

Date: January 14, 2000

Notice to Establish Operating Subsidiaries

Subject to conditions of approval, a federal savings association may create an operating subsidiary chartered in a foreign country to hold financial assets in order to shelter the income on the investments from state taxes.

Subject: Home Owners' Loan Act/Savings Association Powers

P-2000-1



Office of Thrift Supervision

Department of the Treasury

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

P-2000-1

Chief Counsel

January 14, 2000

MEMORANDUM FOR: Richard M. Riccobono, Deputy Director
FROM: Carolyn J. Buck, Chief Counsel
SUBJECT: Notice to Establish Operating Subsidiaries
Filed by []

I. INTRODUCTION AND SUMMARY CONCLUSION

[] (Association) has requested permission under the OTS Subordinate Organizations Regulation¹ to create four wholly-owned subsidiaries to hold financial assets, which are otherwise legal investments for the Association, in a manner that would shelter income on the investments from State taxes.

The Central Regional Office (Regional Office) has recommended approval of the notice, subject to a non-standard condition. In my opinion, there is an adequate legal basis to approve the notice under 12 U.S.C. § 1828(m) and 12 C.F.R. Part 559, subject to the conditions discussed below.

II. BACKGROUND

A. The Association

The Association, a Federally chartered stock savings association, received a CAMELS rating of “[]” in its most recent examination, concluded on [], 1999. The Association’s compliance examination of [], 1998 yielded [] “[]” rating. As of March 31, 1999, the Association had total assets of \$[], and tangible, core and risk-based capital of []%, []% and []%, respectively.

B. The Transaction

The Association proposes to organize two Delaware business trusts, [] Investment Company [] (“[IC I]”) and [] Investment Company [] (“[IC II]”).² The Association will capitalize these entities by contributing

¹ 12 C.F.R. Part 559 (1999).

² A diagram of the organizational structure of these subsidiaries is included as Attachment A to this memorandum.

to each trust \$[] in assets, consisting of cash, U.S. government and agency securities, and securities guaranteed by the United States or its agencies. The Association will retain all of the beneficial interests in [IC I] and [IC II]. The trustees of each Delaware trust will be [], [] and [], all of whom are officers of the Association. The Association and the two Delaware Trusts will, in turn, establish a [foreign] limited partnership (a “[]”), [] Partnership [] (“[P I]”). [P I] acting with [IC I] and [IC II] will then establish a second [foreign] limited partnership, [] Partnership [] (“[P II]”). The Delaware business trusts structure is employed in the transaction to insure that [P I] is viewed as a limited partnership under [foreign] law.

The Association will make an approximately \$[] asset contribution to [P I] and acquire a 98% limited partnership interest therein. [IC I] and [IC II] will each make an approximately \$[] asset contribution to [P I] and will each acquire a 1% general partnership interest therein. [P I], in turn, will make an approximately \$[] asset contribution to [P II] and will acquire a 98% limited partnership interest therein. [IC I] and [IC II] will each make an approximately \$ [] asset contribution to [P II] and will each acquire a 1% general partnership interest therein. Upon the completion of the proposed investments, legal title to the \$ [] of securities in the Association's investment portfolio will be held by [P II].

The activities of [IC I], [IC II], [P I] and [P II] (the “Portfolio Management Entities”) will be limited to: (i) holding partnership interests in the above-described lower-tier entities and (ii) managing and investing the assets in the Association's investment portfolio that have been contributed to [P II] and hedging the risks associated therewith (subject to the limits on such activities that the Association would be subject to if it were acting directly). By holding the assets in a foreign entity, the Association will reduce its state income tax liability by approximately \$ [].³

The Portfolio Management Entities will maintain at all times physical possession of the assets in the United States as well as perform management of the assets at all times in the United States. The Portfolio Management Entities have entered into a contractual relationship with the Association's United States holding company in [], to provide all investment management services for the assets. Further, the Portfolio Management Entities will secure offices in [], from the Association's holding company where the assets and all related records will be maintained at all times. Finally, all the trustees of the Portfolio Management Entities are employees of the Association and the Association will at all times maintain operating control of the

³ The Association has stated that it may wish to use the Portfolio Management Entities to provide flexibility to pursue other financing and capital raising alternatives. The Association must obtain OTS approval before using the Portfolio Management Entities for any purpose other than to shelter income from State taxes as described in this opinion.

Portfolio Management Entities. The actual conduct of business and the potential impact of any such conduct by the Portfolio Management Entities outside of the United States will be minimal.

By letter dated [], 1999, the Federal Deposit Insurance Corporation informed the Association that it would raise no objection to the formation of the Portfolio Management Entities.

III. ANALYSIS

Generally, a federal association may invest in operating subsidiaries if they comply with applicable regulatory requirements mandating that: (1) the operating subsidiaries engage only in activities permissible for federal associations to engage in directly; (2) the federal association owns, directly or indirectly, more than 50 percent of the voting shares of the subsidiaries; and (3) no person or entity other than the federal association may exercise operating control over the subsidiaries.⁴ These requirements appear to be satisfied as to the Delaware business trusts because: (i) the trusts will invest directly or indirectly in securities that are eligible investments for federal associations; (ii) the Association will own, directly or indirectly, all of the voting interests in the trusts; and (iii) the trusts will not be subject to operating control by anyone other than the Association.⁵

The Association also seeks to establish foreign entities (in this case, two [foreign] limited partnerships). Therefore, we must also consider whether the Association has the authority to do so.

Section 5(a) of the HOLA⁶ authorizes the Director of OTS to provide for the organization, incorporation, examination, operation and regulation of federal savings associations. The courts have recognized that this is an exceptionally broad delegation of power that gives the OTS wide regulatory discretion.⁷ We have the discretion to interpret the HOLA reasonably in light of the legislature's "revealed design."⁸

⁴ 12 C.F.R. §§ 559.2, 559.3(c)(1) and (e)(1) (1999).

⁵ Although the trustees of the trusts are individuals, each is an employee of the Association, and each person's eligibility as a trustee terminates upon termination of the person's employment. The Association has the power to remove existing trustees and appoint replacement trustees.

⁶ 12 U.S.C. § 1464(a).

⁷ *Fidelity Federal Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 160-167 (1982); *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-4 (1984).

⁸ *United States v. Haggard Apparel Company*, 526 U.S. 380 (1999); *Nations Bank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 257 (1995) (determination of Comptroller of Currency that national banks may serve as agents in sale of annuities was reasonable construction of National Bank Act); *Chevron*, 467 U.S. at 843-44.

From the outset, the federal thrift charter has had a domestic focus. The HOLA was passed in response to the Great Depression of the 1930s to stabilize the housing industry and provide a more accessible means of credit for home buyers. Over time, the permissible investment and lending activities of federal thrifts have expanded to meet evolving credit needs but the HOLA has nonetheless retained a domestic flavor. Its focus is primarily on providing credit for housing and other services to consumers within the United States. We must consider any proposed foreign activity in this context. To this end, we will carefully examine any proposed foreign activity to determine whether it is incidental to the domestic focus of the thrift charter. Such activities are generally consistent with the HOLA.

In considering whether a proposed foreign activity is incidental to a domestic focus of operations we are guided by commonly accepted definitions of incidental activities including, among other things, whether the proposed activity is: (1) encountered casually or by accident; (2) subordinate, nonessential or inconsequential; or (3) ancillary to the otherwise authorized operations.⁹ In considering whether a proposed activity is incidental, it may also be instructive in some cases to compare OTS legal opinions on the incidental powers of federal savings associations.¹⁰

In this instance, using a foreign entity to manage and invest assets is ancillary to the Association's main activities because it supports the thrift's domestic operations by reducing its cost of operation. The Association's domestic operations subject it to state tax liability. The Association can lawfully reduce its state tax liability by establishing the proposed entities, including the foreign limited partnerships. The Association's sole reason for establishing the foreign entities is to reduce its domestic tax liability, consistent with State law.¹¹ The foreign entities are simply tools the Association proposes to employ to reduce State taxes. The focus of the thrift's operations will remain domestic. For these reasons, we believe the proposed formation of the foreign limited partnerships as operating subsidiaries is incidental to the domestic focus of the federal thrift charter and permissible under the HOLA, subject to safety and soundness considerations.¹²

⁹ See, Webster's Third New International Dictionary of the English Language (Unabridged); Laurence Urdang, *The Oxford Thesaurus: American Edition* (Oxford 1992).

¹⁰ See, e.g., OTS Op. Acting Chief Counsel (March 25, 1994); OTS Op. Acting Chief Counsel (October 17, 1994).

¹¹ The Association has submitted a written opinion from an independent accounting firm concluding that dividends and income earned by the Portfolio Management Entities should not be taxable under pertinent State laws.

¹² In 1994, we concluded that a federal savings association could establish an operating subsidiary in Bermuda to manage a substantial portion of the association's investment portfolio. OTS Op. Acting Chief Counsel (July 6, 1994). As is the case here, the purpose of the operating subsidiary was to reduce the association's State income tax liability. The analysis in this opinion applies with equal force to the activity described in the 1994 opinion. Although the 1994 opinion contains dicta that might be interpreted in various ways, the opinion should be read only in light of the facts then before the agency. It

The proposed limited partnerships also comply with general regulatory operating subsidiary requirements because they will invest only in securities that are eligible investments for federal associations and no parties other than the Association will have effective operating control of the limited partnerships.¹³ However, these same regulations appear to assume that operating subsidiaries must have “voting shares.”¹⁴ Because the proposed limited partnerships will not have voting shares we must address whether an operating subsidiary may be structured as a limited partnership. The preamble to the final regulation on subordinate organizations explains that OTS, on a case-by-case basis, may permit thrifts to establish operating subsidiaries in noncorporate form in the absence of safety and soundness concerns:

While OTS that expects the vast majority of operating subsidiaries will continue to be structured as corporations, in the interest of increasing federal thrifts’ flexibility in structuring their operations, the agency has . . . [removed] specific references to “incorporation”. An operating subsidiary must still satisfy the basic requirements of majority ownership interest, limited liability, and effective operating control. Not all forms of organization will meet those requirements. OTS will therefore continue to address requests by thrifts to establish an operating subsidiary in a noncorporate form on a case-by-case basis through its § 559.11 notice and review process. Organizational forms that meet the requirements of the regulations and do not present safety and soundness concerns will be permitted.¹⁵

In this case, neither the Regional Office nor OES has expressed supervisory concerns with the limited partnerships, and accordingly, we have no objection to the organizational form of the limited partnerships.

The Regional Office’s digest notes that the Association has addressed a number of safety and soundness issues in the materials accompanying the notice it filed with the OTS. The Regional Office believes it would be appropriate to approve the transaction, subject to written conditions to address the unique risks presented by a foreign operation. We raise no legal objection to the imposition of these conditions, and have included them as Attachment B.

does not authorize any savings association to undertake any activity beyond the activity the association requested.

¹³ 12 C.F.R. § 559.3 (1999).

¹⁴ 12 C.F.R. § 559.3(c)(1)(1999).

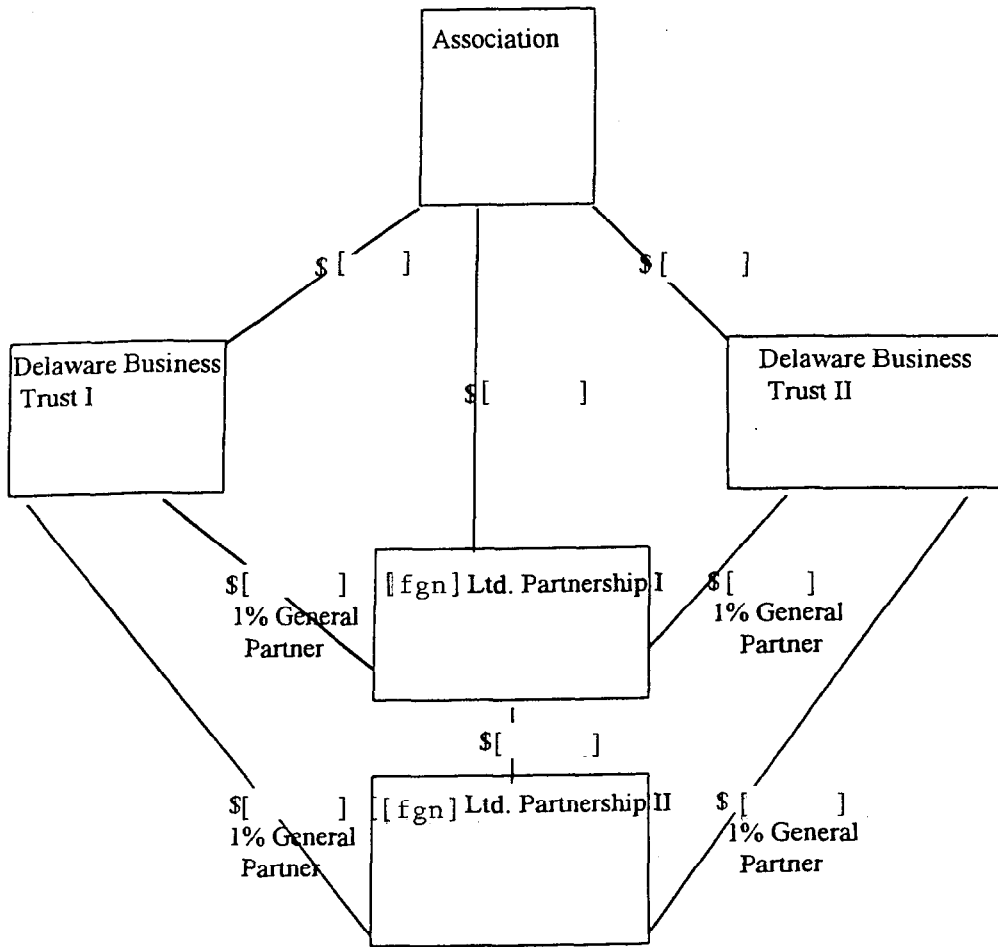
¹⁵ 61 Fed. Reg. 66,561, 66,564 (Dec. 18, 1996).

Accordingly, in our view, there is an adequate legal basis for approving this application, subject to the recommended conditions.

Attachment

cc: Regional Director, Central Region
Regional Counsel, Central Region
Ellen Fowler, Central Regional Office
Lane Langford, OES

Attachment A



Attachment B

CONDITIONS OF APPROVAL

OTS authorization for the Association to establish Delaware and [foreign] operating subsidiaries is subject to the following conditions:

- 1) The activities of the operating subsidiaries shall be conducted in accordance with the representations made in the Association's notice, as supplemented by letters to the OTS dated [] , and [] , 1999. In particular and without limitation, the location and organization of the operating subsidiaries shall be limited to, and in accord with, the laws of, Delaware and [frgn country] and, absent written authorization from the OTS Central Regional Director ("Regional Director), the total amount of assets transferred to the operating subsidiaries shall not exceed \$ [] .
- 2) The Association must establish and document internal controls that demonstrate adequate oversight of the operating subsidiaries, and provide materials documenting the establishment of such internal controls to the Regional Director.
- 3) The operating subsidiaries shall make available to the OTS such information as the OTS deems necessary from time to time to monitor the operating subsidiaries' activities and the effect of those activities on the safe and sound operation of the Association. The operating subsidiaries shall maintain a duplicate set of records in the United States at the Association's home office, or, if satisfactory to the Regional Director, elsewhere in the United States as otherwise represented in the notice materials.
- 4) The operating subsidiaries and any institution-affiliated party associated with the operating subsidiaries shall consent in writing to the jurisdiction of the U.S. over, and the applicability of U.S. law to, the operating subsidiaries and its institution-affiliated parties for purposes of all claims made by, proceedings initiated by, or obligations to, the U.S., the OTS and any U.S. governmental agency, department or division, and shall consent in writing to the jurisdiction of the OTS over the operating subsidiaries and its institution-affiliated parties for purposes of examination, supervision and enforcement. The operating subsidiaries and their institution-affiliated parties shall further agree in writing not to challenge the authority of any conservator/receiver appointed for the Association to control the Association and the Association's interests in the operating subsidiaries.
- 5) The operating subsidiaries shall submit a reasoned opinion of counsel in a form acceptable to the OTS indicating that there are no [foreign] laws that would restrict OTS access to, or enforcement authority over, the operating subsidiaries or its institution-affiliated parties.
- 6) The operating subsidiaries shall maintain a registered agent in the Association's home office or, if satisfactory to the Regional Director, elsewhere in the United States

as otherwise represented in the notice materials, to receive service of process on any subsidiary's behalf.

7) The operating subsidiaries shall consent in writing to the disclosure by [foreign] governmental authorities to the OTS of such information on its operations and its affiliates that the OTS deems necessary from time to time to determine and enforce compliance with applicable U.S. law.

8) The operating subsidiaries shall provide all financial statements in U.S. dollars in accordance with generally accepted accounting principles, including financial information required to be submitted quarterly in the Thrift Financial Report.

9) The Regional Director must be promptly informed, in writing, of all changes in the directors, officers, and employees or managers of the operating subsidiaries.

10) The operating subsidiaries and the Association shall agree in writing to terminate operations of the operating subsidiaries as soon as possible (but no later than 30 days) after being advised in writing that the OTS, in its sole discretion, has determined that such operations present undue risk.

The documents required by conditions 2, 4, 5, 7 and 10 shall be submitted to the Regional Director. Once these documents are submitted and the Regional indicates in writing that the documents are in acceptable form, the Association may transfer securities to the operating subsidiaries and commence operations, subject to the foregoing conditions. The OTS intends to closely monitor the operations of the operating subsidiaries on an ongoing basis and to conduct a focused review one year after the subsidiaries commence operations.