Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #781
June 1997
12 U.S.C. 24(7)88
12 U.S.C. 24(7)92

April 9, 1997

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Re: [ ] ("Bank")

Dear [ ]:

This is in response to your letter requesting approval for the Bank to purchase and hold for its own account money market preferred stock ("MMPS"). For the reasons described below, we conclude that national banks may purchase MMPS as Type III investment securities provided it is "marketable" and "not predominantly speculative in nature" as required under OCC regulations defining investment securities. The Bank's purchases of MMPS also must comply with all applicable statutes and regulations, including the limitations on a national bank's purchase of investment securities set forth in 12 U.S.C. § 24(Seventh) and 12 C.F.R. Part 1.

Background

MMPS owners enjoy only a nominal ownership interest in the issuing corporation, and possess few rights traditionally associated with stock ownership. MMPS generally provides voting rights only when dividends are in arrears for a minimum of 180 days. MMPS holders do not share in the appreciation or the profits of the issuer, but instead are entitled to dividends determined by a formula established under the prospectus, and principal at redemption. The dividend yield floats between set minimum and maximum rates, based primarily on prevailing market interest rates and, to a lesser extent, changes in the credit standing of the issuer.[1] MMPS generally does not have a set maturity date, although the

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[1] Corporations often prefer holding MMPS over traditional forms of debt securities because 70 percent of dividends, but not interest, corporations receive on securities held for

return is reset every 49 days. The issuer generally may redeem MMPS at par. MMPS is subordinate to other forms of debt upon liquidation. Rating agencies assign credit ratings to MMPS and most MMPS is rated A or higher. *See* Morgan Stanley & Co., Inc., *The Auction Preferred and Note Markets* 11-17, 24 (1994).

Discussion

The national banking laws provide that a national bank "may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe." "Investment securities" are further described in the statute as "marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency." 12 U.S.C. § 24(Seventh).

OCC regulations define an investment security as "a marketable debt obligation that is not predominantly speculative in nature." 12 C.F.R. § 1.2(e); *see also* Banking Circular No. 227 (April 26, 1991); *Comptroller's Handbook for National Bank Examiners*, § 203.1 at 6.[2] Type

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46 days or more are not subject to tax. 26 U.S.C. §§ 243 and 246. Remarketing agents generally sell and reset the rate on MMPS through Dutch auctions held every 49 days to satisfy the 46 day minimum hold requirement. The auction agent uses the auction results to reset the dividend yield for the next period, much like a variable interest rate. The reset yield for an entire issue generally will be the highest dividend rate bid at the auction. If all holders choose to hold, the agent will reset the dividend at the minimum rate specified in the prospectus or offering document. If there are more sellers than bidders for available shares, the reset yield generally will be the maximum rate specified in the prospectus or offering document. In that event, the agent satisfies all bids by allocating sellers' shares *pro rata*. Sellers retain all unsold shares for the reset period. *The Auction Preferred and Note Markets, supra*, at 5, 23-24, 33.

[2] A security is not predominantly speculative in nature if it is rated investment grade or is the credit equivalent of a security rated investment grade. Id. A security is marketable if it:

(1) Is registered under the Securities Act of 1933, 15 U.S.C. § 77a *et seq*.;

(2) Is a municipal revenue bond exempt from registration under the Securities Act of 1933, 15 U.S.C. § 77c(a)(2);

(3) Is 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

III securities are defined as "investment securities that do not qualify as Type I, II, IV, or V securities, such as corporate bonds and municipal revenue bonds." 12 C.F.R. § 1.2(k).[3] The regulatory definition, therefore, is general and non-exclusive and relies on the substantive characteristics of an "investment security."

Certain substantive characteristics distinguish common stock and debt securities. Common stock owners typically have broad voting rights, while debt holders ordinarily have very limited voting rights. Debt holders typically have voting rights only in extraordinary circumstances, such as reorganizations or default by the issuer. Common stock owners typically have an ownership interest in the issuer that offers an opportunity to benefit from appreciation in the market value of the issuer and to earn dividends declared by the directorate based on an issuer's profits. In contrast, debt holders typically are entitled to receive periodic payments that may be fixed or fluctuate as provided in the debt instrument, and principal at maturity. Rating agencies may assign credit ratings to debt securities, but typically do not rate equity instruments. Preferred stock is a hybrid and can be structured to resemble either debt or equity. *See, e.g.*, *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); and Robert Hamilton, *Fundamentals of Modern Business,* Little Brown (1989).

MMPS is an instrument that, despite its label, possesses characteristics typically associated with debt obligations such as corporate and municipal bonds. Like debt holders, MMPS holders ordinarily do not possess voting rights if the yield payment is current. MMPS holders, like debt holders, can vote only in extraordinary circumstances, such as reorganizations. MMPS holders do not have an opportunity to benefit from appreciation in the market value of the issuer and do not earn dividends declared by the directorate based on the issuer's profits. Instead, MMPS holders are entitled to a return determined by a formula established in the prospectus, and payment of principal at redemption. Although MMPS does not have a maturity date, it may be viewed as similar to a series of fixed maturity instruments because of the process for resetting the dividend rates every 49 days. Like other debt instruments, MMPS may be redeemed by the issuer at par and is rated by the rating agencies.

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(4) Can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

12 C.F.R. § 1.2(f).

[3] There are quantitative limitations on the ability of a national bank to purchase and hold investment securities. For example, a national bank generally may not purchase the Type III investment securities of any one obligor in an amount greater than 10 percent of its capital and surplus. *See* 12 U.S.C. § 24(Seventh) and 12 C.F.R. § 1.3.

The FDIC has recognized the predominate debt characteristics of MMPS, and excludes MMPS from the definition of an “equity security.”[4] In reaching this conclusion, the FDIC found that MMPS is essentially a substitute for money market investments such as commercial paper and is closer in its characteristics to debt than to equity.[5]

Thus, because MMPS closely resembles and can be properly characterized in substance as debt, MMPS may qualify as an investment security. MMPS ordinarily could be purchased as a Type III investment security, because it does not qualify as Type I, II, IV or V. However, national bank investments in MMPS also must satisfy the same requirements that apply to any other Type III investment securities, including provisions requiring those securities to be marketable and not speculative in nature.

MMPS generally would satisfy the definition of “marketable” in Part 1. Although MMPS is not exchange-traded and price quotations for MMPS are not widely available, MMPS may be registered under the Securities Act to meet marketability requirements. *See* 12 C.F.R. § 1.2(f)(1). Alternatively, should MMPS be sold under an exemption from registration under the Securities Act, it still may be marketable. Although the auction scheme for MMPS may not provide the quickest means for selling securities, it permits holders to dispose of MMPS “with reasonable promptness at a price that corresponds reasonably to its fair value.” *See* 12 C.F.R. § 1.2(f)(4).

MMPS generally will not be predominantly speculative in nature. Rating agencies generally rate MMPS investment grade, and national banks ordinarily will be able to determine whether a specific MMPS issue meets this test.

Conclusion

Accordingly, we conclude that national banks may purchase MMPS as Type III investment securities, provided the MMPS is “marketable” and “not predominantly speculative in nature” as required under OCC regulations defining investment securities. If you have any questions, please contact Frederick G. Petrick, Jr., Senior Attorney, at 202-874-5210.

Sincerely yours,

/s/

Julie L. Williams
Chief Counsel

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[4] 12 C.F.R. § 362.2(l).

[5] 57 Fed. Reg. 53,218-19 (Nov. 9, 1992); *see also* 58 Fed. Reg. 64,476 (Dec. 8, 1993).