states that "[w]hile the receiving and holding of stock warrants is permitted in connection with making a loan, . . . this incidental power does not authorize a national bank to exercise such warrants. The exercise of such warrants would result in a purchase of stock in violation of 12 U.S.C. 24(Seventh)."

[15] 61 Fed. Reg. 4,849, 4852 (1996)(amending interpretive ruling and redesignating it as 12 C.F.R. § 7.1006).

[16] Letter to Kathleen M. O'Day, Associate General Counsel, Board of Governors of the Federal Reserve System, from Julie L. Williams, Chief Counsel (January 29, 1996)(unpublished).

The authority of a national bank to accept warrants is not without limit, however. The bank must require repayment of principal if it is relying on lending authority to engage in the transaction. OCC's regulations at 12 C.F.R. § 7.1006 prohibit the bank from conditioning the borrower's obligation to repay principal on the value of the performance-linked compensation. It is necessary that the borrower be obligated to repay principal in order to preserve the nature of the underlying transaction, *i.e.*, making a loan.[17] Section 7.1006 permits a bank to make a loan, and to structure its compensation on the loan to include a warrant in lieu of some or all interest. If the bank accepts a warrant in lieu of all interest, the warrant will represent the bank's total compensation for the service of providing the loan.

Similarly, a national bank may accept performance-linked compensation for other services, provided such acceptance does not change the fundamental nature of the bank's activity into something impermissible for the national bank. Thus, a national bank may accept warrants as full compensation for private placement services, if such compensation arrangement would not involve the bank in an impermissible activity.

b. The Proposed Compensation Arrangements Do Not Involve Activities Prohibited Under Section 24(Seventh)

The proposed arrangements do not involve "underwriting" or "dealing" in securities or stock or the purchase of stock under Section 24(Seventh). Section 24(Seventh) provides that "[t]he business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock. . . ." Even if warrants are presumed to be securities within the meaning of Section 24(Seventh), a national bank would not be engaged in "dealing" or "underwriting" if it accepted the warrants under the circumstances proposed.

The term "underwriting" is not defined for purposes of Section 24(Seventh). The term, however, is commonly understood to refer to the process by which newly issued securities of one firm are

[17] For example, if a bank wanted to "lend" one million dollars to a real estate developer under an arrangement whereby the real estate developer and the bank would share equally in the profits of the project developed and sold, and no principal would have to be paid to the bank, such an arrangement would change the fundamental nature of the bank's activity. The bank would not be making a loan, but rather would be making a joint venture investment with a real estate developer. Requiring the borrower to repay principal preserves the fundamental nature of the bank's activity, *i.e.*, that of a lender.

purchased by another firm for its own account for distribution and sale to investors.[18] In *Securities Industry Ass'n v. Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), *cert denied*, 483 U.S. 1005 (1987), the court considered the meaning of the term underwriter under the Securities Act of 1933 and concluded that "an 'underwriter' cannot exist unless a 'distribution' exists."[19] Further, the court noted that "a statutory 'distribution' necessarily involved a 'public offering,' thus making clear that one could not be an 'underwriter' in the absence of a public offering."[20] Under the federal securities laws, a person that purchases securities from an issuer with a view to investment, or with a view to reoffering them for investment to persons to whom the issuer might have sold them privately under a private placement exemption, is not an underwriter.[21] Thus a bank that accepted warrants as compensation would not be engaged in underwriting unless it participated in a public offering of the warrants to investors. Our understanding is that the Subsidiary would not be involved in such a public offering.

The term "dealing" as used in Section 24(Seventh) also is not statutorily defined. That term, however, is generally understood to encompass only buying and selling as part of a regular business.[22] A dealer typically maintains an inventory of particular securities and holds itself "out to the public as willing to purchase and sell securities as principal in the secondary market."[23] Here, the Subsidiary will not be

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[18] *See* Interpretative Letter No. 388, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 (June 16, 1987); Interpretative Letter No. 329, *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499 (March 4, 1985).

[19] 807 F.2d at 1063.

[20] *Id*. at 1064 (citing H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934)).

[21] *See* Sec. Act Rel. No. 4552, *reprinted in* 1 Fed. Sec. L. Rep. (CCH) ¶ 2776 (Nov. 6, 1962).

[22] As indicated above, although the securities laws definitions are not dispositive in determining whether a particular type of securities activity is permitted for national banks, these definitions provide a useful starting point for characterizing a bank's securities activities. Under section 3 of the Securities Exchange Act of 1934, a "dealer" is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not part of a regular business." 15 U.S.C. 78c(a)(5).

[23] *See Citicorp, J.P. Morgan & Co. Inc., Bankers Trust New York Corporation*, 73 Fed. Res. Bull. 473 n.4 (1987). *See also Securities Industry Ass'n v. Board of Governors*, 468 U.S. at 218 n. 18 (as underwriter and dealer, a securities firm engages in buying and selling securities on its own account, thereby assuming all the risk of loss).

engaged in "dealing" when it accepts warrants as payment for services since these activities do not involve a regular business of buying and selling warrants in the secondary market. Rather, the Subsidiary's ultimate goal is to engage in a general business of conducting banking activities.[24] Thus, the proposed acceptance of warrants as full payment for services does not involve "underwriting" or "dealing" in securities prohibited under Section 24(Seventh).

The fifth sentence of Section 24(Seventh) provides that "[e]xcept as herein provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation."[25] This sentence refers only to "shares of stock" and not to securities in general. A share of stock represents a unit of ownership interest in a company.[26] The purchaser of shares of stock in a company acquires an equity interest in that company, and that interest generally includes the right to exercise some control over the company, to share in the company's net profits or earnings, and, upon dissolution, to share proportionally in the distribution of assets after payment of debt.[27] A stock warrant, on the other hand, is a certificate entitling the owner to buy a specific amount of stock at a specified time for a specified price.[28] A warrant does not grant to the holder an equity interest in the company issuing the warrant, nor any shareholder rights.[29] Warrants

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[24] In the situations where the OCC's precedents regarding warrants have been applied, the bank's ultimate goal in accepting the warrants as interest or compensation similarly was not to engage in a general business of buying and selling securities. Rather, the bank's ultimate goal was to engage in a general business of lending or conducting other permissible banking activities.

[25] The OCC has previously determined that this sentence is not an absolute prohibition on national banks owning stock. Rather, the OCC has taken the position that this sentence clarifies that the amendments to Section 24(Seventh) made by the Banking Act of 1933 should not be construed to increase the authority of national banks to own stock. If the ownership of the stock is otherwise permitted by law, such as by the powers sentence at the beginning of Section 24(Seventh), the ownership of the stock is permissible. *See* 61 Fed Reg 60342, 60351-52 (November 27, 1996).

[26] *See* II William M. Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 5081 (perm. ed. rev. vol. 1995); Model Business Corp. Act § 1.40(21) (1984).

[27] *See* Fletcher, *supra*, note 26.

[28] Black's Law Dictionary 1585 (6th ed. 1990).

[29] *See Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 200-01 (1942); *Morales v. Mapco*, 541 F.2d 233, 236-37 (10th Cir. 1976), *cert denied*, 429 U.S. 1053 (1977); *In re The Charter Company*, 68 B.R. 225, 229 (Bankr. M.D. Fla. 1986); *Kusner v. First Pennsylvania Corp.*, 395 F. Supp. 276, 282-83 (E.D. Penn. 1975), *rev'd in part on other grounds*, 531 F.2d 1234 (3d Cir. 1976).

are not the equivalent of shares of stock, they are only options to purchase shares of stock.[30] Moreover, while warrants and stocks may both be subject to appreciation and depreciation, warrants do not share all the same risk attributes as stocks.[31] Finally, it is also important to note that under the OCC precedents described above, the exercise of the warrants by the national bank is expressly prohibited. Because the warrants cannot be exercised, but may be exchanged for cash, they are more akin to cash instruments than to stocks. Accordingly, the Section 24(Seventh) prohibition against purchasing shares of stock of any corporation does not apply to the acceptance of warrants by a national bank.

In summary, the acceptance of warrants as compensation for providing private placement and related advisory services does not involve "underwriting" or "dealing" in securities or the purchase of "shares of stock" under Section 24(Seventh).

Accordingly, the Subsidiary may accept warrants or performance-linked compensation as the sole form of compensation for its private placement activities. However, if the performance-linked compensation is in the form of warrants, neither the Subsidiary nor the Bank may exercise the warrants.

B. Accounting Discussion

The warrants that the Subsidiary might acquire as compensation for its private placement services should be accounted for in accordance with generally accepted accounting principles. Specifically, in accounting for any warrants it receives the Subsidiary should follow the guidance provided in Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

The Subsidiary should periodically evaluate any warrants it holds for impairment. If there is an other than temporary decline in fair value from the original assigned cost basis, the Subsidiary should write down the asset to the lower value and consequently recognize a loss.

II. CONCLUSION

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[30] *Id.*

[31] The value of a warrant does not vary directly and proportionately with the price of the stock to which it relates. There are a number of other factors involved in the value of a warrant, including the exercise price, the time remaining before expiration, the degree of leverage, and the volatility of the price of the related stock. *See,* Allen E. Young, *Warrants and Rights, in* Encyclopedia of Investments 787, 789 (Jack P. Friedman, ed., 2d ed.1990).

Based on the foregoing, the Bank may legally establish the Subsidiary to provide, as agent, private placement and related advisory services, and may accept performance-linked compensation, including warrants, as the compensation for such services. Neither the Bank nor the Subsidiary may exercise any warrants, however. Accordingly, the Bank's application is approved.

If you have any questions, please do not hesitate to contact David J. Rogers, Licensing Manager, in the Central District, at (312) 360-8851.

Sincerely,

/s/

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel