NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

February 26, 1992

Mr. Jeffrey A. Dalke
Drinker, Biddle & Reath
Broad and Chestnut Streets
Philadelphia, PA 19107

Re: Mutual Fund Investment (Your November 27, 1991, Letter)

Dear Mr. Dalke:

You have asked whether a federal credit union (FCU) may invest in a mutual fund that engages in covered dollar rolls involving U.S. Government agency mortgage-backed securities. Unless it can be demonstrated that an FCU is considered to own a security after entering into a binding agreement to purchase the security, an FCU may not invest in a mutual fund that engages in such transactions.

<u>Background</u>

You have described a covered dollar roll transaction engaged in by a mutual fund as follows:

(1) A mutual fund purchases a U.S. Government agency mortgage-backed security that is a permissible investment for federal credit unions, and subsequently enters into a covered dollar roll by selling the security to a broker/dealer with a simultaneous commitment to repurchase a substantially similar (same type, coupon and maturity) security on a specified future date not exceeding 120 days. At the time the covered dollar roll is entered into, settlement on the purchased security may or may not have occurred.

(2) During the period of the covered dollar roll (that is, after the settlement of the sale of the

FOIA Vol. I, E, 11

security to the broker/dealer and before its repurchase by the mutual fund), the broker/dealer is entitled to principal and interest payments on the security.

(3) For its participation in the covered dollar roll, the mutual fund is compensated either by a fee or by the difference between the sale price and the lower repurchase price (often referred to as the "drop") for the security, as well as by the interest earned on its reinvestment of the cash proceeds from the sale.

(4) Any cash proceeds received by the mutual fund from the sale of the security are invested during the period of the covered dollar roll in instruments that are legal investments for federal credit unions.

(5) Each dollar roll is "covered" in that during the period of the roll the mutual fund maintains an offsetting cash position or cash equivalent security position that matures on or before the repurchase settlement date in the full amount of the repurchase obligation.

(6) The covered dollar roll is settled on a cash basis on the repurchase date by the delivery of cash against the delivery of the repurchased security.

(7) During the period of the covered dollar roll, the mutual fund may enter into a commitment for a new covered dollar roll that will commence on or after the original repurchase date.

As you know, Section 6060.5.1 of the National Credit Union Administration (NCUA) Accounting Manual provides as follows:

> A dollar price repurchase transaction is a contract whereby a federal credit union sells a security that it owns and agrees to purchase another security on a future date. The dollar price repo does not represent borrowing by a

federal credit union as does a reverse repurchase transaction.

In the case of a reverse repurchase transaction, the transaction represents a borrowing because ownership of the security "sold" does not change; that is, the "seller" of the security still has title and still receives the dividend or interest income from the security. Interest based upon the balance of the proceeds received from the transaction is paid by the "seller." Additionally, the same security "sold" must be "repurchased." As such, essentials of a sale and repurchase do not exist.

In the case of a dollar price repo, the essential elements of a sale do exist, i.e., ownership of the security does change. The buyer now receives the dividend or interest income on the security. No interest is paid by the seller for funds received. The same security sold is not required to be repurchased.

A dollar price repo represents the sale of a security and a simultaneous agreement to purchase another security at a future date by the use of a forward placement contract. As such, a federal credit union may enter into such an agreement only if:

a. Gains and losses on the sale of the security sold are recognized on the settlement date of the sale.

b. The limitations cited in Section 703.3(b) of the NCUA Rules and Regulations for purchasing a security under a cash forward agreement are met.

You describe the basic transaction underlying a covered dollar roll as a sale of a security to a broker/dealer with a simultaneous commitment to repurchase a substantially similar security on a specified future date, with the broker/dealer entitled to principal and interest payments on the security during the period of the transaction. This description appears to meet the definition of a dollar price repo as set forth in the Accounting Manual. Where a dollar price repo involves only a one-time sale and repurchase of securities, however, a covered dollar roll appears to involve a series of sales and repurchases. As you have indicated, in a covered dollar roll a mutual fund could commit to sell certain securities before settlement of its prior commitment to repurchase such securities.

The Accounting Manual provides that an FCU may enter into a dollar price repo if the limitations cited in Section 703.3(b), now Section 703.4(b), of the NCUA Rules and Regulations for purchasing a security under a cash forward agreement are met. Section 703.4(b)(3) states that an FCU may enter into a cash forward agreement to purchase or sell a security, provided that "[i]f the [FCU] is the seller, it owns the security on the trade date." Section 703.2 defines "trade date" as "the date a Federal credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security." Thus, an FCU may only enter into a cash forward agreement to sell a security if it owns the security at the time the agreement is made. Likewise, for a mutual fund to be a permissible investment for FCUs, it could only enter into a cash forward agreement to sell a security if it owned the security at the time the agreement was made.

Although you note that in a covered dollar roll, a mutual fund could commit to sell certain securities before settlement of its prior commitment to repurchase such securities, you argue that a fund owns securities on the date it enters into a binding, legally enforceable agreement to purchase or repurchase them. You state that on that date, the mutual fund acquires all economic indicia of ownership, and thereafter bears the market risks relating to the securities. However, your ownership argument is partly contradicted by your earlier statement that after settlement of the sale of a security to a broker/dealer and before its repurchase by the mutual fund, the broker/dealer is entitled to principal and interest payments on the security. Even though the mutual fund has entered into a binding agreement to repurchase the security, it seems that the broker/dealer retains a significant indicium of ownership in the right to receive principal and interest payments on the security.

We are not convinced that an entity owns securities on the date it enters into an agreement to purchase or repurchase them (trade date). Unless you are able to demonstrate that relevant securities or contract laws establish such ownership, the requirements of Section 703.4(b) are not met. Until such time, we do not view covered dollar roll transactions as permissible activities for FCUs or mutual funds in which they invest.

Sincerely,

Hattie M. Ulan

Hattie M. Ulan
Associate General Counsel

GC/LH:sg
SSIC 4660
91-1205

cc: Charles Felker, Office of Examination and Insurance