Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #851
March 1999
12 USC 24(7)

December 8, 1998

Dear [ ]:

This is in response to your letter dated October 30, 1998 to Eric Thompson, Director, Bank Activities and Structure Division, on behalf of [ ] ("FNB" or "the Bank"), [*City, State*]. You requested confirmation that it would be lawful for the Bank to hold a non-controlling minority interest in a new limited liability company that is being established to engage in investment advisory activities. For the reasons set forth below, it is our opinion that this transaction is legally permissible as described herein.

BACKGROUND

According to your letter, FNB conducts trust and investment advisory activities directly and through its operating subsidiaries under the authority of its charter and 12 U.S.C. § 92a. In 1995, FNB acquired a controlling interest in an investment advisory firm, the [ ] ("*T*"), and has since held [*T*] as an operating subsidiary. To further the Bank's overall investment advisory strategy, the Bank seeks to sell a portion of the assets of [*T*] to a newly created limited liability company, the[ ] ("*G*" or "the LLC"). FNB will own 25% of the LLC for a period not to exceed five years. The remaining 75% will be held by two of the principals from whom FNB originally purchased [*T*], [*3*] and [*2*].[1]

[1] [*3*] is the President and CEO of [*T*]. [*2*] is President, Director and CEO of [ ] ("*AB*"), and Chairman of the Board of [*T*]. Concurrent with the sale of the [*T*] accounts to the LLC, both [*3*] and [*2*] will resign from their current positions within FNB and [*AB*] except that [*2*] will continue to serve indefinitely as a director of [*AB*]. Since [*2*] is a director of an affiliate of FNB, the restrictions in Regulation O, 12 CFR Part 215, apply to extensions of credit made by FNB to [*2*] or to the LLC, a related interest of [*2*], unless FNB has excluded [*2*] by board resolution. However, the proposed transaction is not an extension of credit for the purposes of Regulation O.

[*G*] is a SEC registered investment adviser organized under Rhode Island law. You have represented that FNB will sell to [*G*] approximately $367 million of the assets under management, representing approximately one half of [*T*]'s total investment advisory account relationships. [*T*] will continue to exist as a separate entity for some period of time after the transaction to ensure a smooth transition for clients. Those account relationships not sold to [*G*] will be transferred to FNB or an existing operating subsidiary, [ ]. FNB will continue to receive a portion of the investment advisory revenue for certain accounts transferred for a two year period.

Under the terms of the proposed sale transaction, equity ownership of the LLC will be shared by the Bank and the purchasers. [*3*] and [*2*] will jointly own a 75% controlling interest in the LLC, *i.e.*, each will own a 37.50% membership interest. FNB will receive a 25% non-controlling interest in the LLC. However, FNB will be contractually obligated to sell its equity interest in the LLC to Messrs. [3] and [2] between one year and five years after the initial transfer to [*G*] is consummated. The timing of the sale will be at FNB's option, and the sale price will be determined at the time of the sale. [*3*] and [*2*] will resign from their current positions within FNB and [*AB*]. [*2*] will serve as a consultant to [*AB*] under a one year contract in order to aid in the transition of that company to a new management team and will continue to serve as a director of [*AB*] indefinitely. [*3*] and [*2*] will also provide assistance to FNB during the transition of the advisory accounts from [*T*] to the Bank. FNB will continue to provide custody services and certain ancillary systems and data processing support to the LLC.[2] All such services will be provided on terms and under circumstances that are consistent with comparable market practices.

ANALYSIS

The Bank's proposal to hold a 25% interest in the LLC raises the issue of the authority of a national bank to make a non-controlling, minority investment in a limited liability company. In a variety of circumstances the OCC has permitted national banks to own, either directly or indirectly through an operating subsidiary, a non-controlling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or a limited liability company.[3] In

[2] FNB customer information will remain confidential. As a subsidiary of FNB, [*T*] has no access to any of the Bank's information management systems for deposit account or bank customer account information. [*T*] has access only to account information for the management accounts it manages. While FNB will continue to provide certain administrative and data processing services, the LLC will have no further access to the Bank's information management systems. No accounts will be transferred to the LLC or FNB without first providing notice and obtaining proper consent of the account holders.

[3] *See also* 12 C.F.R. § 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 U.S.C. § 24(Seventh) and other statutes.

various interpretive letters, the OCC has concluded that national banks are legally permitted to make a non-controlling investment in a limited liability company, provided four criteria or standards are met.[4] These standards, which have been distilled from our previous decisions in the area of permissible non-controlling investments for national banks and their subsidiaries, are:

(1) The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking;

(2) The bank must be able to prevent the entity or enterprise from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment;

(3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and

(4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Each of these factors is discussed below and applied to your proposal.

1. *The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.*

Our precedents on non-controlling stock ownership have recognized that the enterprise in which the bank takes an equity interest must confine its activities to those that are part of, or incidental to, the business of banking.[5] The LLC will provide investment advisory services and continue to engage in the same investment advisory activities that are presently conducted by [*T*] as a subsidiary of the Bank under 12 U.S.C. § 24(Seventh) and 12 U.S.C. § 92a.

---

[4] *See e.g.*, Interpretive Letter No. 778 (March 20, 1997), *reprinted in* [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-205 and Interpretive Letter No. 692 (November 1, 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep (CCH) ¶ 81,007.

[5] *See e.g.*, Interpretive Letter No. 380 (December 29, 1986), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (since a national bank can provide options clearing services to customers, it can purchase stock in a corporation providing options clearing services; Interpretive Letter No. 694 (December 13, 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 91-009 (national bank permitted to take non-controlling minority interest in a limited liability company that purchases secured home improvement loans and resells them in the secondary market); Interpretive Letter No. 711, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-026 (February 23, 1996) (national bank may take a minority equity interest in a mortgage banking company).

Clearly the activities of the LLC are within the scope of activities which the OCC has previously determined to be permissible for national banks and their operating subsidiaries.[6] The fact that the Bank seeks to retain a minority interest in the LLC after the sale of a portion of [*T*]'s assets, does not alter the conclusion that the transaction is permissible. Therefore, this standard is satisfied.[7]

2. *The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.*

This is an obvious corollary to the first standard. The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest.

Your letter states that as long as FNB maintains an interest in the LLC, its Operating Agreement will prohibit the LLC from engaging in any activity that is not part of, or incidental to, to the business of banking under the interpretations of the OCC. You have also stated that the Operating Agreement will provide that this restriction may only be amended by a majority of the interests in the LLC, including those held by FNB and its assigns.[8] Therefore, this standard is met.

3. *The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.*

---

[6] *See, e.g.*, Interpretive Letter No. 647 (April 15, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,558 (national banks may establish subsidiaries to acquire assets of investment companies and their subsidiaries, may engage in investment advisory, brokerage and administrative services to various clients, including a family of mutual funds but would not act as distributor of the mutual funds).

[7] We have previously held it lawful for a bank to acquire and hold a minority equity interest in a company which would be the successor to the bank's existing mortgage banking operation. *See* Interpretive Letter No. 711 (February 23, 1996), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,026 (national bank permitted to sell all of the shares of its mortgage company to a newly organized corporation; in return, the bank to receive approximately 45% of the voting stock of the new corporation).

[8] Several provisions of the Draft Operating Agreement submitted to us at our request confirm your representations that this standard is satisfied. Section 2.7 of the Draft Operating Agreement provides that the Company must obtain the "written consent of the [ ] prior to engaging in activities other than those expressly permitted in Section 2.5.1…". Section 2.5.1 provides that "while the [ ] is a Member the Company shall engage solely in activities that are part of, or incidental to, the business of banking, as determined from time to time by the Office of the Comptroller of the Currency." Article II, sections 2.7 and 2.5.1, Draft Operating Agreement.

a. *Loss exposure from a legal standpoint*

A primary concern of the OCC is that national banks not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a national bank's investment not expose it to unlimited liability. As a legal matter, investors in a Rhode Island limited liability company will not incur liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the limited liability company.[9]

Article II, section 2.8 of the proposed Draft Operating Agreement of the LLC provides that "[n]o member or Manager in its capacity as such shall be liable for the debts, obligations or liabilities of the Company, including without limitation under a judgment, decree or order of a court." Additionally, Article II, section 2.10 provides that "[n]o member of the Company shall be subject in such capacity to any personal liability whatsoever to any Person in connection with the assets, acts, obligations or affairs of the Company."

Thus, the Bank's loss exposure for the liabilities of the LLC will be limited.

b. *Loss exposure from an accounting standpoint*

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's 20-50% ownership share of investment in a limited liability company is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances shown on the investor's books.[10]

As proposed, the Bank will have a 25% membership interest in the LLC. Your letter states that FNB intends that its proposed investment in the LLC will not be consolidated on FNB's balance sheet under generally accepted accounting principles. Thus, except to the extent that FNB may extend credit to the LLC, the Bank's risk of loss will be limited to its investment in the LLC as shown on its books.[11] Consequently, the Bank will not have open-ended liability for the obligations of the LLC. Therefore, the third standard is satisfied.

---

[9] *See* R.I. Gen. Laws § 7-16-23 (1998).

[10] *See generally* Accounting Principles Board, Op.18 § 18(1971) (equity method of accounting for investments in common stock).

[11] OCC's Chief Accountant has concluded that the Bank's investment in the LLC should be recorded as "investments in unconsolidated subsidiaries and associated companies" on the Bank's Consolidated Reports of Condition and Income ("Call Reports"). Such classification is consistent with the Call Report Instructions. *See* Instructions to Schedule RC-M, item 8.b.

4. *The investment must be convenient and useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.*

A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank must also satisfy the requirement that the investment have a beneficial connection to that bank's banking business, *i.e.*, it must be convenient or useful to the investing bank's business activities and not constitute a mere passive investment unrelated to the bank's banking business. Twelve U.S.C. § 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful." [12] Therefore, a consistent concept running through our precedents concerning stock ownership is that it must be convenient or useful to the bank in conducting that bank's banking business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.[13]

The Bank, through [*T*], is currently actively involved in providing investment advisory services of the same or similar type as the LLC will provide. FNB's investment in the LLC will enhance its market penetration and earnings in the investment advisory services business and further its overall investment strategy and provide continued services to the Bank's customers. Therefore, the proposed transaction will be both convenient and useful to the Bank in carrying out its banking business and is not a mere passive investment. Thus, the fourth standard is satisfied.

CONCLUSION

Based upon the information and representations you have provided, and for the reasons discussed above, we conclude that [*Bank, City, State*], may acquire and hold a non-controlling 25% interest in the [*LLC*].

Our conclusion is conditioned upon compliance with the commitments made in your letter of inquiry and with the conditions listed below:

(1) [ ] ("the LLC") may engage only in activities that are part of, or incidental to, the business of banking;

---

[12] *Arnold Tours Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

[13] *See e.g.*, Interpretive Letter No. 543, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,225 (February 13, 1991) (national bank authorized to acquire nominal stockholding for membership in corporation of primary dealers in government securities); Interpretive Letter No. 427, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988) (national bank permitted to buy Farmer Mac stock in nominal amounts); Interpretive Letter No. 421, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988) (national bank permitted to invest in the Government Securities Clearing Corporation.

(2) The Bank will have veto power over any activities and major decisions of the LLC that are inconsistent with condition number one or the Bank will withdraw its investment from the LLC if it proposes to engage in any activity that is inconsistent with condition number one;

(3) The Bank will account for its investment in the LLC as an unconsolidated entity under the equity or cost method of accounting; and

(4) The LLC will be subject to OCC supervision, regulation, and examination.

These commitments and conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that the proposed investment is permissible under 12 U.S.C. § 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

I hope that this has been responsive to your inquiry.

Sincerely,

/s/

Raymond Natter
Acting Chief Counsel