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Federal Housing Finance Board

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March 31, 1994

Carol A. Jackson
Group Vice President
Chief Credit Officer
Federal Home Loan Bank of Atlanta
1475 Peachtree Street, N.E.
Atlanta, Georgia 30309

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ENCLOSURE
FEDERAL HOUSING FINANCE BOARD
ATLANTA

Dear Ms. Jackson:

This letter is in response to your correspondence of December 20, 1993 to Philip L. Conover, which has been referred to me for reply.

Enclosed is a legal memorandum prepared by my office addressing your question whether shares of a particular mutual fund may be accepted as collateral under section 10(a)(1) and/or (2) of the Federal Home Loan Bank Act ("Bank Act") pursuant to a "functional equivalence" theory. The memorandum concludes that section 10(a)(1) and (2) reasonably may be interpreted by the Federal Housing Finance Board ("Finance Board") to permit the acceptance of such shares as collateral, where ownership of the shares is the functional equivalent of ownership of the underlying assets and all of the underlying assets qualify as eligible collateral under section 10(a)(1) or (2).

However, to date, the Finance Board has not adopted such an interpretation either in the collateral provisions of its current advances regulation or by adoption of a policy statement. Thus, as of this time the acceptance of such shares as collateral is not authorized.

The legal memorandum also concludes, however, that under the Finance Board's current advances regulation, the Federal Home Loan Bank has the discretion to determine whether such mutual fund shares qualify as other real estate-related collateral under section 10(a)(4) of the Bank Act.

Please feel free to call me at (202) 408-2990 if you have any additional questions.

Sincerely,

Beth L. Climo
General Counsel

Enclosure

cc: Paul B. Heroux



Federal Housing Finance Board

March 25, 1994

MEMORANDUM

TO: Beth L. Climo
General Counsel

THROUGH: Renie Y. Grohl *Be for*
Deputy General Counsel *hwa*

FROM: Sharon B. Like *SL*
Attorney/Advisor

SUBJECT: Acceptance of Mutual Fund Shares as FHLBank Collateral

Issue: Whether shares in a particular mutual fund are eligible collateral for Federal Home Loan Bank ("FHLBank") advances under the Federal Home Loan Bank Act ("Bank Act") and the Federal Housing Finance Board's ("Finance Board") advances regulation?

Conclusion: The plain language of section 10(a)(1) and (2) of the Bank Act and of the Finance Board's advances regulation does not specifically address the authority of the FHLBanks to accept mutual fund shares as collateral for FHLBank advances. However, the Finance Board may reasonably interpret section 10(a)(1) and (2) as authorizing the acceptance of such shares as collateral, where ownership of the shares is the functional equivalent of ownership of the underlying assets of the fund, and all of the underlying assets qualify as eligible collateral under section 10(a)(1) or (2). Such an interpretation should be formally adopted by the Finance Board acting with a quorum, either through amendment of the collateral provisions of the Finance Board's existing advances regulation, or by adoption of a policy statement.

If such an interpretation were adopted by the Finance Board, then the mutual fund shares at issue would appear to qualify as eligible collateral. This is because under the business trust organization of the fund, ownership of the fund shares appears to be the functional equivalent of ownership of the fund's underlying assets, and the fund appears to invest solely in securities that qualify as eligible collateral under section 10(a)(1) or (2). In addition, a security interest in the fund's shares appears to be perfectible. However, all of these facts would need to be verified by the FHLBanks before the fund shares could be determined to be eligible collateral.

In addition, under the Finance Board's advances regulation, it is within each FHLBank's discretion to determine whether shares

of a particular mutual fund are acceptable as other real estate-related collateral under section 10(a)(4) of the Bank Act.

I. BACKGROUND

The FHLBanks of Atlanta and New York have requested that the Finance Board address whether shares owned by FHLBank members in a particular mutual fund are eligible collateral for FHLBank advances under section 10(a)(1) and/or (2) of the Bank Act, based on the view that ownership of the mutual fund shares is the same as, i.e., the functional equivalent of, ownership of the underlying assets of the fund. See 12 U.S.C. § 1430(a)(1), (2). The FHLBanks have concluded that the mutual fund shares would otherwise qualify as other real estate-related collateral under section 10(a)(4) of the Bank Act. See id. § 1430(a)(4). This memorandum addresses the functional equivalence argument, as well as the contention that the mutual fund shares qualify as other real estate-related collateral.

Mutual funds, also known as open-end management investment companies, are typically organized as business (or common law) trusts, which invest the pooled funds of small investors in securities appropriate for the funds' stated investment objectives. See Dictionary of Finance and Investment Terms (Barron's 1985); "The Massachusetts Business Trust and Registered Investment Companies," 13 Del. J. Corp. Law 421 (1988). The trustees hold legal title to the securities and, in accordance with the terms of the trust instrument, manage and control such property for the benefit of beneficiaries whose interests are represented by transferable certificates. See 12A C.J.S. Business Trusts § 2. The certificates entitle the beneficiaries to share ratably in the income of the property and, on termination of the trust, in the proceeds thereof. See id. Mutual funds often are structured as Massachusetts business trusts, because Massachusetts business trust law does not impose certain restrictions, requirements and costs frequently imposed by state laws on organizations structured in the corporate form. See 13 Del. J. Corp. Law 421.

The mutual fund at issue is Federated ARMs Fund Institutional Shares ("Fund"), a Massachusetts business trust which, according to its Prospectus, invests in a diversified portfolio of securities. See Fund Prospectus (October 31, 1993) ("Prospectus").

II. ANALYSIS

A . Creation of Perfectible Security Interest

Section 10(a) of the Bank Act, as implemented in the Finance Board's advances regulation, provides that each FHLBank shall make only fully secured advances to its members. See 12 U.S.C. § 1430(a); 12 C.F.R. § 935.4(c)(1). The Finance Board's advances regulation provides that a FHLBank must execute a written security

agreement with each borrowing member which establishes the FHLBank's security interest in the collateral securing advances, and which gives the FHLBank a perfectible security interest in the collateral. See 12 C.F.R. § 935.5(c)(2), (3). Thus, in order for the shares of the mutual fund to be eligible collateral, the FHLBank first must establish whether a valid security interest can be created in such shares, and whether the security interest is perfectible.

The Fund's counsel has advised the FHLBank of Atlanta that a perfectible security interest can be created in the Fund's shares. See Memorandum from Robert C. Rosselot to Carroll Bray, dated Oct. 18, 1993, pp. 5-7 ("Rosselot Memorandum").

B. Eligible Collateral Requirements

If a perfectible security interest can be created in the Fund's shares, then it is necessary to determine whether the Fund's shares qualify as eligible collateral under section 10(a) of the Bank Act. See 12 U.S.C. § 1430(a).

Section 10(a)(1), (2) and (4) of the Bank Act sets forth three categories of assets that are eligible collateral for FHLBank advances. See 12 U.S.C. § 1430(a)(1), (2), (4). These provisions are further amplified in the Finance Board's advances regulation. See 12 C.F.R. § 935.9(a)(1), (2), (4).

1. Category (a)(1) and (2) Collateral

Section 935.9(a)(1) of the Finance Board's advances regulation implements section 10(a)(1) of the Bank Act and provides that the following types of assets qualify as collateral for FHLBank advances (hereafter, "category (a) (1) collateral"):

(i) Fully disbursed, whole first mortgage loans on improved residential real property not more than 90 days delinquent; or

(ii) Privately issued mortgage-backed securities ("MBSs"), excluding the following:

(A) securities which represent a share of only the interest payments or only the principal payments from the underlying mortgage loans;

(B) securities which represent a subordinate

1. Section 10(a)(3) of the Bank Act also provides that deposits in a FHLBank are eligible collateral for FHLBank advances. See 12 U.S.C. § 1430(a)(3); 12 C.F.R. § 935.9(a)(3). Since the Fund does not invest in FHLBank deposits, there is no issue as to whether Fund shares would qualify under section 10(a)(3).

interest in the cash flows from the underlying mortgage loans;

(C) securities which represent an interest in any residual payment from the underlying pool of mortgage loans; or

(D) such other high-risk securities as the Finance Board in its discretion may determine.

Id. § 935.9(a)(1).

In addition, section 935.9(a)(2) of the Finance Board's advances regulation implements section 10(a)(2) of the Bank Act and provides that the following types of assets qualify as collateral for FHLBank advances (hereafter, "category (a)(2) collateral"):

Securities issued, insured or guaranteed by the U.S. government, or any agency thereof, including without limitation MBSS issued or guaranteed by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association.

Id. § 935.9(a)(2).

Analysis of Category (a)(1) and (2) Collateral. Under a plain meaning reading of section 10(a)(1) and (2) and section 935.9(a)(1) and (2), mutual fund shares would not qualify as eligible collateral because such shares are not themselves whole first mortgage loans, privately issued MBSS or agency securities. See 12 U.S.C. § 1430(a)(1), (2); 12 C.F.R. § 935.9(a)(1), (2). However, the shareholders of a mutual fund organized as a business trust are the beneficial owners of the fund's underlying assets and are entitled to an undivided property interest in such assets. See Mass. Gen. Laws Ann. ch. 182, § 1 (West 1993); Selected Investments Corp. v. Duncan, 260 F.2d 918, 921 (10th Cir. 1958), cert. denied, 359 U.S. 914 (1959); In re Cook, 104 F.2d 981, 984 (7th Cir. 1939); Bryan v. Welsh, 72 F.2d 618, 620 (10th Cir. 1934); Goodhue v. State Street Trust Co., 267 Mass. 28, 34 '(1929); 13 Del. J. Corp. Law 421.

Other regulators have determined, for purposes of treatment of mutual fund shares in connection with the investment powers of federal depository institutions, that the shareholders' ownership of the fund's shares is the functional equivalent of ownership of the fund's underlying securities. Specifically, under section 107(7) of the Federal Credit Union Act ("FCUA"), a federal credit union has the authority to invest in U.S. obligations and fully guaranteed securities. See 12 U.S.C. § 1757(7). The National Credit Union Administration ("NCUA") by regulation has construed this provision to allow federal credit unions to invest in mutual fund shares, provided the investments and investment transactions

of the fund are legally permissible for federal credit unions under the FCUA and NCUA regulations. See 12 C.F.R. § 703.4(j).

The NCUA Assistant General Counsel in a 1987 opinion letter specifically stated that the authority to invest in mutual funds or bank common trusts pursuant to section 107(7) "is based on the fact that an investment in the shares of a mutual fund or bank common trust fund holds the same proportion of the beneficial interest in the underlying assets of the fund or trust as the amount of shares purchased bears to the total amount of outstanding shares of the fund or trust." See NCUA Op. Letter, pp. 2-3 (April 23, 1987). The letter concluded that a mutual fund structured as a business trust, including a Massachusetts business trust, is a permissible investment for federal credit unions, provided that the underlying assets and investment practices of the fund are legal for federal credit unions. Id. at 3.

Similarly, the National Bank Act authorizes national banks to invest in certain types of securities. See 12 U.S.C. § 24 (Paragraph Seventh). The Office of the Comptroller of the Currency ("OCC") in a Banking Circular has advised that national banks generally may purchase shares in a mutual fund, provided the fund's portfolio consists solely of securities eligible for purchase by a national bank under 12 U.S.C. § 24(Paragraph Seventh), and the shareholder has a proportionate undivided interest in the underlying assets of the mutual fund. See OCC Banking Circular No. 220, p.1, 3 (Nov. 21, 1986).

The Federal Reserve Board ("FRB") has reached a conclusion similar to the OCC's in interpreting the authority of state banks that are members of the Federal Reserve System to invest in mutual fund shares under 12 U.S.C. § 24(Paragraph Seventh). See 12 C.F.R. § 208.124 (interpretative rule).

Thus, the NCUA by regulation, and the OCC and FRB by interpretation, essentially treat the ownership of such mutual fund shares as the functional equivalent of direct ownership of the underlying assets of the fund for purposes of determining authorized investments for depository institutions.

The Finance Board has the authority to interpret the language of the Bank Act, as long as the interpretation is reasonable and is consistent with the plain meaning of the Bank Act. See K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 291-92 (1988); Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-44 (1984). Under Chevron, the Finance Board may reasonably conclude that the shareholders' ownership of the fund's shares is the functional equivalent of ownership of the fund's underlying securities. Thus, under this interpretation, shares of

2. No opinions of the former Federal Home Loan Bank Board addressing the issue of acceptance of mutual fund shares as FHLBank collateral were found.

a mutual fund where all of the underlying assets qualify as eligible collateral under category (a)(1) or (2) would be eligible collateral under such categories.

Application of the Analysis to the Fund. If such an interpretation is accepted by the Finance Board, then in determining what is acceptable collateral for an advance, the FHLBanks of Atlanta and New York would have the responsibility to determine that the Fund is structured such that the shareholders hold an undivided property interest in the Fund's underlying assets. The Fund's Prospectus indicates that it is organized as a Massachusetts business trust. See Prospectus at 14. The FHLBanks thus appear to have established that the Fund's shareholders hold an undivided property interest in the underlying assets of the Fund, and therefore that ownership of the Fund shares is the same as ownership of the underlying assets of the ~~th~~See Fando Rosselot Memorandum at 2.

In addition, the FHLBanks of Atlanta and New York would be required to determine that all of the underlying investments of the particular mutual fund qualify as eligible collateral under categories (a)(1) or (2), and that they qualify for as long as the Fund shares serve as security for FHLBank advances. See 12 C.F.R. § 935.9(a).

Review of the Fund's Prospectus by staff of the District Banks Directorate and discussions with the Fund's counsel suggest that as of October 31, 1993, all of the Fund's underlying securities would, in fact, qualify under categories (a)(1) or (2). See Rosselot Memorandum at 1, 5. This would need to be confirmed by the FHLBanks of Atlanta and New York before they accept the Fund's shares as collateral for advances.

However, the Fund's Prospectus indicates that the Fund will invest in assets permitted for purchase by federal savings associations, and that the Fund has the right, without shareholder approval, to make investments that may be allowed as a result of future changes in applicable regulations or federal laws which are consistent with the Fund's investment objectives. See Prospectus at 3-4. Such investments may or may not qualify eligible collateral under categories (a)(1) or (2). While the Prospectus indicates that at least 65 percent of the Fund's assets will be invested in adjustable and floating rate U.S. government MBSs, which are eligible collateral under category (a)(2), this leaves room for investment in other assets that might not qualify as eligible collateral under categories (a)(1) or (2). See id. at 3. In addition, the Fund's Prospectus indicates that the investment objectives of the Fund may be changed with shareholder approval. See id.

Thus, the Fund's investment mix could change such that the underlying assets no longer consist solely of category (a)(1) or (2) type collateral. The FHLBanks of Atlanta and New York would need to establish procedures to enable them to verify that all of

the underlying assets qualify as eligible collateral for as long as the Fund shares secure FHLBank advances.

policy Decision for the Finance Board. The decision whether or not to authorize the FHLBanks to accept mutual fund shares as collateral, based on an interpretation of the statute that ownership of the shares is the functional equivalent of ownership of the fund's underlying assets, is a policy decision for the Finance Board. The collateral provisions of the Finance Board's recently amended advances regulation do not specifically address the acceptance of mutual fund shares as collateral. See 12 C.F.R. § 935.9(a)(1), (2). Thus, such an interpretation should be formally adopted by the Finance Board acting with a quorum, either through amendment of the collateral provisions of the advances regulation, or by adoption of a policy statement.

2. Category (a)(4) Collateral

Section 935.9(a)(4) of the Finance Board's advances regulation implements section 10(a)(4) of the Bank Act by providing that, in addition to categories (a)(1) and (2) collateral, the following types of assets are eligible collateral for FHLBank advances:

(i) Other real estate-related collateral acceptable to the Bank if:

(A) such collateral has a readily ascertainable value; and

(B) the FHLBank can perfect a security interest in such collateral;

(ii) however, the aggregate amount of outstanding advances to any one member secured by such other real estate-related collateral may not exceed 30 percent of such member's capital at the time the advance is issued or renewed.

Eligible other real estate-related collateral may include, but is not limited to:

(A) privately issued MBSs not otherwise eligible under paragraph (a)(1)(ii);

(B) second mortgage loans, including home equity loans;

(C) commercial real estate loans; and

(D) mortgage loan participations.

See 12 U.S.C. § 1430(a)(4); 12 C.F.R. § 935.9(a)(4).

Assuming that the FHLBanks of Atlanta and New York are able

to determine that the Fund's shares have a readily ascertainable value and that a security interest can be perfected in such shares, as required by the statute and regulation (see also discussion under category (a)(1) and (2) collateral above), the question remains whether the Fund's shares are "other real estate-related" and therefore may qualify as eligible collateral under category (a)(4).

Neither section 10(a) of the Bank Act nor the advances regulation defines the term "other real estate-related." Nor does the legislative history of section 10(a) address this issue.

Section 9359(a)(4)(ii) of the advances regulation specifically states that the types of eligible collateral listed therein are not all inclusive. See 12 C.F.R. 935.9(a)(4)(ii). Under this section, each FHLBank has the discretion to determine, in the absence of a Finance Board pronouncement on the issue, the particular types of other real estate-related collateral acceptable to the FHLBank, consistent with the regulatory definition of eligible collateral. See Preamble to Finance Board Advances Regulation, 58 Fed. Reg. 29456, 29462 (May 20, 1993). Thus, it is possible that the FHLBanks will have varying definitions of what is real estate-related collateral. For example, a FHLBank might decide that mutual fund shares are acceptable collateral only if a certain minimum percentage of the fund's underlying assets are real estate-related. The fund's investment mix would then be weighed by the FHLBank in determining the value of the collateral. The FHLBank would be responsible for monitoring the collateral to assure that it meets the percentage test for the period it secures the FHLBank advance.