NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

April 23, 1987

FC/JT 85-660

Office of General Counsel

Mr. Fred Diulus
Credit Union Funds Management, Inc.
4546 B10 El Camino Real, Ste. 345
Los Altos, California 94022

Dear Mr. Diulus:

This Office has reviewed a document purporting to be a "White Paper" entitled "Authorized Mutual Funds For Investment By Federal Credit Unions," of which you are the author. We have serious concerns about the accuracy of the information contained in the White Paper. Furthermore, we believe that the White Paper is misleading and completely misstates the position of this Office with respect to Federal credit union investment in mutual funds that are structured as Massachusetts business trusts. The purpose of this letter is to make you aware of the serious problems we see with the White Paper, and to request that you take action to correct any misconceptions resulting from the White Paper. We will also address the issue of the permissibility of Federal credit unions investing in mutual funds that are structured as Massachusetts business trusts.

The term "White Paper" is generally used to refer to an objective study of a particular subject. Your "White Paper" purports to provide the reader, i.e., the credit unions, with an unbiased narrative on investments in mutual funds. We found it rather interesting that the "About the Author" discussion, including the endorsement that: "You'll find this special report revealing, entertaining, informative and very useful. I did", was prepared by the Managing Officer, Judith Rhoades, of a company that we understand is directly or indirectly owned by you or one of your companies. If, in fact, the White Paper was unbiased and accurate, it could be a useful tool to credit unions considering investing in mutual funds. However, a thorough study of the White Paper has led this Office to the conclusion that the White Paper is far from accurate, and that it is not an objective study, but rather is in the nature of a subtle advertisement for one particular fund, the Credit Union Government Securities Fund (Fund). It is our understanding that you have a business relationship with that Fund.

FOIA Vol I E 2 Mutual Funds
Vol I E. Permissible Investments

Throughout the White Paper, one particular mutual fund gets repeated endorsements. Coincidentally, this is the Fund with which you are connected. Your failure to disclose your connection with this Fund may, in fact, be violative of Federal securities laws. While this Office does not administer the securities laws, we would point out to you that 15 U.S.C. §77q(b) (Securities Act of 1933) provides, in part, that it is unlawful to publish or circulate an article or other communication which does not purport to offer a security for sale, but describes the security in exchange for consideration received by an issuer, underwriter, or dealer, without describing receipt of such consideration.

Page 12 of the White Paper states in part that "Under the latest NCUA guidelines of January 16, 1987, mutual funds organized as trusts may not comply with the new NCUA interpretation of what a legal mutual fund investment is for credit unions." This statement is completely false as the NCUA did not issue any guidelines on January 16, 1987, with respect to Federal credit unions (FCU's) investing in mutual funds that are structured as trusts. In fact, the NCUA has never addressed the specific issue of whether a mutual fund that is structured as a business trust is a permissible investment for FCU's. We will address this issue herein.

Whether it is permissible for FCU's to invest in mutual funds that are structured as business trusts first came to the attention of this Office in early January, 1987. At that time, we were reviewing the prospectus of the Credit Union Government Securities Fund(Fund). At the time of our initial review, the Fund was structured as a Massachusetts business trust. The prospectus of the Fund stated that due to the structure of the Fund, shareholders could be held personally liable for obligations of the Fund under certain circumstances. This Office then raised the issue of whether, given the potential personal liability of Fund shareholders, this type of fund was permissible for FCU's. This issue was presented to the Fund's attorney. Prior to the resolution of this issue by NCUA, the Fund changed its structure from a Massachusetts business trust to a Maryland corporation. The statement on page 19 of the White Paper that NCUA requested the Fund to change its structure is incorrect and misleading.

NCUA has consistently stated that investments in mutual funds or bank common trusts are permissible for FCU's if all of the investments and investment practices of the mutual fund or bank common trust fund are legal if made directly by an FCU. Our position on this issue is based on the fact that an investor 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. Therefore, if the underlying assets and investment practices are legal for FCU's, if made directly, FCU investment in the mutual fund or common bank trust would similarly be legal. In reaching this position, and in our subsequent review of funds, the issue we have directed our attention to is whether the underlying assets are permissible investments for FCU's pursuant to §107(7) of the FCU Act. This Office had not previously considered the business structure of the mutual fund.

A Massachasetts business trust is a form of business organization in which property is transferred to trustees, in accordance with the terms of an instrument of trust, to manage and control for the use of stockholders whose interests are represented by transferable shares. This type of trust is also referred to as a business trust or a common-law trust. A business trust format is often selected as the structure for a business entity because it may avoid any personal liability on behalf of the stockholders, and at the same time free the entity from any restrictions and regulations imposed by laws on corporations. Holders of certificates of beneficial interest in a business trust generally occupy the same relationship toward the trust as that of a stockholder to a business corporation.

Stockholders in a business trust will generally not be held personally liable for trust obligations. Personal liability may result, however, in certain situations: where the trust instrument is considered as having created an entity which is in legal effect a partnership; where the trust operates as a partnership; or in the rare jurisdiction which holds shareholders of a business trust liable as partners for trust obligations. Under these circumstances, the chance of personal liability is remote. Furthermore, the circumstances that would give rise to personal liability are also remote, as a mutual fund will generally not have any creditors and its borrowing practices are heavily regulated by the SEC. To further limit the chance of personal liability, the trust instrument should (1) contain a statement which disclaims any personal liability of shareholders for trust obligations; (2) require that notice of this disclaimer be given in each contractual obligation of the trust; and (3) obligate the trust to indemnify the shareholder if he is held liable for a trust obligation.

Having considered the above, it is our opinion that a mutual fund structured as a business trust is a permissible investment for FCU's, provided that the underlying assets and investment practices of the fund are legal for FCU's.

The discussion on business trusts contained in pages 11-12 and 19-20 of the White Paper does not represent the current or past NCUA position on this issue. As stated previously, this Office has never formally addressed the business trust issue until this date. Furthermore, the list of legal and illegal investments for FCU's contained on pages 15-17 of the White Paper is not correct. Any fund which this Office determined to be a legal investment for FCU's is still viewed as a legal investment, provided the prospectus reviewed by this Office has not been revised. If there have been any revisions or updated prospectuses, the investment may still be legal, but the prior determination of legality by this Office would only apply to the dated prospectus that we reviewed.

While it is difficult to determine the accuracy of the White Paper list since you have not provided the complete names of the funds, it appears that the list contains errors. First, the list states that a Dreyfus GNMA Fund, Inc. was a legal investment in 1986. Our records indicate that no determination was made with respect to the legality of a Dreyfus GNMA Fund. Second, the list shows Fidelity Government Securities as a permissible investment. If this statement is intended to refer to the Fidelity Government Securities Fund, Prospectus dated March 1, 1986, our records indicate that this Fund is not a permissible investment for FCU's.

We provided a copy of the White Paper to NCUA's Office of Examination and Insurance for their review. They provided us with many comments and concerns, some of which are addresed below.

Page 3 of the White Paper states in part that:

> The similarity between a Ginnie Mae fund or a Ginnie Mae security is purely coincidental. A Ginnie Mae security may find its way into a credit union portfolio or a mutual fund portfolio. If the credit union buys the security, it amortizes the security over the expected life and gets paid principal and interest -- takes the risk of the market and plays the portfolio game of guessing where interest rates are going. On the other hand, with a Ginnie Mae mutual fund investment of the same dollar magnitude, the credit union may end up with a share of literally hundreds of Ginnie Maes spreading their rate risk and volatility across the board, plus have a share of the treasuries, government bonds and other government agencies that may round out the mutual fund portfolio.

We believe that the above statements, perhaps in their attempts to present the issue in simple terms, are quite misleading. The similarity between a Ginnie Mae security and a Ginne Mae fund is much more than "purely coincidental." Both the value of the mutual fund and the security respond to the market. While it is true that greater diversification among GNMA investments may help to somewhat reduce interest rate risk, the risk, nevertheless, still exists. Also, GNMA funds, contrary to your statement, generally do not invest in "treasuries, government bonds and other government agencies" securities. Furthermore, it is unclear as to what is meant by the statement that the Ginnie Mae security is "amortized" over its expected life.

Page 5 of the White Paper, captioned "Accounting and Examiners," begins by stating that:

> Generally accepted accounting standards and Section 2040.1.4 of the Accounting Manual for Federal Credit Unions require that marketable securities be recorded at the lower of cost or market on the balance sheet, whichever is lowest.
>
> This seems fair enough, except some examiners have added a little more for mutual fund valuations. They would prefer that this be done monthly.

To the extent that the foregoing states that an investment in a mutual fund is initially recorded at the lower of cost or market value, it is correct. Unlike a direct investment in government securities, shares in a mutual fund do not have a fixed value or specific maturity date. The value of the shares changes based on the portfolio and market conditions. Because market conditions play a more significant role in determining the ultimate recoverable value of an investment in a mutual fund than in an investment with a specific maturity date, at the end of each accounting period, an FCU must determine the net asset value of a share in the mutual fund and adjust the investment to the lower of cost or market value. The White Paper implies that this adjustment applies to a direct investment in government securities. This is <u>not</u> correct. Direct investments in Federal agency securities are not required to be reduced to market value for market price declines of a nonpermanent nature, unless the securities will not be held to maturity. The regular adjustments do, however, apply to investments in mutual funds.

The above-quoted portion of the White Paper states that the examiners would "prefer" that the mutual fund adjustment be made on a monthly basis. The timing of the adjustment is not based on what examiners "prefer," but is based on generally accepted accounting principles. The adjustment is to be made at the end of the FCU's next accounting period. If the FCU is on a monthly accounting period, the adjustment will be made on a monthly basis. While the White Paper states that credit union managers may have a valid position for booking the mutual fund entry only once until a fund is sold, this is not consistent with the NCUA position.

The final paragraph on page 5 of the White Paper states that the mutual fund adjustment is required due to the issue of how to carry mutual fund commission expense. This is only partially true. While commission expense is an issue, the major point, as discussed above, is that the adjustment is required because FCU investments in mutual funds are subject to market fluctuations, which result in gains or losses. The losses must be accurately reflected on the credit union's books. This has been more of a sticking point than how to record the commission expense. Such being the case, investment in a no-load mutual fund would not avoid this issue.

Page 13 of the White Paper deals with the issue of whether a particular fund is a legal investment for credit unions. The White Paper fails to make it clear that the NCUA's role with respect to this issue is limited to Federal credit unions. NCUA does not make determinations as to whether investments are legal for state-chartered federally-insured credit unions.

Page 18 of the White Paper states in part that "federal examiners request an NCUA authorization letter or proof of same when auditing credit unions" (with respect to whether an investment is legal).(Emphasis added.) This is not correct. While an NCUA examiner will request that the FCU show how the legality of the investment was determined, this can be done in several ways, including an analysis of the investment by the FCU's counsel or an analysis of the investment by the broker's attorney. Further, it should be noted that our examiners do not "audit" credit unions.

It is our opinion that the publication of the White Paper has created many misconceptions in the credit union community. This Office and the NCUA Investment Hotline have received numerous phone calls regarding mutual funds labelled in the White Paper as illegal investments. To cure the existing misunderstanding, we request that you send a letter acknowledging the errors in the White Paper to all parties that were provided copies of the White

Paper and to the mutual funds listed therein. The effect of the White Paper is quite serious as it generally misstates the position of the NCUA. Action to remedy this problem should be taken immediately. So that any corrective letter(s) accurately address our concerns, I would be available to review a draft of such before it is sent out. I hope that this matter can be expeditiously resolved without resorting to other remedial measures.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

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