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NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

June 9, 1988

Office of General Counsel

Ms. Mary Lou T. Wyrobek
Trust Officer
Employee Benefits/Institutional Trust Services
Manufacturers and Traders Trust Company
One M&T Plaza
Buffalo, New York 14240

RE: Securities Held in Nominee Name (Your March 17, 1988, letter)

Dear Ms. Wyrobek:

The Federal Credit Union ("FCU") Act does not prohibit or restrict a trust company from the common practice of holding investments in its name (as nominee) for an FCU. However, such an arrangement can present safety and soundness problems if proper steps are not taken to assure that the nominee is trustworthy and that the FCU acquires and maintains title to its investments.

The FCU Act and NCUA's Rules and Regulations -- particularly Sections 107(7), (8), and (15) of the Act [12 U.S.C. §1757(7),(8),(15)] and Part 703 of NCUA's Rules and Regulations [12 C.F.R. §703.1-.4] -- empower an FCU to make certain investments, and do not prohibit the investments' being held in a third party's name as nominee.

Some FCU's have suffered significant losses from third parties who have misappropriated investments held in their names as nominees. As with broker and other trust relationships, it is crucial for an FCU to know the third party and assure it maintains legal title to the investment.

FCIA. Vol. I. E Holding Investments in Nominee Name

Some helpful guidance in this area has been provided in IRPS 88-1, recently issued by the NCUA Board in conjunction with other financial institution regulators. A copy is enclosed.

Sincerely,

Timothy P. McCollum

TIMOTHY P. McCOLLUM
Assistant General Counsel

HMU:sg

Encl.

cc: Director, Office of Examination & Insurance

Year (as of first week ending in July)	Index (percent)	Margin [1] (percentage points)	Interest rate (percent)	Monthly payment [4]	Remaining balance
1977	5.72	3	8.72	$78.46	$9,927.84
1978	8.34	3	[2]10.72	92.88	9,874.87
1979	9.44	3	12.44	105.67	9,832.70
1980	8.51	3	11.51	98.79	9,776.04
1981	14.94	3	[2]13.51	113.51	9,731.98
1982	14.41	3	[3]13.72	115.07	9,683.39
1983	9.78	3	12.78	108.25	9,618.21
1984	12.17	3	[3]13.72	114.98	9,554.38
1985	7.66	3	[2]11.72	101.98	9,456.03
1986	6.36	3	[2]9.72	88.13	9,311.25
1987	6.71	3	9.71	88.07	9,151.55

[1] This is a margin we have used recently; your margin may be different.
[2] This interest rate reflects a 2% points annual interest rate cap.
[3] This interest rate reflects a 5% points lifetime interest rate cap.
[4] Payment of principal and interest.

To see what your payments would have been during that period, divide your mortgage amount by $10,000; then multiply the monthly payment by the resulting amount. (For example, in 1987 the monthly payment for a mortgage amount of $60,000 taken out in 1977 would be: $60,000 ÷ $10,000 = 6; 6 x $88.07 = $528.42.)

[FR Doc. 88-11455 Filed 5-20-88; 8:45 am]

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NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

Interpretive Ruling and Policy Statement No. 88-1; Policy on Selection of Securities Dealers and Unsuitable Investment Practices

AGENCY: National Credit Union Administration ("NCUA").

ACTION: Interpretive ruling and policy statement number 88-1.

SUMMARY: With minor modifications, the NCUA Board has adopted as its statement of general policy for Federal credit unions ("FCU's") the Federal Financial Institutions Examination Council ("FFIEC") supervisory policy entitled "Selection of Securities Dealers and Unsuitable Investment Practices." The FFIEC has recommended that its constituent members adopt the policy.

EFFECTIVE DATE: May 23, 1988.

ADDRESSES: National Credit Union Administration, 1776 G Street, NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: Timothy P. McCollum, Assistant General Counsel, or Julie Tamuleviz, Staff Attorney, Office of General Counsel, NCUA, at the above address or telephone (202) 357-1030.

SUPPLEMENTARY INFORMATION: FFIEC, an inter-agency group, has recommended that its constituent members—the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the National Credit Union Administration, and the Office of the Comptroller of the Currency—adopt its supervisory policy entitled "Selection of Securities Dealers and Unsuitable Investment Practices." The NCUA Board approved the FFIEC supervisory policy, with minor modifications, on April 22, 1988, and authorized its inclusion in NCUA's official system of Policy Statements.

The supervisory policy provides guidance to financial institutions concerning selection of securities brokers and avoidance of unsound investment practices. It is consistent with advice that NCUA has provided to FCU's on numerous previous occasions.

NCUA, in adopting the supervisory policy as its general policy, has made minor modifications to the supervisory policy to clarify that certain investment practices discussed in the statement are not permissible for FCU's. Sections 107(7), 107(8) and 107(15) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8) and 1757(15) and Part 703 of NCUA's Rules and Regulations (12 CFR 703.1–703.4) contain FCU investment and deposit authority. FCU's considering investment in privately-issued mortgage-related securities pursuant to section 107(15)(B) of the Federal Credit Union Act (12 U.S.C. 1757(15)(B)) should also review NCUA Letter to Credit Unions Number 96.

Interpretive Ruling and Policy Statement Number 88-1

Policy on Selection of Securities Dealers and Unsuitable Investment Practices.

Purpose

This issuance is to provide you with recommended procedures to be employed when selecting securities dealers and to advise you of certain securities activities that NCUA and the other Federal financial institution regulators view as unsuitable in an investment portfolio.

Background

The Federal financial institution regulators have become aware of speculative activity which has taken place in a number of financial institutions' investment portfolios. Certain of these institutions have failed because of the speculative activities, and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value.

Speculative activity often occurs when a financial institution's investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

Recommendations Concerning the Selection of a Securities Dealer

It is common for the investment portfolio managers of many financial institutions to rely on the expertise and advice of a securities sales representative for: Recommendations of proposed investments; investment strategies; and the timing and pricing of securities transactions. Accordingly, it is important for the management of these institutions to know the securities firms and the personnel with whom they deal. An investment portfolio manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

The board of directors and/or an appropriate board committee should review and approve a list of securities firms with whom the financial institution's management is authorized to do business. The following securities dealer selection standards are recommended, but are not all-inclusive. The dealer selection process should include:

• A consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.;

• An inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the securities dealer;

• An inquiry of appropriate state or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel;

• An inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise;

• A determination whether the financial institution has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) the board is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors, or a committee of the board, for unsecured transactions (see FFIEC Policy Statement adopted October 1985, NCUA's Interpretive Ruling and Policy Statement No. 85-2). Federal credit unions, when entering into a repurchase agreement with a broker/dealer, are not permitted to maintain the collateral with the broker/dealer, reference Part 703 of the National Credit Union Administration Rules and Regulations.

As part of the process of managing a financial institution's relationships with securities dealers, the board of directors may wish to consider including in the code of ethics or conduct a prohibition by those employees who are directly involved in purchasing and selling securities for the institution from engaging in personal securities transactions with the same securities firm that the institution uses for its transactions without specific board approval and periodic review. The board also may wish to adopt a policy applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel (also see in this connection the Bank Bribery Law, 18 U.S.C. 215 and interpretive releases).

Objectionable Investment Practices

Financial institution directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained to provide earnings, liquidity, and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of prudent investment activities and should be conducted in a securities trading account. Securities trading of the types described in section I of the attached appendix will be viewed as unsuitable activities when they are conducted in a financial institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have strong capital and current earning positions. Acquisitions of the various forms of zero coupon, stripped obligations, and asset-backed securities residuals discussed in section II of the attached appendix will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable activities.

State-chartered financial institutions are cautioned that certain of the investment practices listed in the appendix may violate state law. If any such practices are contemplated, the appropriate state supervisor should be consulted regarding permissibility under state law.

By the National Credit Union Administration Board on April 22, 1988.

Becky Baker,

Secretary of the Board.

Appendix

I. Trading in the Investment Portfolio

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which, when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards, applicable to trading accounts may result in a misstatement of the financial institution's income and a filing of false regulatory reports and other published financial data. It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market, or the lower of cost or market, periodically with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the institution.

The following practices are considered to be unsuitable when they occur in a financial institution's investment portfolio.

A. "Gains Trading"

"Gains trading" is a securities trading activity conducted in an investment portfolio, often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when-issued" securities and "pair-offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

B. "When-Issued" Securities Trading

"When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it. Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a bank's investment portfolio. Federal credit unions engaging in when-issued securities trading must follow NCUA's regulation on cash forward agreements.

C. "Pair-Offs"

A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will commit to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when-issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities. Pair-off transactions using cash forward agreements are impermissible for Federal credit unions. According to NCUA's regulation, cash forward agreements (settlement occurring between 30–120 days) must be settled on a cash basis.

D. Corporate Settlement on U.S. Government and Federal Agency Securities Purchases

Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

E. Repositioning Repurchase Agreements

Dealers who encourage speculation through the use of "pair-off", "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a larger amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for credit unions and other financial institutions.

F. Short Sales

A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on the fall in the price of the security. Short sales are speculative transactions that should be conducted in a trading account, and when conducted in the investment portfolio, they are considered to be unsuitable.

Short sales are not permissible activities for Federal credit unions.

II. Stripped Mortgage-Backed Securities, Residuals and Zero Coupon Bonds

There are advantages and disadvantages in owning these products. A financial institution must consider the liquidity, marketability, pledgeability, and price volatility of each of these products prior to investing in them. It may be unsuitable for a financial institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price.

A. Stripped Mortgage-Backed Securities (SMBS's) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100% of the principal cash flows.

All IO's and PO's have highly volatile price characteristics based, in part, on the payment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, PO's will increase in value when interest rates decline while IO's increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and similar instruments held by a financial institution. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO the investor is speculating on the movements of future interest rates and how these movements will affect the payment of the underlying collateral. Furthermore, those SMBS's that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS's cannot be considered as suitable investments for the vast majority of financial institutions. SMBS's, however, may be appropriate holdings for institutions that have highly sophisticated and well managed securities portfolios, mortgage portfolios or mortgage banking functions. In such institutions, however, the acquisition of SMBS's should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by the institutions' boards of directors and vigorously enforced.

In those financial institutions that prepare their published financial statements in accordance with Generally Accepted Accounting Principles, SMBS holdings must be accounted for in accordance with Financial Accounting Standards Board Statement #91 (FAS #91) which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other institutions may account for their SMBS holdings under FAS #91 or, alternatively, at market value or the lower of cost or market value.

Several states have adopted, or are considering, regulations that prohibit state-chartered banks from purchasing IO strips. Accordingly, state-chartered institutions should consult with their state regulator concerning the permissibility of purchasing SMBS's.

B. Asset-Backed Securities (ABS) Residuals

Residuals are the excess cash flows from an ABS transaction after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cash flow is extremely sensitive to prepayments, and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS's rises when interest rates rise. Theoretically, a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the "yield" on these instruments is inversely related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value usually due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cash flows very difficult.

Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cash flow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher "yielding" interests, because the risk associated over the life of the ABS's may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Only residual interests in ABS's rated in one of the top two rating categories are permissible acquisitions for Federal credit unions. Holding of ABS residuals should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as "Other Assets" on regulatory reports.

C. Other Zero Coupon or Stripped Products

The interest and/or principal portions of U.S. Government obligations are sometimes sold to financial institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CAT's or TIGR's. Also, Original Issue Discount Bonds (OID's) have been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility and, accordingly, disproportionately large long-maturity holdings (in relation to the total portfolio) of zero coupon securities may be unsuitable for investment holdings for financial institutions.

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BILLING CODE 7535-01-M

DEPARTMENT OF COMMERCE

International Trade Administration

15 CFR Part 399

[Docket No. 71024-7224]

Amendments to the Commodity Control List Based on Coordinating Committee Review

AGENCY: Bureau of Export Administration, International Trade Administration, Commerce.

ACTION: Final rule.

SUMMARY: Export Administration maintains the Commodity Control List (CCL), which identifies those items subject to Department of Commerce export controls. This rule amends a number of CCL entries in the categories of metal-working machinery; general industrial equipment; transportation equipment; electronics and precision instruments; metals, minerals, and their manufactures; and chemicals, metalloids, petroleum products and related materials. These amendments have resulted from a review of strategic controls maintained by the U.S. and certain allied countries through the Coordinating Committee (COCOM). Such multilateral controls restrict the availability of strategic items to potential adversaries. With the concurrence of the Department of Defense, the Department of Commerce has determined that these amendments to the CCL are necessary to protect U.S. national security interests.

EFFECTIVE DATE: This rule is effective May 23, 1988.

FOR FURTHER INFORMATION CONTACT: For questions of a technical nature regarding metal-working machinery, contact Surendra Dhir, Capital Goods Technology Center, Bureau of Export Administration, Telephone: (202) 377-5695.

For questions of a technical nature regarding general industrial equipment and transportation equipment, contact Bruce Webb, Capital Goods Technology Center, Bureau of Export Administration, Telephone: (202) 377-3806.

For questions of a technical nature regarding electronics and precision instruments, contact Robert Anstead, Electronics Components Technology Center, Bureau of Export Administration, Telephone: (202) 377-1641.

For questions of a technical nature regarding metals, minerals, and their manufactures, contact Jeff Tripp, Capital Goods Technology Center, Bureau of Export Administration, Telephone: (202) 377-1309.

For questions of a technical nature regarding chemicals, metalloids, petroleum products and related materials, contact Jeff Tripp, Capital Goods Technology Center, Bureau of Export Administration, Telephone: (202) 377-1309.

For questions of a general nature, contact John Black or Patricia Muldonian, Office of Technology and Policy Analysis, Bureau of Export Administration, Telephone: (202) 377-2440.

SUPPLEMENTARY INFORMATION:

Saving Clause

Shipments of items removed from general license authorizations as a result of this regulation that were on dock for lading, on lighter, laden aboard an exporting carrier, or en route aboard a carrier to a port of export pursuant to actual orders for export before June 6, 1988, may be exported under the general license provisions up to and including June 20, 1988. Any such items not actually exported before midnight June 20, 1988, require a validated export license.

Rulemaking Requirements

1. Because this rule concerns a foreign and military affairs function of the United States, it is not a rule or regulation within the meaning of section 1(a) of Executive Order 12291, and it is not subject to the requirements of that Order. Accordingly, no preliminary or final Regulatory Impact Analysis has to be or will be prepared.

2. This rule involves a collection of information subject to the requirements of the Paperwork Reduction Act of 1980 (44 U.S.C. 3501 *et seq.*). This collection has been approved by the Office of Management and Budget under control number 0625-0001.

3. Section 13(a) of the Export Administration Act of 1979, as amended (50 U.S.C. app. 2412(a)), exempts this rule from all requirements of section 553 of the Administrative Procedure Act (APA) (5 U.S.C. 553), including those requiring publication of a notice of proposed rulemaking, an opportunity for public comment, and a delay in effective date. This rule is also exempt from these APA requirements because it involves a foreign and military affairs function of the United States. Section 13(b) of the Export Administration Act does not require that this rule be published in proposed form because this rule implements regulatory changes based on COCOM review. Further, no other law requires that a notice of proposed rulemaking and an opportunity for public comment be given for this rule.