



NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

April 21, 1988

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4660

Office of General Counsel

John A. Cooney, Esq.
Dorsey & Whitney
2200 First Bank Place East
Minneapolis, Minnesota 55402

Re: Investments and Investment Practices of Federal Credit
Unions .

Dear Mr. Cooney:

You asked this Office to determine whether a Federal credit union ("FCU") may invest in mutual funds engaging in the investments and investment practices described in your letter. We are currently undertaking a review of NCUA's investment regulation to determine what changes, if any, may be appropriate. Under current regulations, however, we believe:

(1) As to purchase of permissible securities on a cash forward basis:

(a) An FCU's segregation of cash, cash equivalents, or other permissible securities of equal value to the securities to be purchased satisfies the FCU's obligation to prepare written cash flow projections of its ability to purchase the securities;

(b) an FCU may not, prior to settlement, sell a security so purchased;

(c) An FCU may not, as part of an agreement terminating a cash forward agreement at or prior to settlement, enter into a new cash forward agreement.

(2) As to FCU investment in instruments "of, or issued by, or fully guaranteed as to principal and interest by" an agency of the United States, and in warrants and convertible debt instruments, we have in the past made an ad hoc determination of the permissibility of investments such as these based on statutory and safety and soundness considerations; if you have a

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John A. Cooney, Esq.
21 APR 1988

Page 2

particular investment you would like an opinion on, we will do so; we hope to develop a more definite standard in our regulatory review.

(3) As to "short sales against the box," we have previously stated our opinion that, as generally structured, they are not considered short sales under NCUA's Rules and Regulations and are permissible for an FCU; they must generally be accounted for as short sales, however.

(4) As to requiring shareholder (FCU) vote for change in a mutual fund's policies, this will also be studied in NCUA's regulatory review of Part 703.

General Framework

As you are aware, this Office has taken the position that an FCU may invest in a mutual fund, provided the investment and investment practices of the fund are permissible for FCU's. The investment and deposit authority of FCU's is contained in Sections 107(7), 107(8) and 107(15) of the FCU Act [12 U.S.C. Sections 107(7), 107(8) and 107(15)]. Part 703 of the NCUA's Rules and Regulations [12 C.F.R. Part 703] interprets these provisions and places limitations on the types of investment practices an FCU may use in connection with the purchase and sale of authorized securities, deposits and obligations.

Purchases of When-Issued Securities

You first asked about the general permissibility of certain cash forward purchases. The mutual funds developed by your clients enter into agreements to purchase securities on a "when-issued" or "delayed-delivery" basis. The settlement dates for these types of transactions are determined by mutual agreement of the parties, except that in no case may the period from the trade date to the settlement date exceed 120 days. The mutual funds purchasing such securities also establish segregated accounts with their custodians, in which they maintain cash, cash equivalents or other portfolio securities equal in value to their commitments to purchase securities on a when-issued or delayed-delivery basis. At the time a mutual fund commits itself to purchase securities on a when-issued or delayed-delivery basis, it records the transaction and thereafter reflects the value, each day, of such securities in determining its net asset value. At the time of delivery of the securities, therefore, their value may be more or less than the agreed-upon purchase price.

John A. Cooney, Esq.

Page 3

A purchase on a "when-issued" or "delayed-delivery basis" is a "cash forward agreement," defined in Section 703.2(d) of NCUA's Rules and Regulations [12 C.F.R. §703.2(d)] as:

an agreement to purchase or sell a security with delivery and acceptance being mandatory and at a future date in excess of thirty (30) days from the trade date.

Section 703.3(b) of NCUA's Rules and Regulations states:

A Federal credit union may enter into a cash forward agreement to purchase or sell a security provided that:

(1) The period from the trade date to the settlement date does not exceed one hundred and twenty (120) days;

(2) If the credit union is the purchaser, it has written cash flow projections evidencing its ability to purchase the security;

(3) If the credit union is the seller, it owns the security on the trade date; and

(4) The cash forward agreement is settled on a cash basis at the settlement date.

Use of the segregated accounts in which the mutual fund maintains cash, cash equivalents or other portfolio securities equal in value to the fund's commitment to purchase securities satisfies the Section 703.3(b)(2) cash projection requirement. In all other respects, the described transaction seems a permissible cash forward agreement.

You also asked whether a mutual fund that enters into a cash forward agreement with the intent of actually acquiring such securities for its portfolio may sell the securities in question prior to the settlement date if deemed advisable.

Section 703.2(r) of NCUA's Rules and Regulations defines a short sale as "the sale of a security not owned by the seller." Section 703.4 of NCUA's Rules and Regulations prohibits FCU's from engaging in short sales. The sale of securities subject to a cash forward agreement prior to the settlement date constitutes a short sale. Therefore, FCU's cannot invest in mutual funds engaging in this activity.

John A. Cooney, Esq.

Page 4

You next asked about a situation where a mutual fund (which has committed to purchase securities pursuant to a cash forward agreement) and the seller of the securities to the fund agree not to go through with the transaction either because the mutual fund decides that it is not in its best interest to take delivery of the securities, or the seller is unable to meet its delivery commitment. According to your hypothetical, the transaction is to be closed out at current market values on the settlement date; and at the same time, the parties are to enter into a new, independent cash forward for the same or similar securities, the third-party seller paying the mutual fund an additional fee.

As you have noted, Section 703.3(b)(4) [12 C.F.R. §703.3(b)(4)] requires that cash forward agreements be "settled on a cash basis at the settlement date." This requirement was imposed to prevent cash forwards from being extended or rolled over into new contracts that would extend the original settlement date. [See 44 Fed.Reg. 42673, 42675 (July 20, 1979)]. Your hypothetical would violate the plain language and the purpose of Section 703.3(b)(4), and is therefore an impermissible FCU transaction.

Securities Issued by Agencies, Instrumentalities and Independent Establishments of the United States

Section 107(7)(E) of the FCU Act permits FCU's to invest:

in obligations issued by banks for cooperatives, Federal land banks, Federal intermediate credit banks, Federal home loan banks, the Federal Home Loan Bank Board, or any corporation designated in section [9101] of Title 31 as a wholly owned Government corporation; or in obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association or the Government National Mortgage Association; or in mortgages, obligations, or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to Section 305 or Section 306 of the Federal Home Loan Mortgage Corporation Act; or in obligations or other instruments or securities of the Student Loan Marketing Association; or in obligations, participations, securities, or other instruments of, or issued by, or fully guaranteed as to principal and interest by

John A. Cooney, Esq.

Page 5

any other agency of the United States and a Federal credit union may issue and sell securities which are guaranteed pursuant to Section 306(g) of the National Housing Act;

You have asked us to define the term "any other agency of the United States" and the extent to which such term encompasses "instrumentalities" or "independent establishments" of the Federal Government.

The FCU Act and NCUA's Rules and Regulations do not define the term "agency." We look to the organic statute establishing the "agency" to determine if it qualifies under Section 107(7) of the FCU Act. If you have a particular "agency" investment in mind, we will review its permissibility as an FCU investment. In our regulatory review, we plan to address defining the term "agency."

Warrants and Convertible Debt Instruments

You next asked whether FCU's are permitted to purchase, in connection with acquiring an otherwise permissible debt instrument, attached warrants or other rights to subscribe for voting securities of the entity issuing the debt instrument, provided that the FCU did not exercise such warrants or rights to subscribe. Similarly, you asked whether FCU's could acquire a debt instrument convertible into voting securities provided that the FCU does not exercise such conversion rights.

As with the "agency" issue, we cannot answer this question in the abstract. Section 107(7)(D) [12 U.S.C. §1757(7)(D)] authorizes FCU investment in "shares" of an S&L or mutual savings bank; and Section 107(7)(I) [12 U.S.C. §1757(7)(I)] authorizes FCU's to invest in stock of credit union service organizations. Situations involving these kinds of investments would have to be analyzed differently from those involving FCU investment in obligations such as those issued by banks for cooperatives, Federal land banks, Federal intermediate credit banks, and Federal home loan banks where an FCU is limited to investment in debt instruments. Again, if you have a particular investment in mind, we will review it. We plan to review this matter as well in NCUA's investment regulation review.

Short Sales "Against the Box"

Our understanding of a short sale against the box is as follows: An FCU enters into a cash forward agreement in which it agrees

John A. Cooney, Esq.

Page 6

to sell a security. The FCU owns the security on the trade date. After the trade date, market prices decrease enabling the FCU to purchase the same security as the one covered by the cash forward agreement for a lesser price. The FCU buys the security and arranges to settle on this security on the same date the first cash forward agreement is to be settled. The FCU substitutes the second security for delivery on the cash forward agreement.

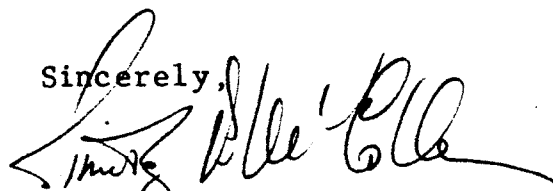
We have previously stated that such an activity is a permissible investment practice for an FCU, provided the proper accounting treatment is followed. We should emphasize that the FCU must actually own the security. If the FCU does not own the security sold on the trade date, the transaction is an impermissible short sale.

Although a short sale against the box is not considered a short sale under NCUA's Rules and Regulations because the FCU owns the security subject to the cash forward agreement at the trade date, the similarities between the two transactions are great enough to support equal accounting treatment. Please contact NCUA's Office of Examination and Insurance if you want a complete description of how an FCU must account for a short sale "against the box."

Shareholder Vote Requirements

In Letter to Federal Credit Unions No. 92, NCUA stated that it was considering requiring that a mutual fund's prospectus and/or statement of additional information provide that the investments and investment practices of the fund may only be changed if authorized by a majority shareholder vote. NCUA has not yet imposed this requirement. This issue will also be addressed in our regulatory review.

Sincerely,



TIMOTHY P. MCCOLLUM
Assistant General Counsel

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