Authority of Federal Savings Associations to Underwrite and Deal in Municipal Securities

Summary Conclusion: A Federal savings association has authority to underwrite and deal in certain municipal securities issued by states and their political subdivisions, subject to certain restrictions.

Date: October 29, 2001

Subjects: Home Owners' Loan Act/Savings Association Powers

P-2001-10

Office of Thrift Supervision
Department of the Treasury
Chief Counsel
1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

October 29, 2001

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Re: Authority of Federal Savings Associations to Underwrite and Deal in Municipal Securities

Dear [ ]:

This responds to your firm's recent letters on behalf of [ ] ("Association"), a federal savings association. You have asked whether the Association may underwrite and deal in certain securities issued by States and their political subdivisions. In brief, we conclude that the Association has authority to engage in the proposed activities, subject to certain restrictions.

I. Background

Under the proposal you have described in a series of letters, the Association would underwrite and deal in the following types of securities issued by States and their political subdivisions ("municipal securities"): (1) general obligation bonds; (2) municipal revenue bonds; and (3) municipal notes. The Association would limit its activity to municipal securities that either: (1) are investment grade; (2) carry municipal bond insurance to raise the issue to an investment grade rating; or (3) otherwise meet the Association's established underwriting standards. The activity also would be subject to the conditions on investments in municipal securities in 12 C.F.R. § 560.42 and any other limitations or restrictions imposed by the Office of Thrift Supervision ("OTS"). The Association expects to act as sole underwriter only on small issues and as a member of an underwriting syndicate on larger issues.

The Association is well capitalized. It intends to limit its total investment in municipal securities to $[ ] million, an amount that currently represents approximately three percent of total capital, with a limit of $[ ] million (about 1% of capital) on the market value of all municipal securities held in the Association's combined trading and syndicate accounts and a limit of $[ ] million (about 2% of capital) on securities held in its pre-sold municipal securities account.

You indicate that the Association has an established department, known as the "[Department]," which, among its activities, provides both banking and financial advisory services to [State A] municipalities. With respect to banking services, you represent that the Association is the primary depository bank for [ ] local government entities and has a significant depository relationship with [ ] others. With respect to financial advisory services, you represent that the [Department] advises [ ] municipal clients regarding borrowing, debt policies, and capital improvement programs, including whether to issue municipal securities.[1]

The Association would offer municipal securities to three target groups: (1) the [Department's] institutional customers; (2) the Association's and Service Corporation's retail customers; and (3) to the extent permitted by regulations of the Office of the Comptroller of the Currency ("OCC") and [State A] law, fiduciary accounts of the Association's national bank subsidiary, which engages only in providing trust services.[2]

Representatives of the Association and your firm have had extensive discussions with staff in OTS's Regional Office and Washington Headquarters about the Association's proposal. The Association has identified underwriting risk, credit risk, market risk, and operational risk as the primary risks of the proposed activities. To mitigate such risks and to ensure that the proposed activities would be conducted in a safe and sound manner, the Association, as stated in its business plan, would do the following: (1) initially act as sole underwriter only on small issues and as a member of an underwriting syndicate on larger issues, thus limiting its exposure to any one offering (the Association would increase its participation level only after its customer base increased and it proved its ability to place its allotments); (2) primarily underwrite and deal in municipal securities issued by [State A] municipalities (which the Association indicates generally have above average credit quality for municipal issuers); (3) subject to any additional limitations or restrictions imposed by OTS, underwrite and deal in municipal securities that are investment grade, carry municipal bond insurance to raise the issue to an investment grade rating, or otherwise meet the Association's established underwriting standards; (4) hold municipal securities in the Association's trading account that (i) meet customer requirements, (ii) are generally of good liquidity and short

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[1] In addition, through its service corporation, [ ] ("Service Corporation"), the Association provides brokerage and investment advisory services. The Service Corporation is registered as a broker-dealer and a municipal securities dealer with the Securities and Exchange Commission ("SEC") and [State A]. OTS concluded recently that the Service Corporation may underwrite and deal in securities of States and their political subdivisions. OTS Op. Chief Counsel (June 19, 2001).

[2] You have represented to us that the Association's intended sales and marketing activities do not currently require it or the [Department] to register as an investment adviser under the Investment Advisers Act, 15 U.S.C.A. § 80b-1 et seq. (West, WESTLAW through P.L. 107-11) or equivalent state investment advisor registration requirements.

duration, and (iii) except as 12 C.F.R. § 560.42 may otherwise permit, are of high credit quality; (5) establish a maximum position size for the trading account and "mark to market" municipal securities in the trading account on a daily basis; and (6) employ experienced Association personnel and hire additional employees with the requisite experience, as needed, to support the proposed activities.

II. Discussion

A federal savings association may underwrite and deal in municipal securities as described in Part I under the municipal securities authority in section 5(c)(1)(H) of the Home Owners' Loan Act ("HOLA"), or because such activities are subsumed within that authority. Accordingly, the Association may conduct these activities subject to the conditions set forth below.[3]

HOLA section 5(c)(1)(H) authorizes federal savings associations to "invest in, sell, or otherwise deal in . . . [i]nvestments in obligations issued by any State or political subdivision thereof (including any agency, corporation, or instrumentality of a State or political subdivision)."[4] OTS's regulations implementing this provision similarly indicate that "a federal savings association may make, invest in, purchase, sell, participate in, or otherwise deal in (including brokerage or warehousing) . . . State and local government obligations."[5] These references to obligations of States and political subdivisions encompass the types of municipal securities the Association proposes to underwrite and deal in.

A brief review of legislative amendments to HOLA section 5(c) illustrates Congress's expansion of the municipal securities authority of federal savings associations over time. In 1964, Congress first authorized federal savings associations to "invest[] in . . . general obligations of any States or of any political subdivision thereof."[6] In 1973, Congress authorized federal savings associations to "invest in" and "purchase for [their] own account shares of stock issued by" state housing corporations.[7] In 1978, Congress expanded the section 5(c) authority to enable federal savings associations to "invest in,

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[3] Since OTS concludes that the particular dealing and underwriting activities involved here are expressly authorized, we do not need to reach the potential application of the incidental powers doctrine.

[4] 12 U.S.C.A. § 1464(c)(1)(H) (West, WESTLAW through P.L. 107-11).

[5] 12 C.F.R. § 560.30 (2001).

[6] Section 907 of the Housing Act of 1964, Pub. L. 88-560, 78 Stat. 769.

[7] Section 5 of the Act of August 16, 1973, Pub. L. 93-100, 87 Stat. 342.

sell, or otherwise deal with . . . investments in general obligations of any State or any political subdivision thereof."[8]

In 1982, Congress removed the limitation that the securities be "general obligations" and specifically provided that the securities may include those issued by "any agency, corporation, or instrumentality of a state or political subdivision."[9] These revisions were among several changes that expanded the powers of federal savings associations.[10] In making these changes, Congress acknowledged the need for savings associations to have more flexibility to expand the range of services they provide to their customers and to improve their ability to generate earnings to sustain the growth in capital needed for future operations.[11] Congress noted that by limiting federal savings associations from investing more than ten percent of their capital in the obligations of any one governmental unit, it was "making this investment authority comparable to the National Bank Act limitation on investment securities."[12]

In 1989, Congress again amended the powers of federal savings associations. This time, however, it changed the language of HOLA section 5(c) to provide that federal savings associations "may invest in, sell, or otherwise deal in" various types of investments, rather than "deal with" these investments.[13]

You have not provided, and OTS has not found, any specific legislative history illuminating the meaning Congress intended in using the phrase "deal with" in 1978, or

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[8] Section 1701 of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. 95-630, 92 Stat. 3641 (emphasis added). In 1980, Congress recodified this authority but left the language on "dealing with" securities unchanged. See section 401 of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, 94 Stat. 132.

[9] Section 324 of Garn-St Germain Depository Institutions Act of 1982, Pub. L. 97-320, 96 Stat. 1469. The statute limited an association from investing more than 10 percent of its capital and surplus in the obligations of any one issuer, exclusive of investments in general obligations. Congress left the phrase "dealing with" various types of investments unchanged.

[10] As stated in the Senate Conference report for the 1982 amendments, the amendments "provide federal thrift institutions with more liberal chartering options; the ability to offer stock; the authority to accept demand deposits from commercial, corporate, and agricultural customers who have established a loan relationship with the thrift; expanded real estate investment authority; ... the ability to invest in a broad range of government securities ... [and] authority to invest in commercial, corporate and agricultural loans up to a specified percentage of their assets." S. Conf. Rep. 97-641 at 87-88 (1982).

[11] H.R. Conf. Rep. No. 97-899 at 87 (1982); S. Conf. Rep. 97-641 at 87 (1982); S. Rep. 97-536 at 13 (1982).

[12] S. Conf. Rep. 97-641 at 88.

[13] Section 5 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, 103 Stat. 183.

changing the wording to "deal in" in 1989. However, a basic canon of statutory construction is that "[i]n the absence of legislative intent to the contrary, or other overriding evidence of a different meaning, technical terms or terms of art used in a statute are presumed to have their technical meaning."[14] As is the case here, "the sense of a word that is commonly used as a term of art in a particular discipline is the relevant sense for purposes of statutory construction, where the statute being construed deals with that discipline."[15] While HOLA is generally regarded as a banking statute, it contains several provisions on securities, including section 5(c)(1)(H).[16]

One who "deals in" securities is a "dealer," a well-established term of art under securities law. Its use in securities law predated its use in HOLA by half a century. The intervening decades were marked by increasing public awareness of, and participation in, the stock market.

Under section 2(a)(12) of the Securities Act of 1933, "[t]he term 'dealer' means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."[17] Similarly, under section 3(a)(5) of the Securities Exchange Act of 1934, "[t]he term 'dealer' means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."[18] Accordingly, in the absence of any identifiable legislative history suggesting Congress intended in HOLA section 5(c) to use the term "deal in" in anything other than its technical meaning, we conclude that the authority to deal in municipal securities is expressly authorized under HOLA section 5(c)(1)(H).

Further, the use of the term "deal in" conformed the terminology of HOLA section 5(c)(1)(H) to the authority already possessed by national banks. Section 21 of the Glass-Steagall Act, adopted over 50 years before these HOLA amendments, prohibited securities dealers from engaging in the banking business, but specifically provided that national banks or other financial institutions were not prohibited from "dealing in, underwriting, purchasing, and selling investment securities" to the extent permitted for

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[14] Sutherland Stat. Const. § 47.29 (5th Ed. 1992) (citing among other authorities Hawley v. Diller, 178 U.S. 476 (1899) and Corning Glass Works v. Brennan, 417 U.S. 188 (1974)).

[15] United States v. Cuomo, 525 F.2d 1285, 1291 (5th Cir. 1976).

[16] See also 12 U.S.C.A. § 1464(c)(1)(C) and (F) (West, WESTLAW through P.L. 107-11) (additional examples of securities provisions).

[17] 15 U.S.C.A. § 77b(a)(12) (West, WESTLAW through P.L. 107-11).

[18] 15 U.S.C.A. § 78c(a)(5) (West, WESTLAW through P.L. 107-11).

national banks under section 24 of the National Bank Act ("Bank Act").[19] Under section 24(Seventh) of the Bank Act the general limitations on a national bank on "dealing in, underwriting and purchasing for its own account, investment securities" do not apply to "general obligations of any State or of any political subdivision thereof."[20] Accordingly, absent any contrary evidence of legislative intent, we conclude that the authority of a federal savings association to "deal in" municipal securities is consistent with the authority of national banks and thus, federal savings association may engage in similar activities.[21]

The Association also proposes to underwrite the following types of securities issued by States and their political subdivisions: (1) general obligation bonds; (2) municipal revenue bonds; and (3) municipal notes. The authority to underwrite municipal securities is subsumed within the authority to "invest in, sell, or otherwise deal in" municipal securities under HOLA section 5(c)(1)(H). The term "underwriter" is defined in securities law, in relevant part, as:

> 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, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.[22]

Broken into its component parts, underwriting is a form of investing, selling, or dealing:

(1) An underwriter assumes the risk of purchasing a new issue from an issuer with a view to the distribution of a security, and offers or sells for an issuer in connection with the distribution of a security.[23] In doing so, an underwriter creates a market for a newly

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[19] 12 U.S.C.A. § 378(a)(1) (West, WESTLAW through P.L. 107-11).

[20] 12 U.S.C.A. § 24(Seventh) (West, WESTLAW through P.L. 107-11).

[21] We note that OCC recently amended its regulations governing the authority of national banks to underwrite and deal in municipal bonds to reflect a statutory amendment to 12 U.S.C. § 24(Seventh) contained in section 151 of the Gramm-Leach-Bliley Act, Pub. L. 106-102 (Nov. 12, 1999). 66 Fed. Reg. 34,784 (July 2, 2001).

[22] Section 2(a)(11) of the Securities Act of 1933; 15 U.S.C.A. § 77b(a)(11) (West, WESTLAW through P.L. 107-11). Accord 15 U.S.C.A. § 80b-2(a)(20) (West, WESTLAW through P.L. 107-11) (same definition under Investment Advisers Act of 1940 (IAA)); 15 U.S.C.A. § 78c(a)(20) (West, WESTLAW through P.L. 107-11) (Securities Exchange Act of 1934 definition cross-referencing of underwriter cross-referencing IAA definition).

[23] Federal Securities Law Reports (CCH), Law § 2(11), ¶ 1551.010 (1990); Dictionary of Finance and Investment Terms (3d ed. 1991) at 491.

issued security and evaluates the market value of an issue that has never traded before. In performing these activities, the underwriter is engaging in forms of investing and selling, including selling functions similar to creating a market for any financial product or service and pricing it. The risk is similar to the risk that exists whenever resources are spent on developing a new financial product and service that may or may not sell.

(2) An underwriter participates or has a direct or indirect participation in the distribution of a security, or participates or has a participation in the direct or indirect underwriting in the distribution of a security.[24] In performing these activities, the underwriter is engaging in selling functions.

While "underwriting" and "dealing in" securities differ in significant ways,[25] underwriting municipal securities also comes within the authority of HOLA section 5(c)(1)(H).[26] Accordingly, federal savings associations have authority to both underwrite and deal in the following types of securities issued by States and their political subdivisions: (1) general obligation bonds; (2) municipal revenue bonds; and (3) municipal notes.

II. Compliance with Applicable Law and Conditions

We conclude that the Association has authority to conduct the proposed activities of underwriting and dealing in certain securities issued by States and their political subdivisions described above. In conducting the activities, however, the Association must comply with all applicable laws and regulations, as well as the following conditions:

1. The Association must comply with the Interagency Statement on the Sale of Nondeposit Investment Products.[27] Accordingly, among other requirements, the Association must disclose to customers that the municipal securities being offered for sale are not insured by the FDIC; are not deposits or other obligations of the Association

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[24] Federal Securities Law Reports (CCH), Law § 2(11), ¶ 1551.010 (1990).

[25] The definition of "dealer" depends on the person's general activities rather than his or her conduct in a particular offering. Louis Loss, Securities Regulation, 1138.71 (3rd ed. 1999). Some dealers never underwrite and some underwriters do not deal in securities. Unlike an underwriter, a dealer provides liquidity to a market that already exists, both buys the security from and sells the security to the public, and accepts the market value as given, quoting a bid-ask spread around it.

[26] We have not been asked to consider, and this opinion expresses no view on, the permissibility of a federal savings association underwriting and dealing in other types of securities (i.e., non-municipal securities).

[27] OTS Thrift Bulletin 23-2 (Feb. 22, 1994) (Interagency Statement on Retail Sales of Nondeposit Investment Products).

and are not guaranteed by the Association; and are subject to investment risk, including possible loss of the principal invested.

2. The Association must register its [Department] with the SEC as a municipal securities dealer.[28] The [Department] will be subject to the financial reporting, anti-fraud, and financial responsibility rules applicable to municipal securities broker-dealers. In addition, the [Department] will be subject to the rules of the Municipal Securities Rulemaking Board ("MSRB"). Both OTS and the SEC will have jurisdiction over the [Department].[29]

3. The [Department] must either refrain from engaging in activities that would necessitate registration under the Investment Advisers Act or must register as an investment adviser.

4. In the course of underwriting and dealing, the Association and its [Department] must comply with all applicable statutory and regulatory limitations and conditions on ownership of municipal securities.[30]

5. The Association also must comply with the supervisory conditions listed in the attachment to this opinion.[31]

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[28] Under a recently promulgated SEC interim final rule, savings associations are exempt from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934 on the same terms and under the same conditions that banks are excepted or exempted. 66 Fed. Reg. 27,760, 27,788, 27,800 (May 18, 2001) (promulgating 17 C.F.R. § 240.15a-9). However, a bank or savings association that is a "municipal securities dealer" must register and be regulated as a municipal securities dealer under section 15B of the Securities Exchange Act. Id.; 66 Fed. Reg. at 27,788 n. 245 (citing 15 U.S.C. 78o-4). See also SEC Release No. 34-44570 (July 18, 2001) and 66 Fed. Reg. 38,370 (July 24, 2001).

[29] A savings association that acts as a municipal securities dealer is considered a bank municipal securities dealer for purposes of the Securities Exchange Act and the rules thereunder, including the rules of the MSRB. 66 Fed. Reg. at 27,800 (promulgating 17 C.F.R. § 240.15a-9). Section 3(a)(34)(A)(iv) of the Securities Exchange Act, 15 U.S.C. § 78c(a)(34)(A)(iv) (West, WESTLAW through P.L. 107-11), designates the OCC, FDIC, and Federal Reserve Board as the appropriate regulatory agency of a bank municipal securities dealer and the SEC as the appropriate regulatory agency of other municipal securities dealers (including savings associations by default). See also 66 Fed. Reg. at 27,788 n.245. At the same time, functional regulation does not limit OTS's oversight of activities conducted within the Association itself, including the [Department].

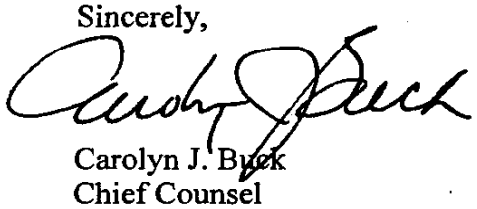
[30] The [Department] may not enter into a binding commitment to sell at a guaranteed price or within a guaranteed time any securities that the Association is not authorized to invest in under applicable statutes and regulations. OTS will view such a de facto commitment as an investment in the securities.

[31] Other federal savings associations that may be interested in dealing in or underwriting municipal securities should first contact their OTS Regional Office, which may set supervisory conditions on approving such proposals.

In reaching these conclusions, we have relied on the factual information and representations in the materials your firm submitted to us and in subsequent telephone conversations with individuals from your firm, as described in the Background discussion above. Our conclusions depend upon the accuracy and completeness of such information and materials. Any material differences or changes in facts or circumstances from those submitted to us and described in this letter could result in different conclusions.

Please feel free to contact Richard Bennett, Counsel (Banking and Finance), at (202) 906-7409, or Vicki Hawkins-Jones, Assistant Chief Counsel, at (202) 906-7034 if you have any further questions.

Sincerely,



Carolyn J. Buck
Chief Counsel

Attachment

cc: All Regional Directors
All Regional Counsel

Attachment

Supervisory Conditions

OTS's approval of the Association's underwriting of and dealing in municipal securities is subject to the following supervisory conditions:

1. The Association must adopt policies and procedures, including appropriate limits on exposure, to govern its participation in transactions the [Department] underwrites or arranges. The Association must submit the policies and procedures to the OTS [ ]Regional Office ("Regional Office") for its review prior to the [Department] commencing these activities. The Association must undertake an independent and thorough credit evaluation in connection with its participation in such transactions and must maintain adequate documentation of the evaluation for OTS review.

2. The Association must limit its entire exposure to 25 percent of core capital, including any municipal securities underwriting exposure of its service corporations and subsidiaries. The Association must limit its direct municipal security underwriting exposure to 15 percent of the Association's core capital for 24 months. After that time, the Regional Office may approve an expansion to 25 percent or more of core capital, provided the activity is performed in a safe and sound manner. For purposes of this approval, "underwriting exposure" means the amount of municipal securities held by the Association, service corporations, or subsidiaries for underwriting purposes, plus any commitments to purchase securities for underwriting purposes.

3. The Association must maintain a well-capitalized status in order to underwrite or deal in municipal securities.

4. The Association must notify the Regional Office before underwriting or dealing in municipal securities for jurisdictions outside of [State A].

5. The Association must obtain OTS approval before underwriting or dealing in any municipal securities that do not meet OTS regulatory requirements. To the extent the [Department] may wish to underwrite or deal in municipal securities that the Association is not authorized to invest in, it must do so through a consignment agreement with the issuer so that neither the Association nor its [Department] takes ownership of the securities.

6. The Association must submit to the Regional Office copies of any reports or notices that the [Department] or the Association files with the SEC or a self-regulatory securities organization.

7. The Association must submit any information required by the Regional Office to monitor compliance with the representations and commitments made by the [Department] or the Association.

OTS also encourages the Association to carry directors and officers insurance to mitigate litigation risk from customers who buy securities from the [Department] that may subsequently lose value.