Office of the Comptroller of the Currency

Interpretations - Corporate Decision #96-52

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One First National Plaza
Chicago, Illinois 60670-0287

Re: Notice of The First National Bank of Chicago of intent to establish an operating subsidiary
Application Control Number: 95-ML-08-008

Dear Ms. Walter:

This is in response to the operating subsidiary notice filed on behalf of the First National Bank of Chicago (the "Bank"). The Bank proposes to establish an operating subsidiary that will sponsor a series of trusts that will hold general obligation municipal bonds. Interests in the bonds will be sold to a limited number of institutional investors. For the reasons discussed below, based upon the facts and analysis set forth herein, the Office of the Comptroller of the Currency (the "OCC") hereby approves the Bank's notification.

Background

The new subsidiary (the "Subsidiary") will sponsor a series of trusts (the "Trusts"), each of which will be a partnership for federal income tax purposes. The Subsidiary will be the equivalent of a general partner of the Trusts. The Trusts will invest in tax-exempt general obligation municipal bonds (the "Bonds") or other securities eligible for underwriting and dealing by national banks.<**NOTE:** The Bank will buy the Bonds and sell them to the Subsidiary, which will provide them to the Trusts in exchange for the Certificates, the Sponsor Certificate, and the Residual Interest Certificate.> Each Trust will hold a single issue of Bonds from a single obligor. The Trusts will issue trust interests (the "Certificates") that the Bank will sell by private placement to a limited number of institutional investors. Each Trust will also issue a Residual Interest Certificate, initially held by the Subsidiary, that entitles the holder to any interest received by the Trust that is not payable to the other Certificate holders. Finally, each Trust will issue a non-transferrable Sponsor Certificate that entitles the holder to receive 1% of any payments received on the Bonds. The Subsidiary, as sponsor of the Trusts, will hold the Sponsor Certificates.

Interest on the Certificates will change periodically to follow market rates. The frequency of the changes will depend on the "Mode" of the Certificate (generally weekly, but the mode could be daily, weekly, monthly, or longer term). Interest will be payable *only* from tax-exempt interest received on the Bonds. If the Bonds do not generate enough interest to pay investors the market rate of interest, the Bank and the Subsidiary will *not* have an obligation to make up the difference.

Under the "Tender Option," a Certificate holder may tender the Certificate at any time for remarketing by the Bank. If the Bank is unable to remarket the Certificate, the Bank must purchase the Certificate for the face amount of the Certificate plus accrued interest.<**NOTE:** Upon purchase by the Bank, a Certificate becomes a "Bank Certificate." A Bank Certificate can be immediately exchanged for a pro rata share of the underlying Bonds.> The face amount of the Certificate may be more or less than the actual market value of the underlying municipal bonds, depending on changes in market interest rates. Investors would most likely exercise the Tender Option if short-term interest rates rise above the interest rate the Bonds can fund.

The Sponsor can terminate a Trust, in effect requiring investors to exercise the Tender Option, if certain adverse credit-related events occur (such as a rating downgrade). Upon termination, investors are entitled to receive the price they would have received for a voluntary exercise of the Tender Option (the face amount of the Certificate plus accrued interest) plus ten percent of any appreciation in the value of the Bonds.

The investors' Tender Option terminates automatically if (i) either Moody's or Standard and Poors lowers its rating on the Bonds to below investment grade; (ii) the Bonds default; (iii) the Bonds are determined to be taxable; or (iv) certain other events occur. Upon termination of the Tender Option, Certificate holders would receive their pro rata share of the underlying Bonds.

Under the "Opt-Out Right," a Certificate holder may, at specified times occurring semiannually, "opt-out" and receive the Bonds underlying its interest, less a fee equal to 90 percent of any appreciation in the market value of the Bonds relative to the original purchase price.

The Bank will have some price risk (resulting from interest rate risk and credit risk) due to the proposed transactions. If short-term interest rates rise beyond what the interest provided on the Bonds can fund, or if the Bond obligor for a Trust has a significant rating downgrade, Certificate holders will likely exercise the Tender Option, requiring the Bank to purchase the Certificates at par.<**NOTE:**As noted above, however, a rating downgrade below investment grade or an issuer default will automatically terminate investors' Tender Option, in which case the Bank would *not* be required to purchase the Certificates. Instead, investors would receive their pro rata share of the underlying bonds.> In either case, the Certificates would be worth less than par (either due to the increase in interest rates or the increased credit risk). The Tender Option could, therefore, cause the Bank to purchase the Certificates for a price higher than their market value at the time of the purchase. The Bank's ownership of the Residual Interest Certificate will result in similar risks to the Bank since it will also reflect interest rates and the creditworthiness of the obligor.

The credit risk exposure for the Bank will be minimal because the Bonds will be general obligation municipal securities and because the Bank will be able to immediately terminate a Trust in the event of an obligor default or rating downgrade. The Bank has represented that it will manage the interest rate risk exposure in accordance with its standard interest rate risk management policies.

Discussion

1. Authority

The proposed activities are essentially discounting and negotiating (that is, buying and selling) evidences of debt, one of the expressly-authorized powers granted to banks under 12 U.S.C. 24(7). Section 24(7) expressly authorizes a national bank to discount and negotiate "promissory notes, drafts, bills of exchange, and other evidences of debt." The sentence does not limit either the types of debt instruments a bank may buy and sell or the manner in which the purchases and sales can take place. The evidences of debt upon which the Bank's proposal is based are general obligation municipal bonds that national banks are authorized to purchase, sell, deal in, and underwrite.<**NOTE:** *See, e.g.*, Letter from Robert L. Clarke, Comptroller of the Currency (June 16, 1987), *reprinted in* [1987-1988 Transfer Binder] Fed. Banking L. Rep. (CCH) 86,994.>

Although the proposed structure is complex, all of the elements -- the Trusts, the Opt-Out right, the Tender Option -- are intended to perform a simple function: to change the rate of return on the Bonds from fixed to variable without losing their tax-exempt status.<**NOTE:** *See* G. Wolf, G. Hermann, and A. Glass, *Certain Legal Aspects of Secondary Market Municipal Derivative Products*, 49 Business Lawyer 1629 (1994).> The Bank is buying fixed-rate debt instruments (the Bonds) and selling variable rate debt instruments (the Certificates). The risk to the Bank from its proposed activities is a combination of interest rate risk and some credit risk. These are the types of risks that a bank normally undertakes when it discounts and negotiates debt obligations.<**NOTE:** The partnership structure that the Bank has proposed to use to conduct the proposed activity is similar to one that the OCC approved in 1989. OCC Interpretive Letter No. 496 (December 18, 1989), *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) 83,087.>

2. Glass-Steagall Act

> *a. Section 16* <***NOTE:***Because the Bank's proposal is permissible under 12 U.S.C.. 24(7) and, as is discussed below, does not violate section 16, it cannot violate section 21. *See Securities Industry Association v. Board of Governors of the Federal Reserve System*, 807 F.2d 1052, 1057 (D.C. Cir. 1986) ("section 21 cannot be read to prohibit what section 16 permits").>

Section 16 of the Glass-Steagall Act, 12 U.S.C. 24(7), limits the securities activities of national banks. It provides,

> [The] business of dealing in securities and stock [by a national bank] 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 [bank] shall not underwrite any issue of securities or stock.

Under the Bank's proposal, the Bank will purchase the Bonds and sell them to the Subsidiary, the Subsidiary will provide the Bonds to the Trusts, and the Trusts in exchange will issue to the Subsidiary the Certificates, the Residual Interest Certificate, and the Sponsor Certificate. The Bank will market the Certificates through private placement to sophisticated institutional purchasers, repurchase Certificates it has sold, and resell those Certificates, again, through private placement to the same types of purchasers. Viewed separately, each of these activities would be permissible under section 16. For example, private placement of securities has been held not to constitute underwriting of securities within the meaning of section 16. *Securities Industry Association v. Board of Governors of the Federal Reserve System*, 807 F.2d 1052 (D.C. Cir. 1986). The OCC also has repeatedly taken the position that a national bank may purchase interests in entities -- including investment companies and limited partnerships -- that invest solely in bank-eligible securities. *See* Banking Circular 220 (November 21, 1986), *reprinted in* 5 Fed Banking L. Rep. (CCH) 62-083; Letter from Lee Walzer, Senior Attorney, Securities and Corporate Practices Division (September 5, 1995).

To the extent that the various roles that the Bank will play could be viewed as "dealing" in the Certificates, the dealing would be permissible. When the Bank purchases a Certificate, the Certificate becomes a "Bank Certificate," which the Bank may exchange for a pro rata interest in the underlying municipal bonds. Thus, the nature of the Bank's interest and risk is fundamentally that of acquiring general obligation municipal bonds. If the Bank is "dealing" at all, it is effectively dealing in general obligation municipal bonds, a permissible bank activity.< NOTE: Alternatively, the proposed activities could be viewed as permissible under a transparency analysis. The OCC has applied a transparency analysis to loan-backed securities to find that a national bank may own, underwrite and deal in the interests in loans without violating the Glass-Steagall Act. *See Securities Industry Association v. Board of Governors of the Federal Reserve System, 839 F.2d 47, 62(2d Cir. 1988);* 60 FR 66154, 66155 (December 21, 1995) (list of OCC letters on asset securitization). Such securities are considered to be transparent for purposes of the Glass-Steagall Act, even where the securities have payment characteristics that differ from those of the underlying assets. *Id;* Letter from Robert L. Clarke, Comptroller of the Currency, to the Honorable Alfonse M. D'Amato, Chairman, Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs (June 18. 1986). *See also* H.R. Rep. No. 127, 104th Cong., 1st Sess. at 78 (1995) ("It is . . . recognized that a national bank is 'expressly authorized' to underwrite and deal in . . . bonds collateralized by U.S. Government obligations."). The Certificates here represent interests in tax-exempt municipal general obligation securities that a national bank may purchase, sell, underwrite and deal in without limitation. Therefore, a transparency analysis also supports the conclusion that the Bank may own, underwrite and deal in the Certificates. >

b. Section 20

Section 20 of the Glass-Steagall Act, 12 U.S.C. 377, prohibits affiliation between a bank and a company "engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities." An "affiliate" for this purpose includes any company directly or indirectly controlled by the Bank. 12 U.S.C 221a(b)(1). The Trusts will be affiliates of the Bank under this definition because the Bank will control them through the Subsidiary. As a result, the Bank's proposal will violate section 20 if the Trusts are engaged principally in section 20 activities.

Functionally, some of the basic activities of the Trusts will resemble certain characteristics of investment companies in that they will issue, redeem, and resell shares evidencing interests in the underlying municipal securities. Whether an investment company is engaged principally in section 20 activities depends, however, on whether it is an "open-end" or a "closed-end" investment company. The FRB has explained the distinction between open-end and closed-end investment companies as follows:

> [An open-end investment company] is continuously engaged in the issuance of its shares and stands ready at any time to redeem the securities as to which it is the issuer; a closed-end investment company typically does not issue shares after its initial organization except at infrequent intervals and does not stand ready to redeem its shares.

12 C.F.R. 225.125(c). An open-end investment company is engaged in section 20 activities because it is continuously engaged in issuing its shares. *Investment Company Institute v. Camp*, 401 U.S. 617 (1971). A closed-end investment company, even if it allows occasional redemptions, does not continuously issue its shares and so has been held not to be engaged principally in section 20 activities. *Board of Governors of the Federal Reserve System v. Investment Company Institute*, 450 U.S. 46, 51 (1981).

The Opt-Out Right involves redemption but not reissuance, and it only occurs twice a year, so this feature does not make the Trusts open-end.

The Tender Option is available at any time and so involves continuous redemption and remarketing of the Certificates. However, the *Bank* rather than the Trusts or the Subsidiary will handle remarketing under the Tender Option. The Bank will be responsible for remarketing the Certificates, and the Bank will purchase Certificates that it cannot remarket. Because the Bank, rather than the Trusts, will purchase and remarket the Certificates, the *Trusts* will not be engaged principally in section 20 activities (i.e., continuously redeeming and issuing shares). Moreover, as discussed above, this activity is permissible since the nature of the Bank's interest in the certificates in connection with this activity is fundamentally that of acquiring and reselling general obligation municipal bonds.

Conclusion

In sum, we conclude that the Bank's proposal, as described herein, involves discounting and negotiating evidences of debt, an expressly authorized banking activity which, on the facts presented here, is not curtailed by the Glass-Steagall Act.

Accordingly, the Bank's operating subsidiary notification is approved. If you have any questions, please contact Richard Erb at (202) 874-4610 or David Thede at (202) 874-5210.

Sincerely,
/s/
Julie L. Williams
Chief Counsel