



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

December 20, 2005

Interpretive Letter #1047
January 2006
12 USC 92a
12 USC 24(7)
12 CFR 1

Re: Authority of a National Bank Trust Company to Sponsor a Closed-End Fund and Investment in Fund Shares Under 12 C.F.R. § 1.3(h)(2)

Dear []:

This is in response to your letter, on behalf of [], [*City, State*] (“Trust Company”) concerning whether the Trust Company may act as a sponsor of a closed-end investment company (the “Fund”) that will be exempt from registration under section 3(c)(1) of the Investment Company Act of 1940 and advised by an affiliate of the Trust Company, and whether shares of the Fund (“Fund Shares”) are a permissible investment for certain national banks pursuant to 12 C.F.R. § 1.3(h)(2).

Based on the information you provided and for the reasons discussed below, we conclude that the Trust Company may engage in the described sponsoring activities with respect to the Fund, subject to the applicable safety and soundness requirements. We also conclude that because the Fund’s underlying portfolio consists of bank eligible investments, purchase of the specific Fund Shares related to the proposal described herein are a permissible investment for the particular types of national banks proposed, subject to the described safe and sound banking practices, including an aggregate investment limitation of 1% of the investing bank’s capital and surplus.

In particular, we recognize that the described Fund Shares arise from a structured finance transaction that is complex, and as discussed in your letter, holdings of the Fund Shares are only appropriate in a well-diversified portfolio at an institution that has sophisticated risk management processes to conduct the necessary due diligence and ongoing monitoring of risk exposures. As proposed, the purchasers are large and medium-sized money center and regional banks with an asset size of at least \$25 billion that have the requisite sophistication for evaluating the potential risks of the investment. Under section 1.3(h)(2), we limit our determination to the facts and circumstances you describe.

I. Background

The Trust Company is a nationally chartered limited purpose trust company subsidiary of [] (“Parent Bank”), which operates banking and trust businesses in the United States through, among other vehicles, the Trust Company and a subsidiary [] state chartered member bank. Parent Bank is registered with the Board of Governors of the Federal Reserve System as a financial holding company under the Bank Holding Company Act and maintains various nonbanking subsidiaries in the United States, including [] (“Securities”), a registered broker-dealer under the federal securities laws. As described below, the Trust Company and Parent Bank propose a complex product involving the Fund, which invests in preferred shares issued by certain newly established Companies engaged in credit default swap index activities.¹ The Trust Company’s role as Fund sponsor is an essential, but limited, role in the structure of a product designed by the Parent Bank. The Fund Shares represent an indirect investment in a credit strategy that, due to structural credit protection, has a very low probability of experiencing cash “realized” losses, but nonetheless reflects embedded credit leverage that as a safety and soundness matter presents unique risk considerations for investors in the Fund.²

A. *The Fund and the Shares*

The Fund will be established as a trust or a limited liability company under the laws of the State of [].³ The Fund’s portfolio will consist of the preferred stock issued by certain newly established limited purpose companies (each, a “Company,” or collectively “Companies”). The

¹ A credit default swap (“CDS”), in general, is a type of credit derivative that separates out credit risk of an underlying obligation or entity from other financial risks and transfers the credit risk from one party (the protection “buyer”) to another party (the protection “seller”). The buyer typically pays a periodic, fixed rate payment to the seller for protection related to the occurrence of credit events related to the underlying obligation or reference entity (or to the reference entity’s obligations). When a credit event (e.g., a reference entity’s bankruptcy or failure to pay on borrowed money) occurs, the buyer delivers bonds issued by the reference entity to the seller in exchange for the underlying obligation’s par value. The difference between the par value paid by the protection seller and the current market value of the bonds, which due to the credit event may be well below par value, represents a loss for the protection seller. Similarly, in general, credit default swap index activities involve exchanges of payments between a protection buyer and a protection seller based on an index reflecting the credit exposures of multiple underlying reference entities.

² Technically, even before there are realized cash losses, the Fund Shares may experience significant unrealized losses due to changes in the value of the credit default index exposures. In addition, should actual losses on the underlying portfolio of exposures exceed structural credit protection, the Fund Shares would experience concentrated losses (i.e., the embedded credit leverage).

³ The Fund will be exempt from registration under section 3(c)(1) of the Investment Company Act of 1940 because the Fund will have 100 or fewer investors. 15 U.S.C. § 80a-3. The Trust Company and the Parent Bank anticipate that Fund Shares will be sold to more than one and fewer than 99 U.S. institutional buyers, such as large and medium-sized money center and regional banks with an asset size of at least \$25 billion that have the sophistication needed to evaluate the potential risks of the investment. The Trust Company also represents that it will not purchase shares for its own portfolio or in its fiduciary capacity on behalf of Trust Company customers.

Companies will engage only in activities reflecting investment exposure to: (1) credit default swap index tranches (the “Index Swaps”);⁴ and (2) highly-rated debt instruments of European and U.S. issuers (the “Debt Instruments”).⁵

The Trust Company and the Parent Bank represent that the preferred stock invested in by the Fund or any Debt Instruments will be rated at least investment grade and within the highest four categories by a nationally recognized statistical rating organization (“NRSRO”). As the Fund’s sponsor, the Trust Company will engage in activities related to the formation and initial organization of the Fund.⁶ Securities will serve as investment manager of the Fund and manage the assets in the Fund’s portfolio.⁷ Securities also will have the entire responsibility for distributing and marketing the Fund.

The Fund will issue one class of shares, and all Fund Shares will be entitled to equal distributions and liquidation preference. The Parent Bank will enter into a performance agreement with the Fund for the benefit of the Fund shareholders, pursuant to which quarterly distributions will be made.⁸ Fund shareholders will have limited voting rights directly proportional to their interests in the Fund.⁹ The Fund Shares will have no termination or mandatory exchange date, but

⁴ Each Company will enter into an “Index Swap” contract with a highly rated derivatives counterparty, which may be the Parent Bank, involving an exchange of payments between the parties similar to an ordinary CDS. The payments will be based, however, on a specified tranche of the Dow Jones CDX Index (“CDS Index”), which is comprised of 125 investment grade entities (“Reference Entities”). Under the tranching Index Swap, the protection buyer will pay periodic payments calculated as a fixed percentage on a notional amount of the Index. When aggregate losses on the Index exceed the subordination level of the tranche, subsequent credit events will require the protection seller (the Company) to make a payment to the protection buyer. Although payments by a respective Company as a credit protection seller are very unlikely, due to the anticipated amount of subordination (at least 7%), once losses on the pool of Reference Entities exceed the subordination level, payment obligations can substantially exceed the compensation received for selling the protection. And, well before losses exceed the subordination level that protects the Company from making payments against initial defaults, the mark-to-market value of the Index Swap may decline as Reference Entities experience credit events. Even absent credit events, as the premium for credit protection for a specific tranche increases, the mark-to-market value of the tranche may decrease. The proposed Index Swaps may use different tranches of the CDS Index, however, the Trust Company and Parent Bank indicate that the contemplated tranches would not involve subordination of less than 7 percent.

⁵ The Debt Instruments will be U.S. dollar denominated notes or deposits of U.S. or European institutions or entities. All Debt Instruments will mature by the fifth year after issuance of the Fund shares. Thereafter, they will be rolled over or renewed, but always with maximum maturities of five years.

⁶ The Trust Company represents it will comply with all applicable guidance concerning the naming of the Fund, and other applicable requirements, including to the extent appropriate OCC Bulletin 2004-2, *Banks/Thriffs Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates* (Jan. 5, 2004).

⁷ The Trust Company and the Parent Bank represent that Securities will indemnify the Trust Company for all losses and claims incurred as the result of any negligence, gross negligence or willful misconduct by Securities in connection with the Fund.

⁸ The Fund will make distributions of all cash available from the Index Swaps and rated Debt Instruments after payment of the fund management fee on a quarterly basis.

⁹ Voting rights will be limited to: (1) curing breaches and non-performance; and (2) general administrative matters consistent with typical investment company practices.

Securities will agree to redeem the Shares at the option of any Fund Shareholder on a daily basis at the posted dealing level.¹⁰

The Trust Company and the Parent Bank represent that the return to the Fund's shareholders will approximate the return of a "fully invested" position in a static credit default swap index single tranche (e.g., DJ CDX.NA.IG 10% - 15%) and LIBOR on the debt instruments (less fees payable).¹¹ In North America, the capital structure of the Dow Jones CDX Index ("the CDS Index"), for example, is tranching into standard classes representing equity (0% - 3%), BBB (3%-7%), AAA (7%-10%), junior super-senior (10%-15%), and super-senior (15%-30%).¹² The underlying elements of the Fund Shares are designed to be transparent to facilitate independent monitoring by each investor.¹³

The Fund shareholders would be expected to account for the Fund Shares in accordance with generally accepted accounting principles. Pursuant to Statement of Financial Accounting Standards No. 115 ("FAS 115"), the Fund Shares should be measured at fair value and classified as available-for-sale if they were not bought and held principally for the purpose of selling them in the near term (i.e., classification as trading). If the Fund Shares were classified as trading and not available-for-sale, the unrealized holding gains and losses would be included in earnings as opposed to accumulated other comprehensive income.

¹⁰ Securities will post periodic dealing levels of the Fund Shares on accessible electronic media (i.e., Bloomberg or Reuters). The posted dealing levels will be based on the net asset value of the Fund. Dealing levels will incorporate a load or a bid-offer spread.

¹¹ Thus, here each Company will enter into an Index Swap representing a replication of a fractional horizontal tranche of the Dow Jones CDS Index. Each single tranche is divided (fractionalized) into subsets of the single tranche, such as 10%-11%; 11%-12%; 12%-13%; 13%-14%; and 14%-15%. As mentioned, the 125 investment grade Reference Entities comprising the Index are listed and may be accessed on Bloomberg. For any return period the Trust Company and the Parent Bank represent the return on the Fund Shares will be the sum of: (a) LIBOR on Fund shareholders' investments; (b) monies received from selling credit protection on the specific tranche of the Index Swap; and (c) the change in market price of the specific tranche of the Index Swap; minus (d) floating amount payments due under the Index Swap not already reflected in the mark-to-market price from (c) (collectively, the "Share Return"). As represented by the Trust Company and Parent Bank, the Share Return replicates an investment in a broad-based investment grade portfolio with generous subordination (provided by the subordinated tranches).

¹² Investment grade risk is 3% to 100% (i.e., all tranches with subordination equal to or greater than 3% are rated investment grade or higher). Various trading strategies exist in the market. Index tranches offer market participants the opportunity to trade correlation/subordination products through their standardized form and liquidity. Through the Index, investors can acquire investments in a diversified pool of investment grade U.S. credits, with virtually any desired level of credit enhancement and rating. Current CDS Index prices, data, and parameters are publicly available on Bloomberg. In addition, the mechanics on the underlying Dow Jones CDX Index are available on the Dow Jones index website (<http://www.djindexes.com>).

¹³ The Trust Company and the Parent Bank indicate that Bloomberg and other market data services will publish credit aspects of the underlying Reference Entities and the pricing on the Index Swaps. Further, the Parent Bank will provide narrative and sensitivity analysis on the Fund Shares with respect to defaults and spread movements. Tradable marks and valuations on the Funds Shares will be posted daily on either Reuters or Bloomberg.

The Trust Company and Parent Bank state that the Fund provides a means for investors to achieve efficient returns on capital investments without the complexities of trading, managing, and settling credit derivatives, such as credit default swaps, directly. You explain that the proposed structure involving the Fund, the Companies, and exposure to the CDS Index, offers certain investors an investment option that provides tailored exposure to specific credit risk in a diversified portfolio of reference entities (both geographically and by industry). You indicate that the proposed structure also offers rating agency review, transparency, and beneficial accounting treatment for investors.

B. The Companies and the Underlying Investment Strategy

The Parent Bank, or its affiliate Securities, will incorporate each single purpose Company under the laws of the Cayman Islands concurrent with the establishment of the Fund and sales of Fund Shares.¹⁴ Each Company will issue three classes of shares: common, junior preferred, and preferred. The Fund will hold the preferred shares, and the Parent Bank or an affiliate (such as Securities) will acquire the common and junior preferred shares. The general characteristics of the shares are as follows:

- (1) The “Preferred Shares” typically will represent 75% of the ownership interests of the respective Company.¹⁵ The shares will be rated investment grade or higher by a NRSRO and will be non-voting. If not otherwise called, the Preferred Shares will be subject to a mandatory redemption on the 20th anniversary. The Preferred Shares will be senior to the Junior Preferred Shares with respect to losses or shortfalls, if any, under the Index Swaps or a Debt Instrument. The Preferred Shares, along with the Junior Preferred Shares, will be pro rata with respect to liquidation preference and any floating amounts due under the Index Swaps.¹⁶
- (2) The “Common Shares” typically will represent 5% of the ownership interests of the respective Company; be entitled to 20% of the vote; and bear the first risk of loss (subordinate position) regardless of cause.
- (3) The “Junior Preferred Shares” typically will represent 20% of the ownership interests of the respective Company; be entitled to 80% of the vote; bear the next loss position relating to losses or shortfalls under a Debt Instrument or shortfalls relating to the non-payment of fixed amounts under an Index Swap; and, if not otherwise called, be subject to a mandatory redemption on the 20th anniversary.

¹⁴ The Companies will be domiciled in the Cayman Islands in order to preclude the imposition of an (intermediate) entity level tax.

¹⁵ The percentages may vary somewhat to correspond to the risk parameters associated with each class of shares. The Fund’s shares always will reflect the most senior risk of the Companies.

¹⁶ The Preferred Shares and the Junior Preferred Shares, subject to available funds, will be entitled to non-participating distributions of a fixed percentage over LIBOR. The Common Shares will be entitled to all excess amounts once fixed distributions, if any, are made to the Preferred and Junior Preferred Shares.

The Companies' overall investment strategy concerning the Index Swaps involves details that may impact the Preferred Shares.¹⁷ In particular, the Preferred Shares of each Company will be subject to a call (the "Clean-Up Redemption") at fair market value (based on dealer quotations of the underlying swaps, if any are outstanding) on the occurrence of certain specified events in the governing instruments. Absent the occurrence of one of the listed events, the Fund Shares are not expected to be called. Because the call will be at fair market value, the Trust Company and the Parent Bank represent that the Fund Shareholders' return will not be adversely impacted by a call.¹⁸

In addition, each Company will manage their Debt Instrument exposure with consideration to certain contingent amounts payable under the Index Swaps. Under the Index Swaps, a Company will pay the swap counterparty a so-called "floating amount" in the event of large credit losses in the Reference Entities. Liquidity for payment of floating amounts, if any, will come from liquidating Debt Instruments.¹⁹ Floating Amounts will not be payable if either: (a) no Credit Events occur on any of the Reference Entities, or (b) the aggregate net losses associated with all Credit Events on the Reference Entities are less than the subordination built into the Index Swaps.

The Trust Company and the Parent Bank represent that the Companies will not incur significant debt obligations (i.e., there is no intent to utilize leverage), and the activities of the Companies will be limited to activities related to the specific investment strategy outlined here and reflected in the governing instruments.²⁰ The Companies likely will be variable interest entities under FASB Interpretation No. 46R, and thus: (a) the Companies may be subject to consolidation by the Parent Bank or any subsequent holder of the majority of the Common Shares; and (b)

¹⁷ The operative terms of the Index Swaps largely will be consistent with terms used in conventional collateralized debt obligation transactions. For example, for a Company a "Credit Event," such as bankruptcy or failure to pay, related to a Reference Entity may occur under the Index Swaps. The Trust Company and the Parent Bank represent that a Credit Event under an Index Swap will be consistent with the International Swaps and Derivatives Association, Inc.'s ("ISDA's") definitions. See ISDA, *Credit Derivative Definitions*, Art. IV (2003).

¹⁸ The arrangement of separate Companies is designed to facilitate timely partial cash settlements of the index position upon the occurrence of a Credit Event. Upon the occurrence of a Credit Event on one of the tranche subsets related to an underlying Reference Entity, the related Company shares will be called pursuant to the Clean-Up Redemption provision. Immediately following a Credit Event, each Fund shareholder will receive a partial liquidation based on the market value of the specific Company Preferred Shares.

¹⁹ If Debt Instruments are liquidated to make the floating amounts payments, the Fund Shareholders will incur an impairment to their value and may incur an impairment to their liquidation preference. As a result, Companies with Index Swap positions with lower subordination may have additional need for liquidity and therefore may carry Debt Instruments with shorter maturities.

²⁰ The transactions involve the use of one standardized set of ISDA's documents relating to the Index Swaps, and one standardized management agreement. The Trust Company and the Parent Bank represent that purchasers of Fund Shares will receive disclosures of the initial conditions and ongoing operating terms of the Companies, including identification of the original Index Swap counterparty and the original list of Debt Instruments, and of the risk elements of the Fund Shares.

consistent with the AICPA Investment Company Audit Guide, the Fund will not consolidate the Companies.

II. Discussion

A. Authority to Organize and Sponsor a Closed-End Investment Company

The OCC has long held that national banks may engage in investment advisory services related to investment companies, including closed-end funds, as part of or incidental to the business of banking authorized under 12 U.S.C. § 24(Seventh).²¹ Trust power provisions in 12 U.S.C. § 92a also authorize investment advice.²² The OCC has found the activities of sponsoring and organizing closed-end investment companies are properly included within the ambit of a bank providing investment advice and administrative services to investment companies and likewise are authorized.²³ The Trust Company represents that its sponsoring activities for the new closed-end fund essentially involve administrative functions of a ministerial nature, the use of the Trust Company's name, and other similar functions that may assist in establishing the Fund. Further, the Trust Company's charter is sufficiently broad to encompass the proposed closed-end fund sponsoring activities.²⁴ Accordingly, we find the Trust Company's proposed organizing and sponsoring activities with respect to the Fund authorized by OCC precedent, subject to applicable safety and soundness requirements.²⁵

²¹ See, e.g., Interpretive Letter No. 648 (May 4, 1994); Interpretive Letter No. 622 (Apr. 9, 1993); *Decision of the Comptroller of the Currency Concerning an Application by American Nat'l Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice* (Sept. 23, 1983). Investment companies may be open-ended, which are commonly referred to as mutual funds, or closed-ended. The principal distinction between closed-end and open-end companies is that shares of an open-end fund are redeemable on any business day while typically closed-end fund shares are not.

²² See, e.g., Interpretive Letter No. 897 (Oct. 23, 2000).

²³ See Cond. Approval No. 164 (Dec. 9, 1994) (sponsorship of closed-end fund). Similarly, the Board of Governors of the Federal Reserve System has determined that organizing and sponsoring closed-end investment companies is an adjunct to a bank's rendering of investment or financial advice. See 12 C.F.R. § 225.28(b)(6) (investment or financial advisory activities, including sponsoring, organizing, or managing a closed-end fund).

²⁴ The OCC, when it chartered the Trust Company, authorized the Trust Company to conduct the business of a trust company under a national bank charter and did not restrict or address its investment advisory or investment fund-related activities. The OCC may charter national banks that offer a full or limited range of banking products and services, including special purpose banks such as trust banks. See 12 C.F.R. § 5.20(l); Interpretive Letter No. 877 (Dec. 13, 1999) (trust banks may engage in a range of incidental and nonfiduciary activities, including annuity sales and insurance agency activities).

²⁵ See *infra* section III. The Trust Company represents that its board of directors will approve the sponsorship activities prior to commencement of the Fund, and that the Trust Company will receive appropriate arms-length compensation for its sponsorship role in accordance with section 23B of the Federal Reserve Act, 12 U.S.C. § 371c-1. The Trust Company and the Parent Bank represent the Fund and other subsidiaries of Parent Bank performing services for the Fund would be affiliates of the Trust Company for purposes of section 23B, and all transactions between the Trust Company and those affiliates would be effected in accordance with the provisions of section 23B. Also, the Fund will be an affiliate of the Trust Company for purposes of section 23A of the Federal Reserve Act,

B. Authority to Purchase Shares of the Fund Under 12 C.F.R. § 1.3(h)(2)

National banks, as described in this letter, may purchase interests in the Fund under the authority of the OCC's investment securities regulation, 12 C.F.R. Part 1, because the underlying portfolio consists solely of investments eligible for national banks to purchase and hold directly.²⁶ Under Part 1 generally, a national bank may purchase for its own account fund shares of a registered investment company provided that the investment company's portfolio consists exclusively of assets that the national bank could purchase directly.²⁷ Under section 1.3(h)(2), the OCC also may permit a national bank to invest in shares of an entity that is exempt from registration as an investment company if the underlying instruments in the Fund's portfolio are permissible investments for national banks.²⁸ The OCC has permitted national banks to purchase shares in unregistered investment companies.²⁹

A crucial factor in section 1.3(h)(2) and in prior OCC interpretive opinions is whether the investment company's underlying assets are bank-eligible investments. The Fund's portfolio here will invest in the Companies' Preferred Shares that meet Part 1 standards as discussed below. Of additional consideration with the Preferred Shares are unique risks arising because of the leverage positions related to the underlying Index Swaps activities.³⁰ As set forth

12 U.S.C. § 371c. The Trust Company also represents that it will not purchase shares for its own portfolio or in its fiduciary capacity on behalf of Trust Company customers.

²⁶ The OCC promulgated the current rules in 12 C.F.R. Part 1 governing a national bank's purchase of so-called "investment securities" for the bank's own account pursuant to the authority granted in 12 U.S.C. § 24(Seventh). See 61 Fed. Reg. 63972 (Dec. 2, 1996). Part 1 prescribes the limitations and restrictions on a bank's purchase and holding of investment securities. Various limits on the aggregate investment amount vary according to the characteristics of the security.

²⁷ See 12 C.F.R. § 1.3(h)(1). For purposes of this subsection, an investment company, including a mutual fund, means a company registered under the Investment Company Act of 1940, 15 U.S.C. § 80a-8. 12 C.F.R. § 1.2(c).

²⁸ See 12 C.F.R. § 1.3(h)(2). In adding this subsection to Part 1, the OCC explained its intent that the OCC may determine on a case-by-case basis that interests in other entities, including unregistered investment companies, the portfolios of which consist exclusively of investments eligible for national banks to hold directly, also are permissible investments for national banks. 61 Fed. Reg. at 63978.

²⁹ See, e.g., Interpretive Letter No. 911 (June 4, 2001) (banks may purchase interests in a privately offered investment fund that invests in loans, cash and cash equivalents, and an offshore fund that invests solely in loans as securities); Interpretive Letter No. 779 (Apr. 3, 1997) (banks may purchase interests in privately offered investment fund investing in loans). See also Interpretive Letter No. 1013 (Jan. 7, 2005) (banks may invest in investment trust issuing gold shares); Interpretive Letter No. 912 (July 3, 2001) (banks may invest in fund holding municipal revenue bonds and Type I securities); and Interpretive Letter No. 687 (Sept. 5, 1995) (banks may become limited partners in limited partnership that invests solely in fixed income securities that banks could invest in directly).

³⁰ As previously mentioned, the Companies will engage in single tranche credit default index swaps on a portfolio of 125 Reference Entities, the so-called "Index Swaps," and transactions involving highly rated debt instruments of European and U.S. issuers (the "Debt Instruments"). See further discussion on Index Swaps activities *infra* at section III.B.

subsequently in section III, those risks in this context are permissible under 12 C.F.R. § 1.5 because the activities of the Companies are permissible banking activities.³¹

C. Authority to Purchase Preferred Shares of Stock

The OCC previously has recognized that a national bank may acquire and hold preferred stock under the authority of 12 U.S.C. § 24(Seventh) to discount and negotiate evidences of debt if the preferred stock is, in substance, a debt obligation of the issuer.³² The OCC also has permitted a national bank to purchase and hold preferred stock as a Type III investment security under 12 C.F.R. Part 1.³³ Part 1 defines “investment security” as a “marketable debt obligation that is not predominantly speculative in nature.”³⁴ A security is not “predominantly speculative in nature if it is rated investment grade.”³⁵ The term “marketable” means a security that is: (1) registered under the Securities Act of 1933; (2) a municipal revenue bond exempt from registration under the 1933 Act; (3) offered and sold pursuant to Securities and Exchange Commission Rule 144A, 17 C.F.R. § 230.144A, and rated investment grade or is the credit equivalent of investment grade; or (4) can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.³⁶ There is no definition of debt obligation in Part 1. Hence, OCC precedent considers the substantive characteristics of the investment instrument in interpreting this term.

Certain substantive characteristics distinguish common stock and debt securities.³⁷ Common stock usually is perpetual with broad voting rights, while debt securities generally have a limited

³¹ Section 1.5 provides a “national bank shall adhere to safe and sound banking practices and the specific requirements of this part in conducting the activities described in § 1.3.” 12 C.F.R. § 1.5.

³² See, e.g., Interpretive Letter No. 941 (June 11, 2002) (authority to acquire preferred stock under bank’s authority to discount and negotiate evidences of debt). Similarly, the OCC has concluded that national banks may purchase trust preferred securities as debt obligations under the authority to discount and negotiate evidences of debt even if the instruments do not qualify as investment securities. See, e.g., Interpretive Letter No. 908 (Apr. 23, 2001); Interpretive Letter No. 777 (Apr. 8, 1997).

³³ See, e.g., Interpretive Letter No. 781 (Apr. 9, 1997) (authority to acquire money market preferred stock as a Type III investment security). Type III securities include marketable debt obligations that are rated investment grade, such as corporate bonds. See 12 C.F.R. § 1.2(k). As previously mentioned, quantitative limitations on the ability of a national bank to purchase and hold investment securities may apply.

³⁴ 12 C.F.R. § 1.2(e).

³⁵ *Id.* The Trust Company and Parent Bank represent that any Preferred Shares the Fund would invest in will be rated investment grade.

³⁶ 12 C.F.R. § 1.2(f). The Trust Company and the Parent Bank represent that the Preferred Shares are marketable because they may be offered and sold pursuant to SEC Rule 144A and will be rated investment grade. Further, the Parent Bank represents that it (or a subsidiary) will provide daily liquidity for the Fund Shares (analogous with the Preferred Shares in this context) by standing ready to purchase the shares at net asset value (NAV) at the end of the day and by providing continuous intra-day pricing on Fund Shares.

³⁷ See, e.g., *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686-87 (1985); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 850-51 (1975).

life and few, if any, voting rights. Common stock provides an ownership interest and appreciation in the market value of the issuer and dividends. In contrast, debt securities offer investors periodic interest payments that may be fixed or fluctuate as provided in the debt instrument, and a principal payment at maturity. With debt securities, if the issuer should fail, the claims of the common stockholders are subordinate to the debt holders. Rating agencies may assign credit ratings to debt securities, but typically do not rate equity instruments. By examining an instrument's substantive characteristics, the OCC may permit national banks to purchase certain instruments with debt-like characteristics.

Here the Preferred Shares possess substantive characteristics typically associated with debt securities and not equity. The Preferred Shares are not perpetual, but have a limited life of 20 years. There are very limited voting rights associated with the Preferred Shares. The Fund holding the Preferred Shares, like a debt holder, is not intended to share in the profits of the issuer, but rather generally receives a specified payment amount during the term of the Preferred Shares,³⁸ and principal at redemption.³⁹ If the issuer should fail, the claims of the Preferred Shares are senior to those of the common shares. The Preferred Shares also will receive a credit rating by rating agencies, as with debt.

Based on these characteristics, we find the Preferred Shares, in substance, are debt obligations. As such, the Shares qualify as bank-eligible investment securities under Part 1 because they are marketable and not predominantly speculative in nature.⁴⁰ Hence, for purposes of 12 C.F.R. § 1.3(h)(2), the underlying assets directly comprising the Fund's portfolio (i.e., the Preferred Shares) consist exclusively of assets that a national bank may purchase and sell directly. Accordingly, the particular types of national banks proposed may purchase the Fund Shares pursuant to section 1.3(h)(2), subject to the applicable safety and soundness requirements discussed in Section III.⁴¹

³⁸ See *supra* footnote 11 (specified formula for the Share Return for a given period). In addition, the structured nature of the exposure with its embedded credit leverage creates additional risks but because the Preferred Shares meet Part 1 standards, we find investment in the Fund Shares permissible. See also discussion *infra* at section III on safety and soundness requirements.

³⁹ The Trust Company and Parent Bank recognize that the highly improbable possibility of a Clean-Up Redemption that could result in an enhancement of the return to Fund shareholders reflects a slight difference in the facts here from earlier OCC letters. In this regard, because a Clean-Up Redemption must be executed at net asset value, the Preferred Shareholder could theoretically receive more than the principal value upon redemption if the net asset value exceeds the original value of the Preferred Shares subject to redemption. The Trust Company and the Parent Bank represent the likelihood of this excess distribution is remote, and accordingly we do not believe it changes the analysis that the Preferred Shares are the substantial equivalent of debt instruments.

⁴⁰ Based on the Trust Company's and Parent Bank's representations that the Preferred Shares may be offered and sold pursuant to SEC Rule 144A and will be rated investment grade, the Shares satisfy the standards for Type III investment securities and are eligible for national bank investment. See 12 C.F.R. §§ 1.2(e) and (l). Likewise, we note the Companies' investments in the highly rated debt instruments also qualify under Part 1 as Type IIIs.

⁴¹ This includes an aggregate investment limitation of 1% of the investing bank's capital and surplus.

III. Safety and Soundness Requirements

A. Sponsoring a Closed-End Investment Company

With respect to the proposed Fund sponsorship activities, the Trust Company must conduct its activities vis-à-vis the Fund in a safe and sound manner.⁴² This would include assessing the Trust Company's activities under an effective new product due diligence process and maintaining appropriate policies, procedures, and risk controls that address the Trust Company's Fund-related activities and their compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income and generally accepted accounting principles. Further, appropriate disclosures concerning the role and activities of the Trust Company should be provided by the Parent Bank on all applicable Fund documents and subjected to review by the Trust Company. The Trust Company's board of directors must review and approve the sponsorship activities prior to commencement of the Fund. The Trust Company also must undertake appropriate safety and soundness measures prior to commencing the proposed Fund-related activities.

B. Purchase of Fund Shares by National Banks

A national bank considering purchase of Fund Shares must adhere to the prudential requirements set forth in 12 C.F.R. § 1.5, and all other applicable supervisory guidance on safe and sound banking practices.

1. Authority to Engage in Credit Default Swap Index Activities

Because of the unique risks related to the leverage embedded in the Fund Shares, as part of the consideration of this request we have reviewed the Companies' Index Swaps activities.⁴³ The Index Swaps are fundamental to the Fund's overall investment strategy. As discussed earlier, the Fund's portfolio holds the Preferred Shares of the Companies, and the investment strategy of each Company includes entering into the Index Swaps based on a CDS Index single tranche with highly rated derivatives counterparties.⁴⁴ Although the OCC has not specifically opined on the legal permissibility of activities involving CDS index products, the OCC generally has recognized that national banks may enter into credit derivative transactions and hedge credit

⁴² See *supra* representations related to safety and soundness in footnotes 3, 6, and 25.

⁴³ We clarify that, as a matter of law, the OCC does not require the underlying companies issuing preferred shares that are eligible as national bank investments to engage only in permissible national bank activities. Here, however, because of the unique risks related to the embedded credit leverage, we have reviewed the proposed Index Swap activities of the Companies and we address the permissibility of credit default swap index activities.

⁴⁴ *E.g.*, Dow Jones CDX.NA.IG – 10% - 15%. The exposures are based on the underlying baskets of Reference Entities. See *supra* at section I.A (description of the Index Swaps). Bloomberg reports the current CDS Index prices, data, and parameters.

risk.⁴⁵ A credit derivative in its basic form is a financial instrument designed to permit the transfer of credit exposure between parties -- i.e., the buyer and seller of the credit protection -- in isolation from other forms of risk. These derivatives represent a natural extension of the market for similar products that “unbundle” risks, such as certain interest rate swaps and foreign exchange products.⁴⁶ For example, the OCC has opined that a bank may purchase cash-settled options on futures contracts on bank impermissible commodities to hedge the credit risk in its agricultural loan portfolio.⁴⁷

Credit default swaps are a type of credit derivative.⁴⁸ The mechanics of a CDS allow a bank to both acquire and hedge risk. A CDS is a swap contract where one party (the protection “seller”) acquires risk by taking on a credit exposure with respect to a “reference entity” (or reference credit) for which it receives a fee and the other party (the protection “buyer”) seeks to reduce the credit risk with respect to the reference entity, and thus is laying off the risk.⁴⁹ The protection buyer typically pays a quarterly or annual percentage fee (in basis points) of a notional principal value of the reference entity, which effectively represents an option premium. In return, the protection buyer receives the right to receive a conditional payment from the protection seller if a credit event occurs with respect to the reference entity. Credit events include bankruptcy and failure to pay, among others, as defined in the 2003 ISDA Credit Derivative Definitions.⁵⁰ The reference entity is simply the party whose credit performance will determine credit derivative

⁴⁵ See, e.g., Interpretive Letter No. 896 (Aug. 21, 2000) (hedging credit risk); OCC Banking Bulletin No. 96-43, *Credit Derivatives* (Aug. 12, 1996) (“BB 96-43”). Credit risk is the risk to earnings or capital arising from an obligor’s or counterparty’s failure to meet the terms of any contract with the bank or to perform otherwise as agreed.

⁴⁶ See BB 96-43, *supra*. When a bank hedges credit risk, it transfers a credit exposure, but not the asset itself, to a counterparty that agrees to make a payment under certain conditions. Thus, the buyer of credit protection can hedge an existing exposure, much as the bank can with a loan participation. With a credit derivative, however, the asset remains on the bank’s books. Because the exposure, but not the asset itself, is sold, credit derivatives can assist banks in managing internal limits, while avoiding customer relationship problems that can arise if the bank sells the asset. *Id.*

⁴⁷ See Interpretive Letter No. 896, *supra*. The OCC has found that making loans and hedging the associated risks to minimize the credit risk in those transactions is part of the business of banking. See Interpretive Letter No. 961 (Mar. 17, 2003). The OCC also has opined on risk-based capital treatment for various credit derivative structures. See, e.g., Interpretive Letter No. 946 (Sept. 27, 2001); Interpretive Letter No. 945 (June 30, 2000).

⁴⁸ When used properly, CDSs can help to diversify credit risk, improve earnings, and lower the risk profile of an institution. Conversely, the improper use of CDSs, similar to poor lending practices, can result in an imprudent credit risk profile. Banks use and evaluate these products as tools for credit risk management. Unlike traditional loan assets, CDSs are off-balance-sheet contracts. See BB 96-43. See also Comptroller’s Handbook, *Risk Management of Financial Derivatives* (Jan. 1997); Banking Circular 277, *Risk Management of Financial Derivatives* (Oct. 27, 1993) (providing guidance on financial derivatives activities which also is appropriate for users of credit derivatives).

⁴⁹ The risk acquirer (i.e., seller of credit protection) may have several reasons for assuming the risk of a specific reference credit. For example, the protection seller may be underloaned and would like to take carefully targeted credit risk in order to improve earnings, while also diversifying credit risk by assuming a risk position that has a low correlation with existing portfolio risks.

⁵⁰ See International Swaps and Derivatives Ass’n, Inc. (“ISDA”), *Credit Derivative Definitions*, Art. IV (2003).

cash flows.⁵¹ The methods used to determine the amount of the conditional payment that would be triggered by the default vary by instrument.⁵²

Credit default swaps are swap transactions, but function in a manner similar to standby letters of credit.⁵³ In its most basic form, a standby letter of credit provides payment protection to one party upon the occurrence of certain events, such as the other party's default, related to an underlying contract. The underlying obligations between the two parties, however, are separate and independent from the agreed-upon payment under the standby letter of credit. Similarly, parties negotiating a conditional payment related to credit protection in the form a CDS do not become obligated on the underlying reference entity's credit exposures. The CDS operates according to its own payment terms and conditions. As such, CDSs and standby letters of credit do not function to guarantee payment on behalf of another primary obligor, but rather, both represent independent, primary obligations to pay a third party to avoid loss and provide credit protections.⁵⁴

The OCC has long recognized the ability of national banks to engage in originating, trading, and making markets in a wide array of swaps as part of the business of banking.⁵⁵ CDSs simply are a newer form of bank permissible swap activities.⁵⁶ Similarly, the development of the CDS Index

⁵¹ The credit protection buyer may or may not have a relationship with the reference entity. A bank may diversify its portfolio by reducing its exposure to a borrower, and a CDS enables it to do so without disturbing its relationship with the customer.

⁵² In some contracts, the amount of the payment is agreed upon at the inception of the contract. In others, the amount paid is determined after the default event and is based upon the observed prices of similar debt obligations of the borrower in the corporate bond market.

⁵³ See 12 C.F.R. § 7.1016 (OCC interpretive ruling specifically recognizes a national bank's authority to issue letters of credit and other independent undertakings); *American Ins. Ass'n v. Clarke*, 865 F.2d 278 (D.C. Cir. 1988) (use of standby credits to insure municipal bonds is functionally equivalent to issuance of a standby letter of credit).

⁵⁴ A guaranty in its classic form is an agreement ancillary to some other contract or relationship, thus the guarantor becomes secondarily liable for another's debt or performance. Although at first glance a CDS's characteristic of payment for losses in the event of a reference party's default may bear some resemblance to a guaranty, significant differences exist in the nature and function of a CDS and a guaranty. In particular, as discussed, a CDS is a primary and separate obligation of the parties. Thus, for example, the protection seller is not contracting with the original obligor to guarantee an underlying obligation. Instead, the protection seller for a price is agreeing to make conditional payments to a third party (the protection buyer) based on losses to a reference party resulting from pre-determined credit events over a certain period.

⁵⁵ National bank swap activities are permissible as part of the business of banking as a form of financial intermediation. See, e.g., Interpretive Letter No. 1018 (Feb. 10, 2005). Financial intermediation includes, for example, engaging in swap transactions and assuming offsetting swap positions and hedges. In assuming an offsetting swap or hedge, a bank protects itself against risks arising from an established, permissible banking activity and acts as a financial intermediary by interposing itself between customers initiating swaps and customers providing offsetting cash flows or returns. See e.g., Interpretive Letter No. 937 (June 27, 2002); Interpretive Letter No. 725 (May 10, 1996); Interpretive Letter No. 652 (Sept. 13, 1994).

⁵⁶ Notably, Congress recognized the authority of national banks to engage in derivative transactions, including credit swaps, in section 206 of the Gramm-Leach-Bliley Act of 1999. See 15 U.S.C. § 78c note.

provides another mechanism for use by market participants to engage in activities related to the risk exposures of credit defaults. The OCC also has long recognized national banks' ability to engage in swap activities tied to index-related transactions.⁵⁷ Accordingly, the credit derivative activities, including the CDS Index activities,⁵⁸ engaged in by the Companies are permissible under the authority of 12 U.S.C. § 24(Seventh) as part of the business of banking,⁵⁹ subject to the applicable safety and soundness requirements.⁶⁰

2. Safe and Sound Banking Practices Related to the Fund Share Purchases

A national bank considering purchase of the Fund Shares must satisfy itself, based on an independent analysis, that the contemplated investment in the Fund is an appropriate investment.⁶¹ The nature and extent of the bank's independent assessment is a function of the

⁵⁷ See, e.g., Interpretive Letter No. 652 (Sept. 13, 1994) (national banks may use price fluctuations in an equity or equity index to calculate payments based on notional amounts as an exercise of their authority to accept deposits and make loans); OCC No-Objection Letter 90-1 (Feb. 16, 1990) (national banks may engage in interest rate, currency, and matched and unmatched commodity price index swaps); *Decision of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A., to Offer the Chase Market Index Investment Deposit Account* (Aug. 8, 1988) (national banks may buy and sell futures on the S&P 500 Index to hedge deposits with interest rates tied to the S&P 500 Index).

⁵⁸ The CDSs are similar to traditional banking credit activities and are functionally equivalent to recognized banking activities. Credit derivatives, such as CDSs, provide bank customers the opportunity to manage credit risks and concentrations. Moreover, credit derivatives allow banks to reduce concentration risks. For example, using a credit default swap, a bank may hedge a concentration risk by purchasing credit protection against a specific borrower's default. Alternatively, banks can adjust their credit profile by purchasing credit protection (i.e., hedging risk) against borrowers in an industry where an undesired exposure exists and selling protection (i.e., acquiring risk) in another industry. Portfolio management techniques allow banks to increase the return on a portfolio, for a given level of risk, by structuring the portfolio to diversify credit exposures. CDSs involve risks similar to those already assumed by banks in connection with other permissible banking activities.

⁵⁹ Twelve 12 U.S.C. § 24(Seventh) provides the legal framework for assessing the permissibility of these activities. The Supreme Court has held that this authority is a broad grant of powers to engage in the business of banking, including, but not limited to, the enumerated powers and the business of banking as a whole. See *NationsBank v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995) ("VALIC"). See also *Merchants' Bank v. State Bank*, 77 U.S. 604 (1871); *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978); *American Ins. Ass'n v. Clarke*, 865 F.2d 278 (D.C. Cir. 1988).

⁶⁰ The OCC has long considered safety and soundness as part of determining whether an activity is permissible under 12 U.S.C. § 24(Seventh). See, e.g., Interpretive Letter No. 1018 (Feb. 10, 2005) (affiliate hedging activities must be conducted in safe and sound manner to be permissible); Interpretive Letter No. 949 (Sept. 19, 2002) (proposed activity cannot be part of the "business of banking" if the bank in question lacks the capacity to conduct the activity on a safe and sound basis).

⁶¹ 12 C.F.R. § 1.5. This would include adhering, as applicable, to the prudential requirements in OCC Banking Circular 220 (Nov. 21, 1986). While shares of closed-end funds may present particular liquidity issues at times, in this context the Parent Bank represents that it (or a subsidiary) will provide daily liquidity for the Fund Shares by standing ready to purchase the shares at net asset value (NAV) at the end of the day and by providing continuous intra-day pricing on Fund Shares.

type of transactions at issue and the bank's own credit and investment policies.⁶² In particular, the bank should recognize that the structured nature of the exposure on the Fund Shares could lead to large unrealized losses in the value of the Preferred Shares even if losses do not exceed subordination levels. In the unlikely event that losses from credit events exceed subordination levels, realized losses due to payment obligations will then rapidly erode the value of the Fund Shares, as those losses would be concentrated in the tranche on which the Company has sold protection. This embedded credit leverage, or so-called levered credit exposure, warrants additional internal bank review.⁶³ A bank's review and analysis of Fund Shares should explicitly consider, for example, estimated loss severities, which may be greater than anticipated should the number of credit events result in losses in excess of subordination levels.⁶⁴

A national bank's purchase of Fund Shares is also subject to the applicable legal investment limitations under 12 U.S.C. § 24(Seventh) and 12 C.F.R. Part 1. The Trust Company and Parent Bank have represented that an aggregate investment limit on the closed-end fund shares of 1% of the investing national bank's capital and surplus would be reasonable. We agree, as we find this an appropriate prudential limit based on safety and soundness considerations.⁶⁵

In addition, the described Fund Shares arise from a structured finance transaction that is complex, and as such, holdings of Fund Shares are only appropriate in a well-diversified portfolio at an institution that has sophisticated risk management processes to conduct the necessary due diligence and ongoing monitoring of risk exposures. An effective risk management process includes appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, management information systems and an effective and independent risk control function that oversees and ensures the appropriateness of the risk management process.⁶⁶

A bank's risk management process must ensure that the proposed activities are conducted in a safe and sound manner. In particular, national bank purchasers of Fund Shares should recognize

⁶² For example, a bank may choose to take the proposed investment through a new product review committee, or some other type of special review process. The bank also may ascertain that its investment policy addresses the type of exposures represented by the investment.

⁶³ As discussed previously, the return on the Fund Shares reflects replication of a position in a CDS Index single tranche and the underlying investment strategy of the Companies involving the Index Swaps.

⁶⁴ For the AAA+ tranche (e.g., 10% - 15%), assuming a 60% loss severity, more than 20 of the 125 names in the portfolio would need to default in order to cause a principal loss to the Fund. This is in contrast to a pro-rata risk position where the incremental loss from, for example, the 20th default to the 22nd default, in a 125 company basket would have limited impact on an instrument's principal loss.

⁶⁵ See, e.g., Interpretive Letter No. 941, *supra* (limit of less than 5% based on safety and soundness reasons).

⁶⁶ See e.g., OCC Bulletin 2004-20, *Risk Management of New, Expanded, or Modified Bank Products and Services* (May 10, 2004).

that daily liquidity for the Fund Shares, as a practical matter, can come from only one source, *i.e.*, the Parent Bank standing ready to purchase the shares at net asset value (NAV) at the end of the day, and from the Parent Bank setting intra-day pricing on Fund Shares. Purchasers should understand that prices set by the Parent Bank may not necessarily represent the most efficient prices for the underlying CDSs available in the market. As a result, the Fund Shares may have higher liquidity risks than other portfolio investments.

Accordingly, purchasers should evaluate and monitor the liquidity of Fund Shares and establish investment position limits consistent with their evaluation of inherent liquidity risks. Purchase of Fund Shares without an appropriate risk management process, or without demonstrating a thorough and independent analysis, including consideration of the mark-to-market risks of the investment and the possibility for a levered credit exposure in an environment of multiple defaults, may constitute an unsafe and unsound practice in violation of 12 C.F.R. § 1.5.

IV. Conclusion

For the reasons discussed in this letter and based on a review of the information you provided, including the specific representations and commitments made by the Trust Company and the Parent Bank, we conclude that the Trust Company may act as sponsor of the proposed closed-end investment company, referred to as the Fund, subject to the described safety and soundness requirements. We also conclude that the specific Fund Shares, *i.e.*, those Shares relating to the proposed structure described in this letter and offered for sale to particular types of national bank purchasers, are a permissible investment for those national banks pursuant to 12 C.F.R. § 1.3(h)(2), subject to all applicable statutes, regulations, and prudential considerations and requirements, including a 1% aggregate investment limitation.

We reiterate that the described Fund Shares arise from a structured finance transaction that is complex, and that holdings of the Fund Shares are only appropriate in a well-diversified portfolio at an institution that has sophisticated risk management processes to conduct the necessary due diligence and ongoing monitoring of risk exposures. The proposed purchasers are large and medium-sized money center and regional banks with an asset size of at least \$25 billion that have the requisite sophistication for evaluating the potential risks of the investment. Accordingly, the OCC's determination on purchase of the Fund Shares applies only to the specific facts and circumstances set forth in this letter. The OCC does not recommend or endorse purchase of Fund Shares by national banks or other investors. If you have any questions concerning this letter, please contact Suzette H. Greco, Special Counsel, Securities & Corporate Practices Division, at 202/874-5210.

Sincerely,

/s/ Julie L. Williams

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel