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Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #940

May 24, 2002 **July 2002**

12 USC 24(7)

Re: **[ ]** Investment Management Activities

Dear **[ ]**:

This is in response to your letter requesting confirmation that **[ ]** (the "Bank") may hold for limited periods of time, limited interests in certain private investment funds for which it serves as investment manager. The Bank contends that holding such limited interests is convenient and useful for the Bank in order to conduct its investment management business. For the reasons set forth below, we conclude that the Bank may hold the interests in the funds in the manner and as described herein.

A. Background

The Bank, which is a subsidiary of **[*A*]**, is a national bank with powers limited to trust powers. As a national bank, the Bank is exempt from registration as an investment advisor under the Investment Advisers Act of 1940.[1] The Bank serves as investment manager for a number of private investment funds organized in the United States (the "Funds").[2] The Funds invest in a

[1] 15 U.S.C. § 80b-1 to 80b-21.

[2] In addition to the Funds, the Bank also serves as investment manager for a number of private investment funds organized outside the United States. This letter does not address the permissibility of the Bank's activities with respect to the foreign funds.

variety of financial instruments, including stocks and bonds, currencies, and commodities. The Funds use cash instruments as well as over-the-counter and exchange-traded derivatives. The Funds also take both short and long positions in securities. The Funds may invest in securities and other financial assets in which a national bank ordinarily is not permitted directly to invest.[3]

The Funds are structured as multi-advisor funds. As investment manager, the Bank chooses the advisors for each Fund, allocates Fund assets to each advisor, and sets up stop-loss provisions and other limits for the advisors. The Bank also monitors the advisors' performance and processes, re-allocates assets among advisors, and, if necessary, terminates advisors that no longer meet performance or other standards. Certain of the Funds are organized as Delaware limited partnerships and others are organized as Delaware limited liability companies. All of the Funds are taxed as partnerships. Consistent with this tax treatment, all the losses, gains, fees, and expenses are passed through from the Funds to their respective investors.

The Funds' investors are primarily high net worth individuals who meet the definitions of both accredited investors under the Securities Act of 1933[4] and qualified purchasers under the Investment Company Act of 1940.[5] The Funds are marketed primarily by broker-dealers that are affiliates of the Bank. These affiliated broker-dealers are registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934.[6] As investment manager, the Bank receives both a management fee and a fee for performance for each of the Funds. The management fee is a percentage of the assets of each Fund. The fee for performance is a percentage of the profits of each Fund above a certain hurdle rate.

The Bank represents that it would be to the advantage of U.S. investors in the Funds if the Bank's compensation for performance were paid as a share of profits, rather than as a fee. To receive a share of the profits, the Bank would need to hold an interest in the Funds. In the case of Funds organized as limited partnerships, the Bank would become a special limited partner. As a special limited partner, the Bank would not participate in all of the gains and losses of the partnership, but only in the gains equal to the performance fee to which the Bank is entitled as investment manager. In the case of Funds organized as limited liability companies, the Bank would be a special member of those companies, with the same types of rights it would have in the limited partnerships. We refer to the Bank's special limited partner and special member interests in the Funds as "Special Interests."

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[3] The Bank plans to invest only in funds that invest primarily in securities. Any non-securities investments will be limited to financial investments, and will not include real estate or tangible personal property.

[4] 15 U.S.C. § 77a to 77aa.

[5] 15 U.S.C. § 80a-1 to 80a-64.

[6] 15 U.S.C. § 77b *et seq.*

Performance compensation can be a substantial percentage of the Funds' respective returns. The Bank represents that individual investors, trusts, and investors taxed as partnerships that in turn have individual or trust investors, prefer that investment funds structure performance compensation as an allocation to the investment manager's equity account rather than as a fee. Under U.S. tax law, individual investors must report as income their proportionate share of the gross amount of an investment fund's income and gains *before* deducting investment-related fees and expenses paid by the investment fund. The limit placed by the U.S tax laws on the deductibility of these fees and expenses may preclude high-income individuals from deducting their full proportionate share of the fees and expenses of the investment funds. If, however, the investment manager is paid in the form of a profit allocation, rather than through a performance fee, the amount so paid is not treated as income to investors who are not recipients of the allocation.

For these reasons, the Bank represents that it is an industry practice for investment advisors and managers of certain types of investment funds to receive performance-related compensation as a profit allocation. The Bank has provided examples of other, similar private investment funds that its affiliated broker-dealer markets to investors. The similar funds marketed by the broker-dealer are structured to provide payments for advisory services as fund allocations rather than as fees to maximize tax efficiency for investors. Because several nonbank investment managers follow industry practice in structuring performance compensation as an equity interest, the Bank believes that the limitation on deductibility on the Funds' performance fees as currently structured (rather than the proposed performance-based equity allocation to the Bank as investment manager) is having a significant adverse effect on the Bank's ability to compete for this type of advisory business. The Bank represents that if it is not able to structure its performance-based compensation using an allocation of income and gains to its equity account, the Funds would be significantly disadvantaged in competing for investors' money.

The Bank's ownership interest in the Funds would be limited. The Bank does not propose to make any out-of-pocket investments in the Funds, although it will hold a Special Interest in each Fund to enable it to receive its performance-based compensation in the form of a profit allocation as described above. The Bank has represented that under the terms of the instruments governing the Funds and creating the Special Interests, the Bank will not participate in any losses suffered by the Funds. The Bank will account for its Special Interest in the Funds under the equity method of accounting. The Bank's loss exposure from an accounting perspective will be limited to the amount of profit allocation it expects to receive as compensation. The Special Interest would not entitle the Bank to voting rights. The Bank represents that it will receive a Special Interest in a Fund only while the Bank provides investment management services to the Fund. The Bank will withdraw all profit allocations immediately.[7]

The Bank proposes to receive a Special Interest in a Fund for which it serves as investment

[7] The Bank has indicated that it will have a standing request for redemption of all equity allocations from each Fund. The Bank will receive the redemption proceeds on the same business day that a Fund determines the final amount of each allocation. Because the Bank will in effect withdraw all profit allocations immediately, the amount of the Bank's interest in any Fund as a practical matter would, consistent with Interpretive Letter No. 897, *supra*, never exceed 24.99 percent of the total equity of any fund.

manager only to the extent it is necessary to attract investors into the Fund. The Bank will hold Special Interests only in investment funds that hold securities and financial instruments, and will not invest in any fund that includes real estate or tangible personal property. The Bank will hold a Special Interest in a Fund containing bank-ineligible investments only while the Bank serves as an investment manager to the Fund, and only if the terms of the instruments governing the Fund allow the bank to sell, redeem or otherwise dispose of its equity allocation if it no longer services the Fund.

B. Analysis

1. The Bank's holding an interest in funds in order to engage in the investment advisory business is incidental to the business of banking.

The OCC has long held that a national bank may provide investment management services as part of the business of banking authorized under 12 U.S.C. § 24(Seventh) and pursuant to their fiduciary powers under 12 U.S.C. § 92a.[8] Section 24(Seventh) also gives national banks incidental powers to engage in activities that are incidental to enumerated bank powers as well as the broader "business of banking."[9] Prior to *VALIC*, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in *Arnold Tours*.[10] The *Arnold Tours* standard defined an incidental power as one that is "convenient or useful" in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act."[11] Even prior to *VALIC*, the *Arnold Tours* formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act. The *VALIC* decision, however, has established that the *Arnold Tours* formula should be read to provide that an incidental power includes one that is "convenient" or "useful" to the "business of banking," as well as a power incidental to the express powers specifically enumerated in 12 U.S.C. § 24(Seventh). Thus, it would be considered incidental to a permissible bank activity for a national bank to hold interests in an investment fund to which it provides investment management services if, under the circumstances presented, holding the interests is convenient or useful to the clearly bank-permissible investment management activities conducted by the Bank.[12]

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[8] *See*, *e.g.*, Interpretive Letter No. 897 (October 23, 2000) *reprinted in* [2000-2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-416; Interpretive Letter No. 851 (December 8, 1999) *reprinted in* [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,308; Interpretive Letter No. 871 (October 14, 1999) *reprinted in* [1999-2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,365; Conditional Approval Letter No. 164 (December 9, 1994); Interpretive Letter No. 648 (May 4, 1994) *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) & 83,557; Interpretive Letter No. 647 (April 15, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) & 83,558; Interpretive Letter No. 622 (April 9, 1993) *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) & 83,557; Interpretive Letter No. 403 (December 9, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) & 85,627.

[9] *VALIC*, *supra,* at 258 n. 2.

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

[11] *Id*. at 432.

[12] *See* Interpretive Letter No. 897 (October 23, 2000), *reprinted in* [2000-2001 Transfer Binder] Fed. Banking Law.

The OCC recently confirmed that it was legally permissible for an investment advisor that was partly owned by a national bank to hold limited equity interests in certain investment funds to which the investment advisor provided services.[13] In Interpretive Letter No. 897, the OCC noted several reasons in support of limited equity investments in funds by an investment advisor in which a national bank proposed to hold a noncontrolling interest, to: (1) assure that the advisor's interests were aligned with those of the other investors in the funds; (2) provide a tax-efficient means for the advisor to receive performance-based compensation; and (3) efficiently fund the advisor's obligations to its staff for performance-based bonuses. These three reasons each constituted reasons why the advisor's investments in the funds were convenient or useful to the national bank in carrying out its business, and not mere passive investments unrelated to the bank's business.

In the instant proposal, the Bank's ownership for limited periods of small interests in investment funds it manages is directly related to, and an integral part of, the Bank=s activity of providing bank-permissible investment management and administrative services to certain investment funds. The purpose of holding the Special Interests is to enable the Bank to act as an investment manager to the types of investment funds in which this form of ownership by the investment manager is convenient and useful--indeed, necessary. The level of such investments by the Bank in any single fund and in the aggregate will be limited. The proposed Special Interests in the investment funds are not passive or speculative investments on the Bank=s part. The investments are made solely to enable the Bank to provide investment management services as conducted by its competitors in the investment management industry. As a practical matter, in order to offer the funds it manages, the Bank must structure its compensation to hold these investments in this limited manner. They will be held only when, and for so long as the Bank is providing such investment management services.

Investing in the funds it manages enables the Bank to receive its compensation in a manner that provides tax treatment to investors in a Fund comparable to that of investors in similar funds. As described above, because performance-based compensation frequently can be a substantial percentage of a private investment fund's returns, the use of a performance-based allocation can have a significant effect on individual investors. As a result, private investment funds traditionally have structured performance compensation as an equity allocation in order to prevent individuals from being disadvantaged by limits on the deductibility of performance-based compensation in the form of fees. Permitting the Bank to receive the Special Interests in the Funds enables it to compete more effectively with entities that can offer this tax result to their individual investors.

Rep. (CCH) ¶ 81-416. *See also* Interpretive Letter No. 742 (August 19, 1996), *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-106; Interpretive Letter No. 737 (August 19, 1996), *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-101; Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

[13] Interpretive Letter No. 897 (October 23, 2000), *reprinted in* [2000-2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-416.

Accordingly, in the instant case, because the Bank's ownership of limited equity interests in the funds it advises is restricted to a context where the holding is integral to facilitating a recognized bank-permissible activity, such holdings are permissible as an incident to the bank-permissible investment management activities.

2. Holding an interest in funds in order to engage in the investment advisory business is not prohibited by 12 U.S.C. 24(Seventh).

Section 24(Seventh) addresses the ability of a national bank to underwrite and deal in securities. Specifically, Section 24(Seventh) provides that "[t]he business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided,* That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe."

Here, the Bank would not be "dealing" in or "underwriting" securities prohibited for national banks by Section 24(Seventh). Although Adealing@ and Aunderwriting@ are not defined in Section 24(Seventh),[14] "dealing" in securities is generally understood to encompass the purchase of securities as principal for resale to others.[15] Dealing is buying and selling as part of a regular business. A dealer typically maintains an inventory of securities and holds itself out to the public as willing to purchase and sell and continuously quote prices.[16] "Underwriting" is generally understood as encompassing the purchase of securities from an issuer for distribution and sale to investors.[17] Case law confirms that one cannot be an underwriter in the absence of a public offering.[18]

Under the above definitions, the Bank receiving the Special Interests would not constitute

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[14] Although the securities laws definitions are not dispositive in determining whether a particular type of securities activity is permitted for banks, these definitions provide a useful starting point for characterizing a bank's securities activities. Under section 3 of the Securities Exchange Act of 1934, a "dealer" is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not part of a regular business." 15 U.S.C. § 78c(a)(5). Under the Securities Act of 1933, an "underwriter" includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." 15 U.S.C. § 77(b)(a)(11).

[15] Interpretive Letter No. 393 (July 5, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,617 (national bank with limited market presence not considered a dealer). *See also* Louis Loss, *Securities Regulation* 2983-84 (3d ed. 1990).

[16] *Citicorp, J.P. Morgan & Co. Inc., Banker Trust New York Corporation,* 73 Fed. Res. Bull. 473 n.4 (1987); OCC Interpretive Letter No. 684, *supra.*

[17] Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1998-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; Interpretive Letter No. 329 (March 4, 1985), *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499.

[18] *SIA v. Board of Governors,* 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

"dealing" or "underwriting." The Bank has represented that it will receive the Special Interests solely for purposes of engaging in the investment management business. The Bank will not hold the Special Interests in order to engage in a regular business of buying and selling them in the secondary market[19] and will not participate in a public offering of the securities to investors.

The ownership by the Bank of the Special Interests would be a type of equity investment, and therefore is not the type of security subject to the limitations placed upon national banks' purchase of investment securities in 12 U.S.C. § 24(Seventh) or in 12 C.F.R. Part 1. The statutory definition of investment securities includes "marketable obligations evidencing the indebtedness of any person, copartnership, association or corporation in the form of bonds, notes, and/or debentures, commonly known as 'investment securities'" and gives the Comptroller the authority to define further that term. Accordingly, the OCC issued implementing regulations defining "investment securities" at 12 C.F.R. Part 1. Under Part 1, an investment security is defined as "a 'marketable' debt obligation that is not predominantly speculative in nature."[20] Equity securities do not represent debt obligations.

The language in the fifth sentence of Section 24(Seventh) "nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation" is not a blanket bar on national bank acquisitions of stock. Rather, as discussed below, that language was intended to make clear that the express authorization contained in the statute permitting banks to invest in "investment securities" does not include an authorization for investments in stock. This proviso does not affect national banks' authority to hold equities, *if* the holding can qualify as permissible because it is part of or incidental to permissible banking activities.[21]

In the present situation, the Bank=s receiving the Special Interests enables it to engage in permissible banking activities and act as investment manager for investment funds that, in practice, require the manager to take an equity stake. Institutional and sophisticated individual investors in these funds require the manager to structure the payment of performance fees in this fashion. In this connection, these investments permit the Bank to offer funds that provide investors with a tax treatment comparable to that of investors in other, similar funds. The Bank would be unable to offer these funds on a competitive basis unless it makes these investments. Based on these circumstances, the proposed investments are an integral component of investment management services provided by the Bank to the investment funds.

C. Conclusion

Based upon a review of the information you provided, including the representations and

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[19] The Bank will not act as market maker in the securities by quoting prices continuously on both sides of the market.

[20] 12 C.F.R. § 1.2(e).

[21] The legislative history of the language in the fifth sentence of Section 24(Seventh) is discussed in detail in Interpretive Letter 892 (September 13, 2000).

commitments made in your letter, and for the reasons discussed above, we conclude that the Bank may receive the Special Interests in the Funds, subject to the following conditions:

(1) The Funds shall constitute "affiliates" of the Bank and Citibank, N.A. for purposes of Sections 23A and 23B of the Federal Reserve Act.

(2) Prior to receiving the Special Interest in the Funds, the Bank shall adopt and implement an appropriate risk management process, acceptable to the OCC Examiner-in-Charge, to monitor these interests. The Bank's risk management process shall be comprehensive and shall include:

(i) Adoption and implementation of a conflict of interest policy addressing all inherent conflicts associated with the Bank's holding of the Special Interests in the Funds; and

(ii) Adoption and implementation of risk management policies and procedures for monitoring the Special Interests in the Funds and the risks associated with those interests, taking into account relevant factors noted in OCC guidance (e.g., OCC Banking Circular 277 (BC-277 - October 1993), Supplemental Guidance 1 to BC-277 (January 1999) and the Handbook for National Bank Examiners, Risk Management of Financial Derivatives (January 1997)).

The Bank shall provide the OCC with copies of the policies and procedures described in (i) and (ii) prior to receiving a Special Interest in the funds it manages.

(3) The Bank shall not receive Special Interests in the Funds other than Funds that invest in securities and financial instruments, and the Bank shall not invest in any Fund that holds real estate or tangible personal property.

(4) The Bank shall make reports and other information in the Bank's possession readily available to OCC supervisory staff as necessary for the OCC to determine compliance with these conditions.

(5) The Bank will account for its Special Interests in the Funds under the equity method of accounting.

(6) The Bank will hold Special Interests in a Fund only when, and only for so long as, it is providing investment management services to the Fund.

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

Sincerely,

-signed-

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel