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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

June 11, 2002

**Interpretive Letter #941**  
**August 2002**  
**12 USC 24(7)**

Dear [ ]:

This responds to your request for confirmation that [ ] (“Bank”) had authority to acquire preferred stock of [ ] (“Company”), a subsidiary of [ ], pursuant to its authority to discount and negotiate evidences of debt. The Bank acquired the preferred stock (“Preferred Stock”) as partial consideration for the disposition of a loan portfolio to the Company. Based on the information and representations you provided, we conclude that the Bank had authority to acquire and may continue to hold the Preferred Stock pursuant to its authority to discount and negotiate evidences of debt. The Bank’s existing holdings represent less than 5% of the Bank’s capital and surplus and are within applicable limits.

**Background**

The Bank recently disposed of a portfolio of loans to the Company in exchange for cash and Preferred Stock. The Bank had negotiated to dispose of the loan portfolio for cash, but had accepted the Company’s offer of 90% cash and 10% Preferred Stock because the cash portion of the Company’s offer was significantly higher than other offers the Bank received.

The Preferred Stock was issued in a private placement and is rated above investment grade by two nationally recognized statistical rating organizations. It has a limited life of 20 years and is not otherwise redeemable at the option of the issuer. Dividend payments are cumulative with a fixed dividend of 6.2%. Preferred Shareholders have a priority over common stockholders upon dissolution of the corporation and have no voting rights other than those required under state law (generally relating to the preferred shareholders’ liquidation preference rights). There is a one-year restriction on the sale or transfer of the Preferred Stock except to the Bank’s affiliates. After one year, the Bank may transfer the Preferred Stock to a commercial bank, finance company, insurance company, or other financial institution or fund, that is regularly engaged in making, purchasing or investing in loans, and has a tangible net worth in excess of \$100,000,000.

You have asked whether the Bank had authority to acquire and hold the Preferred Stock under its authority to discount and negotiate evidences of debt.<sup>1</sup>

## Discussion

### A. Legal Authority to Acquire and Hold the Preferred Stock

National banks may acquire and hold preferred stock under the authority in 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.

Section 24(Seventh) expressly authorizes national banks to conduct the business of banking, including “by discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt.”<sup>2</sup> 12 U.S.C. § 24(Seventh). This authority has long included the power to acquire and hold a variety of debt and debt-like instruments, including certain instruments denominated as securities.<sup>3</sup>

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<sup>1</sup> The OCC has permitted national banks to purchase and hold preferred stock as Type III investment securities if the securities meet the applicable rating and marketability requirements of 12 C.F.R. § 1.2. *See* Interpretive Letter No. 777 (April 8, 1997), *reprinted in* [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-204. The OCC does not express any view on whether the Preferred Stock, in this case, meets the marketability requirements of 12 C.F.R. § 1.2 or qualifies as a Type III investment security. Regardless of whether it qualifies as a Type III investment security, however, the Preferred Stock should be reported as a security under FAS 115. In addition, the Preferred Stock should be categorized as a security and listed in Schedule B (Securities) in the Call Report.

<sup>2</sup> The courts have long held that the term “discount” includes purchases of notes and other evidences of debt. *See, e.g., National Bank v. Johnson*, 104 U.S. 271 (1881); *Steward v. Atlantic National Bank*, 27 F.2d 224, 228 (9th Cir. 1928); *Morris v. Third National Bank*, 142 F. 25 (8th Cir. 1905); *Danforth v. National State Bank of Elizabeth*, 48 F. 271 (3d Cir. 1891). *See also* 12A *Words and Phrases* 285-95 (West 1954 and Supp. 1986). And negotiation is a form of transfer, disposition or sale. *Black’s Law Dictionary* 934 (5th ed. 1979); 28 *Words and Phrases* 758-766 (West 1955 & Supp. 1986). Thus, the OCC has concluded that the authority to discount and negotiate evidences of debt includes the authority to purchase and sell debt and debt-like instruments. *See e.g., OCC Conditional Approval No. 262, Interpretations and Actions*, Dec. 1997, Vol. 10, No. 12 (“the power to discount and negotiate is the power to purchase and sell, and purchasing and selling as principal defines underwriting and dealing”).

<sup>3</sup> *See* Interpretive Letter No. 833 (July 8, 1998), *reprinted in* [1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-287 (Interpretive Letter No. 834, (July 8, 1998), *reprinted in* [1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-288; Interpretive Letter No. 600 (July 31, 1992), *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,427; Interpretive Letter No. 182 (March 10, 1981), *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,263. The OCC has sometimes referred, more broadly, to a national bank’s “general lending authority” to purchase debt securities rather than the authority to discount and negotiate evidences of debt. For example, the OCC approved a bank’s purchase of participation certificates that represented interests in pools of FHA-insured Title I property improvement loans under its general lending powers. *See, e.g.,* Interpretive Letter No. 579 (March 24, 1992), *reprinted in* [1991-1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,349. This reference to a bank’s general lending authority includes the authority to discount and negotiate evidences of debt.

For example, the OCC concluded that a national bank could acquire privately placed asset-backed securities under its authority to negotiate evidences of debt.<sup>4</sup> In that case, the bank had asked whether the asset-backed securities qualified as investment securities under 12 C.F.R. Part 1. The OCC determined that the securities did not meet the marketability requirements for investment securities, but could be purchased under the authority to negotiate evidences of debt. The OCC stated that the ability of a national bank to acquire asset-backed securities is not limited by the fact that such investments may not be eligible as investment securities.<sup>5</sup>

The OCC reached the same conclusion in a recent matter involving trust preferred securities.<sup>6</sup> Trust preferred securities are debt-like instruments that are issued by trusts organized by banks or bank holding companies. In a typical structure, the trust sells common securities to the organizing bank or bank holding company and sells preferred securities to third party investors. The proceeds of the preferred securities issuance are then used to purchase a junior subordinated debenture from the bank or bank holding company. The bank or bank holding company guarantees that the trust will pay its obligations with the cash it has collected from the interest payments on the junior subordinated debt it owns.

The OCC had previously determined that, although trust preferred securities were denominated as securities, they were, in substance, debt obligations.<sup>7</sup> As debt obligations, the trust preferred securities would qualify as investment securities as long as they met the applicable rating and marketability requirements of 12 C.F.R. Part 1. The OCC later concluded that national banks could purchase trust preferred securities under the authority to discount and negotiate evidences of debt even if they did not qualify as investment securities, because the trust preferred securities were debt obligations.<sup>8</sup>

The OCC has considered several factors to determine whether securities with characteristics of both debt and equity have sufficient indicia of debt to qualify as debt obligations.<sup>9</sup> These factors include whether the returns on the investment are fixed or based on the success of the enterprise,

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<sup>4</sup> Interpretive Letter No. 600, *supra*.

<sup>5</sup> *Id.*

<sup>6</sup> Interpretive Letter No. 908, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-433 (April 23, 2001).

<sup>7</sup> Interpretive Letter 777, *supra*.

<sup>8</sup> Interpretive Letter No. 908, *supra*.

<sup>9</sup> Some of these decisions addressed whether the securities would qualify as investment securities and did not discuss the authority to discount and negotiate evidences of debt. Nonetheless, these decisions are instructive because the OCC first had to determine whether the securities were debt obligations in order to determine whether they qualified as investment securities. An investment security is, by definition, “a marketable *debt obligation* that is not predominately speculative in nature.” 12 C.F.R. 1.2(e).

the voting rights of the stockholder, the obligation to pay dividends, rights of stockholders in the event of the failure of the issuer, whether the security has a limited life and whether it is rated.<sup>10</sup>

These factors distinguish equity securities (or common stock) from debt securities. For example, common stock provides an ownership interest and appreciation of the market value of the issuer and dividends. In contrast, debt securities offer investors periodic interest payments, often in the form of fixed dividend payments, and a principal payment at maturity. In addition, common stock typically is perpetual and has broad voting rights, while debt securities can be perpetual or limited in term and have limited voting rights. In the event of the failure of an issuer, the claims of the common stockholders are subordinate to the holders of debt securities. Finally, rating agencies typically do not rate equity instruments but will assign credit ratings to debt securities.

Relying on these factors, the OCC has determined that national banks may purchase preferred stock as an investment security where the preferred stock can be properly characterized, in substance, as a debt obligation. For example, the OCC concluded that money market preferred stock had sufficient indicia of debt to qualify as an investment security under 12 C.F.R. Part 1.<sup>11</sup> Like debt holders, money market preferred holders did not share in the appreciation or the profits of the issuer, but instead were entitled to dividends determined by a formula established in the prospectus and principal at redemption. Money market preferred holders also had limited voting rights typical of debt holders. Although the money market preferred stock did not have a set maturity date, the OCC viewed it as similar to a series of fixed maturity instruments because dividend rates on the stock was reset every 49 days. Finally, like other debt instruments, the money market preferred stock was given a credit rating by the rating agencies.

In addition, as noted above, the OCC has concluded that trust preferred securities are debt-like instruments that may be purchased as investment securities or under the authority to discount and negotiate evidences debt.<sup>12</sup> Trust preferred securities have many characteristics typically associated with debt obligations including fixed and cumulative dividends, limited voting rights, and limited life.

The Preferred Stock is analogous in virtually all relevant respects to the preferred stock the OCC has previously concluded are debt obligations and not equity.<sup>13</sup> The Preferred Stock has characteristics typically associated with debt obligations, such as corporate bonds and municipal revenue bonds. For example, like debt holders, the Preferred Stockholders do not share in the

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<sup>10</sup> See e.g., Interpretive Letter 777 and Interpretive Letter No. 781, both *supra*.

<sup>11</sup> See Interpretive Letter No. 781, *supra* (money market preferred stock closely resembles and can be properly characterized in substance as debt).

<sup>12</sup> See Interpretive Letter No. 777, *supra* (trust preferred securities are debt-like obligations) and Interpretive Letter No. 908, *supra* (trust preferred securities qualify as debt obligations and may be purchased and held as loans). See also, OCC Conditional Approval No. 262, *supra* (“trust preferred securities are debt securities representing the long term secured or unsecured debt obligations of the issuing corporation”).

<sup>13</sup> See e.g., Interpretive Letter No. 781, Interpretive Letter No. 777 and Interpretive Letter No. 908 all *supra*.

profits of the issuer, but rather receive fixed dividend payments during the term of the Preferred and principal at redemption. Also, like holders of debt, the Preferred Stockholders do not have authority to vote on ownership matters other than in limited situations. And claims of the common stockholders are subordinate to the holders of the Preferred Stock upon dissolution of the Company. In addition, like most debt, the Preferred Stock is not perpetual. It has a limited life of 20 years. It is also given a credit rating by rating agencies, just as with debt. Thus, because the Preferred Stock closely resembles and can be properly characterized, in substance, as debt, the Bank may acquire and hold it under the authority to discount and negotiate evidences of debt.

Because the Preferred Stock is, in substance, a debt obligation, the Bank's acquisition of the Preferred Stock does not violate the Glass-Steagall Act's limitation on stock ownership. That provision limits the ownership of the "stock of any corporation" unless "otherwise permitted by law."<sup>14</sup> Here the preferred stock, despite its label, is not, in substance, "stock of any corporation."<sup>15</sup> Functionally, it is a debt obligation. As a debt obligation, its acquisition is "otherwise permitted by law."<sup>16</sup> Specifically, national banks may acquire the Preferred Stock pursuant to the authority to "discount and negotiate . . . evidences of debt."<sup>17</sup>

#### B. Prudential Standards and Regulatory Limits on Preferred Stock

Banks that hold debt obligations, such as the Preferred Stock, are subject to limits on the amount of debt the bank may hold. Most debt obligations are subject to limits of 10 to 15% of the bank's capital and surplus.<sup>18</sup> Some debt obligations, such as subordinated, unsecured long-term debt may be subject to stricter limits for safety and soundness reasons. In this case, the Preferred Stock represents less than 5% of the Bank's capital and surplus.<sup>19</sup> This amount is within the prudential limits that the OCC would apply to such subordinated unsecured long-term debt.

The Bank also must adhere to the prudential requirements in Banking Circular No. 181 (Rev.).<sup>20</sup> In that regard, the Bank should conduct an independent analysis to determine that the acquisition

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<sup>14</sup> 12 U.S.C. § 24(Seventh).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> For example, debt obligations that qualify as Type III investment securities under 12 C.F.R. Part 1 are subject to a 10% investment limit. Debt obligations that qualify as loans and other extensions of credit are generally subject to a 15% lending limit, under 12 U.S.C. § 84 and 12 C.F.R. § 32. A financed sale of assets is generally exempt from that legal lending limit, however. *See* 12 C.F.R. § 32.2(k)(2)(iii).

<sup>19</sup> The Bank acquired \$105 million of preferred stock from the Company. This represents 4.64% of the Bank's total equity capital of \$2,260,849M as of March 31, 2002.

<sup>20</sup> *See* OCC Banking Circular 181 (Rev.) (August 2, 1984), *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 63-506.

of the Preferred Stock meets the Bank's own internal underwriting standards. The nature and extent of the Bank's independent analysis is a function of the type of transaction at issue and the Bank's lending policies and procedures. The Bank's acceptance of a favorable analysis of the Preferred Stock by the issuer, a credit rating institution, or another entity does not satisfy the need to conduct an independent credit analysis. The Bank may, however, consider analysis by other sources as factors when independently assessing the Preferred Stock. The Bank must maintain its analysis on an ongoing basis and must have continued access to appropriate credit and portfolio performance data as long as it holds the Preferred Stock.

### **Conclusion**

The Bank had authority to acquire and may hold the Preferred Stock under its authority to discount and negotiate evidences of debt. The Bank's existing holdings represent less than 5% of the Bank's capital and surplus and are within applicable limits. If you have any questions, please contact Beth Kirby, Special Counsel, at (202) 874-5210.

Sincerely,

**-signed-**

Ellen Broadman  
Director  
Securities and Corporate Practices Division