Rules and Regulations

Federal Register
Vol. 51, No. 58
Wednesday, March 26, 1986

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FARM CREDIT ADMINISTRATION

12 CFR Part 611

Farm Credit System Capital Corporation; Organization

Correction

In FR Doc. 86–5533 beginning on page 8665 in the issue of Thursday, March 13, 1986, make the following correction:

On page 8668, in the second column, in the fifth line of § 611.1141(b), "but" should read "out".

BILLING CODE 1505-01-M

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 701

Investments in and Loans to Credit Union Service Organizations

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: The Federal Credit Union Act (Act) authorizes Federal credit unions (FCU's), under certain limitations, to invest in and make loans to credit union service organizations (CUSO's) and subjects Federal credit union CUSO activity to National Credit Union Administration Board approval. The NCUA Board has determined to address Federal credit union involvement and the Board's own approval authority through the regulation process. This rule reflects the Board's determination on these matters and revises the NCUA's existing rule concerning CUSO's. The final rule expands and clarifies the permissible services and activities of CUSO's and provides a specific mechanism for the addition of new services and activities. The rule interprets the limitations of the Act, and addresses safety and soundness concerns, through provisions related to organizational structure, customer base, conflicts of interest, accounting practices, and NCUA access to CUSO books and records.

EFFECTIVE DATE: May 27, 1986.

ADDRESS: National Credit Union Administration, 1776 G Street NW., Washington, D.C. 20456.

FOR FURTHER INFORMATION CONTACT: Robert M. Fenner, General Counsel, Steven R. Bisker, Assistant General Counsel, or Hattie Ulan, Staff Attorney, Office of General Counsel, at the above address or telephone: (202) 357–1030.

SUPPLEMENTARY INFORMATION:

Background

The Federal Credit Union Act authorizes Federal credit union investments in (sec. 107(7)(I), 12 U.S.C. 1757(7)(I)) and loans to (sec. 107(5)(D), 12 U.S.C. 1757(5)(D)) what have come to be known as credit union service organizations. Pursuant to the Act, the National Credit Union Administration Board is required to determine the types of organizations eligible to receive loans and investments from FCU's. The NCUA Board has interpreted sections 107(7)(I) and 107(5)(D) as applying to the same type of organizations. The Act provides only limited guidance as to the nature of these organizations. For example, section 107(7)(I) specifies that CUSO's provide services "associated with the routine operations of credit unions," and section 107(5)(D) requires that CUSO's be established "primarily to serve the needs of . . . member credit unions" and that a CUSO's business "[relate] to the daily operations of . . . credit unions."

The first CUSO regulation was promulgated in 1979. The rule placed many controls and restrictions on FCU involvement with CUSO's. The rule required NCUA approval prior to formation of a CUSO, and limited CUSO's to six specific activities. In 1982, NCUA substantially deregulated the CUSO rule, eliminating provisions with respect to issues such as organizational structure, customer base, and NCUA access to books and records. The 1982 rule also failed to provide clear guidelines concerning the permissible services and activities of CUSO's. In January, 1985, the Board determined that a reevaluation was necessary because of the lack of guidance provided by the regulation and the existence of significant supervisory problems involving CUSO's.

On January 24, 1985, the NCUA Board issued a proposed rule requesting public comment on several issues concerning the CUSO regulation (*see* 50 FR 4698, February 1, 1985). The January, 1985, proposal did *not* contain specific regulatory language. Some 90 comment letters were received. After reviewing the comments, on September 5, 1985, the NCUA Board issued a proposal containing specific regulatory language (*see* 50 FR 36998, September 11, 1985). Sixty-eight comment letters were received before the close of the comment period on November 8, 1985. Overall, the response to the proposed regulation was positive. Comment letters were received from: 31 Federal credit unions; 4 state-chartered credit unions; 8 CUSO's; 6 credit union trade associations and state leagues; and 19 others, including several law firms representing FCU's and CUSO's, a credit union mutual insurance company, trade groups representing insurers and realtors, a Congressman, and an economist.

The September 5 proposed rule contained four sections (proposed §§ 701.27(a)-(d)) involving the scope, statutory limitations and limited applicability of the regulation. The remainder of the proposal addressed the following six substantive CUSO issues: Structure and capitalization (proposed § 701.27(e)); customer base (proposed § 701.27(f)); services and activities (proposed § 701.27(g)); insider dealing (proposed § 701.27(h)); accounting procedures and NCUA access to information (proposed § 701.27(i)); and preexisting CUSO's (proposed § 701.27(j)).

The format of the final rule has been revised in order to shorten and further clarify the rule. The first four sections of the proposed rule (proposed §§ 701.27(a)-(d)) have been consolidated into two sections in the final rule §§ 701.27 (a) and (b)). Section 701.27(c), a definitional section, has been added. A new § 701.27(d) sets forth the six substantive issues previously addressed in proposed §§ 701.27(e)-(j). In addition to the changes in form, the Board has made certain substantive revisions to the rule in response to the comments received.

The following is a section-by-section analysis of the final rule with a discussion of the comments received and the changes that have been made.

Section-by-Section Analysis

Section 701.27(a)—Scope

Section 701.27(a) sets forth the scope of the regulation. It cities that statutory authority for FCU investments in and loans to CUSO's. The Board has clarified that § 701.27 does not directly regulate CUSO's but rather establishes conditions of FCU investments in and loans to such organizations. In general, the commenters found the provisions now contained in this section to be helpful.

Section 701.27(b)—Limits Imposed by the Federal Credit Union Act

This new subsection sets forth the CUSO lending and investment provisions of the FCU Act. The section is divided into two parts—§ 701.27(b)(1) addresses the provisions found in section 107(7)(I) of the Act (investment authority) and § 701.27(b)(2) addresses the provisions found in section 107(5)(D) of the Act (lending authority).

The information in this new section was set forth in three separate provisions of the proposed rule—§§ 701.27 (b), (c), and (g)(5). The commenters generally found a restatement of the statutory limitations to be helpful. One commenter suggested that the Board define what is meant by "control" and "financial institution" in the restatement (now found at § 701.27(b)(1)(iii)) of the statutory prohibitions against an FCU using the CUSO investment authority to acquire control of another financial institution. In view of the limited experience with this aspect of the CUSO authority, the Board has decided not to define these terms at this time. Regulatory definitions might not adequately address issues that arise in the future. The Board has previously stated a policy, however, that this authority may not be used to purchase shares of stock in other *deposit* taking institutions, and that policy will continue to apply.

Section 701.27(c)—Definitions

This section is new. All four of the definitions in this section appeared in various sections of the proposed rule. They have been consolidated in a "definition" section in order to improve the organization of the rule. One commenter suggested that the Board expand upon the definition of "paid-in and unimpaired capital and surplus." The definition remains as "shares and undivided earnings." A further explanation is found in Article XVIII, sections 1(g) and (h) of each FCU's Bylaws.

Section 701.27(d)—Regulatory Provisions

This section contains the provisions found in §§ 710.27(e)–701.27(j) of the proposed rule. The section is divided into eight numbered parts, each addressing a specific substantive issue. Each part is discussed separately below.

Section 701.27(d)(1)—Limits on Funding

The first sentence of this section clarifies that FCU's may invest in or loan to CUSO's in participation with other credit unions and non-credit union parties. This provision was set forth in the proposal as the first sentence of § 701.27(e). The provision has been reworded to clarify that an FCU need not invest in a CUSO before it can lend to it. The remainder of this section clarifies the point of time use to determine an FCU's unimpaired capital and surplus, for purposes of ascertaining compliance with the 1% limits on loans and investments. In response to the comments received, the rule provides that the figures reflected in the last calendar year-end financial report shall be used.

Section 701.27(d)(2)—Structure

The contents of this section were contained in § 701.27(e) of the proposed rule. As proposed, the final rule limits CUSO structure to either a corporation or a limited partnership (with FCU's serving only as limited partners). Also as proposed, CUSO's are required to be adequately capitalized and operated as separate entities. The Board believes that these requirements are the minimum necessary to ensure that FCU's will not be exposed to potential losses in excess of their funds invested in or lent to the CUSO. Twenty-one commenters specifically addressed this subsection of the proposal, with 14 basically agreeing with the subsection and only 3 totally opposed to it. The three in opposition believed that there should be no limit on CUSO structure.

Two other commenters believed that a corporation should be the only permitted CUSO structure. One of these commenters stated that an FCU limited partner can easily, and perhaps inadvertently, take part in the control of the business of the CUSO and thus lose its limited liability. While limited partnership CUSO's will be permitted, it is emphasized that FCU's must take care to limit their involvement and activities to those permitted under the law (State law) for limited partners. The rule sets forth a nonexclusive list of examples of those activities which, if engaged in by a limited partner, may cause the loss of the limited partner status and result in the partner being treated as a general partner with unlimited liability.

Several commenters asked who can be the general partner in a limited partnership CUSO, since FCU's are prohibited from serving as the general partner. The Board has not limited who, other than FCU's, may serve as the general partner. The general partner may, for example, be a credit union league, trade association, insurance company, or an individual, etc. Participating FCU's should ensure that the general partner has adequate capital and management capabilities.

One commenter suggested that CUSO's be permitted to have a cooperative corporate structure. This commenter reasoned that, since FCU's are financial cooperatives and cooperatives have the same limited liability as corporations, the cooperative corporate structure would be appropriate for CUSO's. The Board agrees. Statutes authorizing the cooperative corporate structure exist in all states and, for the most part, limit the liability of stockholders or members to the same extent as in a regular stock corporation. The cooperative corporate structure is a permissible one for CUSO's provided that appropriate state laws provide for limited liability of the members (owners) of the cooperative corporation.

At least three commenters, including one trade association, suggested that insurance coverage be obtained by the CUSO in order to protect affiliated FCU's and the National Credit Union Share Insurance Fund (NCUSIF). Property and casualty insurance should be obtained in the ordinary course of business. Other insurance, for example, against loss caused by mismanagement, may be impossible to obtain or prohibitively expensive. Accordingly, NCUA is not requiring such insurance at this time. The other safeguards of this regulation should provide adequate protection to the credit union, its members and the NCUSIF.

Several commenters stated their concern that a court will look to all the requirements that NCUA places on FCU's involvement with CUSO's and treat CUSO's as mere extensions of their investing FCU's, thus removing limited liability. As previously explained, the Board has revised the rule to make it clear that it places conditions on FCU loans and investments, rather than directly regulating CUSO's. A court decision to look past the CUSO and to the FCU would depend upon such

factors as: Inadequate capitalization; lack of separate corporate identity; common board of directors and employees; control of one corporation over another; and lack of separate books and records. These factors, as well as others, may be relied on by a court in deciding whether to pierce the corporate structure and hold the stockholders personally liable. If the CUSO is adequately capitalized and maintained as a separate entity, and the above conditions are avoided, a court is not likely to pierce the corporate veil. Of course, the courts and not the NCUA Board will be the ultimate arbiters of this issue.

Another issue addressed in the comments was whether CUSO's, once established, could form subsidiary corporations and partnerships. While CUSO's may establish corporations and partnerships, they may not be used as vehicles by which to circumvent this regulation. FCU's investing in or making loans to a CUSO that is merely a shell corporation for the purpose of forming other corporations with which to circumvent the regulation will be required to divest their investments and loans. The formation, by a CUSO, of a subsidiary corporation or a partnership should be done only in connection with carrying out permissible activities under the rule.

Section 701.27(d)(3)—Legal Opinion

Language similar to that found in this new section appeared in § 701.27(e) of the proposal. Federal credit unions must obtain written legal advice to help ensure that they are meeting the goal of limited liability in their investments in CUSO's. Since the factors to be considered may vary from state to state, it is advisable that FCU's obtain the opinion of local counsel on the issue of limited liability. While NCUA recognizes that it will not be possible to obtain a legal opinion providing absolute assurances against FCU liability, obtaining legal advice should help FCU's determine whether they have taken reasonable steps in light of applicable state law. One commenter asked how often an FCU should obtain or update this advice. FCU's should obtain a legal opinion prior to their initial investment in a CUSO and should update this information as conditions change or as otherwise warranted.

Section 701.27(d)(4)—Customer Base

Section 701.27(f) of the proposed rule limited the customer base of a CUSO to primarily affiliated credit unions (defined as those credit unions that have invested in or made loans to a CUSO) and the membership of such credit unions.

Twenty-six comments were received on the customer base issue. Eight commenters agreed with the section as written.

Sixteen commenters stated that CUSO's should be able to serve both affiliated and nonaffiliated credit unions. These commenters believed that the proposed rule was too restrictive and would not be beneficial to the credit union community. As an example, they argued that a small FUC should not be prevented from obtaining services from a CUSO specializing in data processing services because it has not invested in or made a loan to the CUSO. Other commenters pointed out that the "affiliated" restriction could be easily circumvented by an FCU making a *de minimus* investment in or loan to a CUSO.

Some of the commenters suggested that CUSO's "primarily serve credit unions and the membership of affiliated credit unions." Others urged that a broader customer base be adopted that would leave out any reference to "affiliation" and have CUSO's serve primarily credit unions and their memberships. One commenter suggested that CUSO's also be permitted to serve primarily other CUSO's. Only four commenters requested that "primarily" be defined in the regulation. However, a workable definition was not suggested.

The Board has modified the customer base subsection in the final rule, now § 701.27(d)(4), to enable CUSO's to serve both affiliated and nonaffiliated credit unions. Thus in the language of the final rule, FCU's may invest in and lend to CUSO's that serve "primarily credit unions and/or the membership of affiliated credit unions." FCU's are authorized to invest in and loan to a CUSO that serves other CUSO's financial institutions and their customers, other organizations, members of nonaffiliated credit unions, etc., *provided* the CUSO *primarily* serves credit unions and members of affiliated credit unions. FCU's cannot invest in or loan to CUSO's that *primarily* serve nonaffiliated credit union members. The Board believes that if any FCU's members seek the services of a CUSO, the FCU can either establish its own CUSO or become affiliated with an existing CUSO.

In light of the comments, the Board again considered providing a definition of the term "primarily." As it had concluded in the proposed rule, the Board believes that defining the term as a percentage of business or percentage of customers served would be arbitrary. The lack of a definition is not deemed critical since the wording in § 701.27(d)(4) reiterates the statutory requirement and will provided the Board with a sufficient basis to deal with any clear abuses.

Section 701.27(d)(5) Permissible Services and Activities

Section 701.27(d)(5) is a revised and amended version of § 701.27(g) in the proposed rule. As proposed, the subsection contained five subparts. Three of the subparts appear here. Proposed § 701.27(g)(3)—State and Local Law, has been moved to the end of the regulation (*see* § 701.27(e) of this final rule) and proposed § 701.27(g)(5)—Statutory Prohibitions, is now found in § 710.27(b)(1)(iii).

The first two subparts of § 710.27(d)(5) provide an exclusive listing of services and activities that CUSO may perform. Section 701.27(d)(5)(i) lists operational services and § 701.27(d)(5)(ii) lists financial services. Section 701.27(d)(5)(iii) sets forth the procedure for approval of additional services and activities not listed in the regulation.

Almost all of the commenters addressed the activities subsection in their letters. The vast majority of these commenters were in favor of a listing of CUSO activities. Several commenters suggested that the list be nonexclusive. Only twelve of the commenters suggested eliminating the activities list. Some of these commenters stated that a CUSO should be able to provide *any* service or activity that would benefit credit unions and their members. Other commenters argued that each FCU should be authorized to determine what is within its routine operations and its CUSO(s) should be authorized to provide those services. The majority of the commenters, however, preferred an expanded, exclusive list of services and activities.

It is important to note that sections 107(5)(D) and 107(7)(I) of the FCU Act place limits on the types of services a CUSO may provide. By statute, Federal credit unions may not invest in and lend to CUSO's that offer services beyond the limits of the Act. The final rule contains an expanded, exclusive list of service and activities. The list eliminates uncertainty by providing the NCUA Board's interpretation of the limits of the Act. All services and activities listed in the proposed rule appear in the final rule. Other services and activities have been added. They are discussed below.

Section 701.27(d)(5)(ii)—Operational Services

In response to recommendations of many commenters, the Board has added several activities to the list of operational services. The Board believes that these activities are related to an FCU's "daily operations" and are "associated with their routine operations" as required by sections 107(5)(D) and 107(7)(I) of the FCU Act. The majority of these services are self-explanatory and do not require further discussion. They include: Check cashing and wire transfers, internal audits for credit unions, shared credit union branch (service center) operations, sale of repossessed collateral, servicing of computer hardware or software, research services, record retention and storage, microfilm and microfiche services, alarm monitoring and other security services, and provision of forms and supplies.

Two activities added to the list of operational services do warrant further discussion. They are addressed below.

The single most requested activity was mortgage lending. Fourteen commenters asked that real estate mortgage origination, processing, service and sales be added to the activities list. Several reasons were given for the requested addition. Some of the commenters noted that pursuant to the former pilot program rule (former Part 723 of the NCUA Rules and Regulations), several CUSO's were approved for consumer mortgage lending. Under the pilot program, the consumer mortgage loans could only be made to members of those credit unions that had invested in the CUSO and such loans had to be made in conformance with NCUA's mortgage lending regulation. Although the pilot program regulation has been eliminated (*See* 50 FR 27417, July 3, 1985), there are FCU's that have investments and loans to CUSO's that continue to engage in mortgage lending under the prior grant of authority. These and other commenters stated that it is their belief that mortgage lending is within an FCU's routine operations and that it meets the needs of credit union members. They stressed that CUSO mortgage lending produces less liquidity risk and interest rate risk to FCU's and less risk to the NCUSIF than if the service is offered directly by the FCU. One commenter noted that a CUSO enables several credit unions to join together to offer their members consumer mortgage loans. Such an arrangement promotes the economies of scale which are essential to provide such service in a cost effective and professional manner.

In consideration of the comments, the Board has added "consumer mortgage loan origination" to the list of permissible services and activities. The reference to *consumer* mortgage loan origination is intended to clarify that the mortgage loan authority may not be used to engage in commercial real estate loans or real estate development loans. Also, the authority to engage in loan processing, which appeared in the proposed rule, has been expanded to allow loan "processing, servicing and sales," thus enabling CUSO's to provide a full range of support services for mortgage loans and for other loans originated by the credit union.

The second activity added to the list of operational services requiring further discussion is management, development, sale or lease of fixed assets. Although this activity did not appear in the proposed rule, the preamble to the rule did discuss sale and leaseback and CUSO participation in the purchase, sale, and leasing of real property with affiliated credit unions. At that time, the Board stated that, although such transactions were permissible for FCU's to enter into with CUSO's, they were not placed on the list of ongoing CUSO activities since such real property transactions can be considered a matter of general business operation. Credit unions involved in these transactions are subject to the fixed asset regulation (12 CFR 701.36) and the NCUA Interpretive Ruling and Policy Statement on Sale and Leaseback (IRPS 81–7). However, the NCUA Board now believes that these transactions should be added to the CUSO regulation both in the interest of clarity and for other reasons explained below.

A few commenters described a situation where the principal function of the CUSO is to construct, manage and maintain an office building to be leased by an FCU that has invested in and/or made loans to the CUSO. This arrangement would be faciliated by the CUSO forming a limited partnership, with the CUSO serving as the general partner, and credit union members and others as limited partners. Because of the tax shelter aspects of such an investment, and the small investment required, it would be of particular interest to members and other investors. Limited partnership interests as well as investment by the general partner CUSO would fund the project. The purpose of the limited partnership would be to acquire land, construct a building for the FCU, and to then lease the building to the FCU. Other than its involvement in the limited partnership to construct the building, and its continuing involvement in managing and servicing the building, the CUSO would not be engaging in any other significant activities.

Although this CUSO activity may be beneficial to FCU's and their members, such a project could result in significant losses to the CUSO and, correspondingly, to those FCU's that have invested in or lent funds to the CUSO. One of the commenters suggested guidelines which the Board believes represent necessary safeguards in order to ensure that an FCU engaging in this activity is in compliance with the requirements of the FCU Act and basic standards of safety and soundness. These requirements are: (1) The overall development cost of the project (e.g., the building and all attendant costs and expenses), when added to the fixed assets of the FCU involved, should not exceed 5% of the shares and retained earnings of the FCU. If more than one FCU is involved, the limit should take into account the ability of those FCU's, in the aggregate, to invest funds up to 5% of their shares and retained earnings, in fixed assets. This guideline would serve to ensure that, in the event the limited partnership (in which the CUSO is the general partner with unlimited liability) is unable to raise sufficient funds to complete the project, the FCU(s) could purchase the project from the limited partnership and complete it without violating the fixed asset regulation (*see* § 701.36 of the NCUA Rules and Regulations). (2) The maximum amount of investment by the CUSO, as general partner, should not exceed the amount of funds available to it from its affiliated credit unions (i.e., through their authority to invest in and make loans to CUSO's). The minimum level of investment participation by the limited partners that should be obtained before the project is started should be that amount which, when added to the amount available to the CUSO general partner from its affiliated credit unions, would be sufficient to complete the project without the necessity of borrowing funds from outside sources. If the limited partnership were forced to borrow additional funds from outside sources, the cost of the project (because of added interest costs) would increase and would impact on the cost effectiveness and, potentially, the economic viability of the project.

Additionally, FCU's should be aware of applicable Federal and state securities laws when they become involved in these types of projects. Further, FCU's engaging in sale and leaseback or straight lease arrangements with their CUSO must comply with IRPS 81–7 (Sale and

Leaseback) and the fixed asset regulation § 701.36 of the NCUA Rules and Regulations). It should be noted that the fixed asset rule is applicable to lease payments (e.g., for the FCU's building, etc.). Therefore, FCU's entering into transactions with their CUSO's, as discussed above, must ensure that they consider their lease payments for the space leased from the CUSO to determine that they are within the 5% limitation of § 701.36. Also, FCU's should be advised that the Board will critically review those instances where a CUSO is established as a vehicle to circumvent the limitations of the fixed asset rule. If necessary, appropriate administrative enforcement remedies will be taken.

Although not a regulatory requirement, it may be advisable for FCU's whose CUSO's are contemplating these types of transactions to be in contact with their NCUA Regional Office before engaging in such ventures to review potential safety and soundness problems. Before contacting its NCUA Regional Office, an FCU should have a preliminary plan prepared for review by the Agency.

Lastly, one commenter suggested that the Board add "building maintenance services" to the list of permissible operational services. The Board interprets building maintenance services as coming within management of fixed assets (contained in the list) and, therefore, has not separately listed this activity.

Section 701.27(d)(5)(ii)—Financial Services

Fewer comments were received with respect to the financial services section. The comments and changes that have been made are as follows:

Travel agency services have been added to the list of permissible activities. Ten commenters made this suggestion. Several of these commenters noted that some CUSO's are already providing travel agency services for their affiliated credit union members. The Board believes that travel agency services are associated with the routine credit union operations of making vacation and travel loans and issuing and selling travelers' checks. Further, such services are associated with vacation and travel savings programs.

Another service added to the list is acting as administrator for prepaid legal service plans. The Board believes that a plan which provides legal services to credit unions and/or credit union members is within a credit union's "routine operations." As part of their normal operations, credit unions have a need to obtain legal advice and services. Members may have such a need in connection with their personal financial decisions. This activity will allow a CUSO to administer a prepaid legal plan for credit unions and/or for members of affiliated credit unions providing a means by which legal services may be obtained at reduced cost.

A number of commenters suggested that "discount brokerage services" was unnecessarily limited and that FCU's should be allowed to participate in CUSO's offering a full range of securities services to credit unions and members of affiliated credit unions. The NCUA Board agrees and has substituted "securities brokerage services" for "discount brokerage services." CUSO's that choose to engage in securities activities should be aware of various Federal and state securities laws that may apply.

One commenter requested that "real estate agency services" be changed to "real estate brokerage services." Brokerage services is the term used in the industry. A trade association for real estate brokers commenting on the rule believes that real estate agency services should be eliminated from the list. They reasoned that permitting such activity would produce unfair competition and tying arrangements. Inasmuch as real estate brokerage services are associated with routine credit union operations (particularly related to FCU's mortgage lending), it has not been removed from the permissible list. The Board believes that there are adequate laws in place to protect realtors from unfair competition and, therefore, does not feel it is appropriate to prohibit such activity for CUSO's.

Three commenters representing the insurance industry recommended that the authority to act as agent for the sale of insurance be eliminated from the permissible list. They argued that involement by CUSO's in this activity was anti-competitive and anti-consumer. Acting as an agent for the sale of insurance is not a new activity for CUSO's. The Board is not aware of anti-consumer or anti-competitive practices in the sale of insurance either through a CUSO or through an FCU (pursuant to Part 721 of the NCUA Regulations). The sale of insurance is an area heavily regulated by the states, and any CUSO involvement in insurance activities will be subject to applicable state laws and regulations. Also, it should be noted that neither FCU's nor CUSO's with whom they are affiliated may underwrite (issue) insurance. This activity is *not* authorized for FCU's or CUSO's.

There were a few activities suggested by commenters that were not added to the permissible list of services. Sale of used cars was suggested by one commenter. The Board believes that this broad activity does not fall within routine credit union activities. However, sale of repossessed collateral has been added to the list. This would include sale of used cars that have been repossessed as a result of defaults by credit union members on their auto loans. Car rental was also suggested as a permissible activity. This has not been included in the final rule. However, personal property leasing (e.g., auto leasing) is in the final rule. While the courts have reocgnized auto leasing as the functional equivalent of making auto loans, it does not extend to short-term car rentals. One commenter suggested that CUSO's be permitted to offer all financial services allowed by FCU's. With such authority, a CUSO would, in effect, become a financial institution. The prohbition against an FCU acquiring control of another financial institution (*see* sect. 107(7)(I) of the FCU Act and § 701.27(b)(1)(iii) of this regulation) would preclude the addition of this authority to the permissible list.

Finally, with respect to the services offered by CUSO's, the Board has considered requiring that a formal business plan be developed both prior to formation of a CUSO and prior to offering any new service or activity. The Board believes that this is something that should always be done in the normal course of business, and that it will be done by any well-planned and well-operated CUSO. Thus, it need not be imposed as a regulatory requirement at this time. The Agency will, however, as a part of its regular examination of FCU's involved in CUSO's, determine whether this practice is followed, and will consider any necessary regulatory amendments if this appears to be a problem area in the future.

Section 701.27(d)(5)(iii)—NCUA Approval of Other Services

Section 701.27(d)(5)(iii) corresponds to § 701.27(g)(4) of the proposed rule and provides that a request to add a new service or activity not listed in the regulation will be treated as a petition to amend the regulation. The requests are to be submitted to the appropriate NCUA Regional Office and NCUA will request public comment or otherwise act on the petition within 60 days after receipt.

Nine commenters addressed this section in their comment letters. Several recommended that the time period be reduced from 60 to between 10–30 days. One commenter believed that NCUA staff approval rather than an amendment to the regulation was all

that was necessary. Another suggested that CUSO's be able to start up a new service or activity with the understanding that NCUA may object after the fact and stop activity. This commenter reasoned that waiting for NCUA approval will cause CUSO's to miss the market for new services and activities. The Board believes that "after the fact" approval is inappropriate. It is recognized that the procedure set forth in this regulation may cause some limited time delay in providing new services or activities. However, the Board believes this is preferable to the costs and other complications that would result if FCU's were to invest in or loan to a CUSO engaged in an activity that the Agency determined at a later date to be unauthorized.

One commenter asked that the Board clarify that requests to add a new service or activity are not limited to FCU's and could also be made by the credit union leagues, trade associations or any other interested parties. Leagues, trades, CUSO's themselves or others may make such requests. As note in the proposal and in the final rule, requests should be submitted to the NCUA Regional Office where the requestor is located. Requests should include a full explanation and complete documentation of the service or activity and how it is associated with routine credit union operations. Initial review will be completed by the Regional Offices. Inasmuch as the addition of a new activity to the list is a substantive change in the regulation, the requirements of the Administrative Procedure Act must be followed.

Section 701.27(d)(6)—Conflicts of Interest

Section 701.27(h) of the proposed rule addressed the issue of "insider dealing." The corresponding provisions of the final rule, now contained at § 701.27(d)(6), have been retitled "Conflicts of Interest," which the Board believes more accurately describes the scope of the provision.

The proposed section imposed a broad prohibition against FCU officials, employees, and their immediate family members receiving any type of income or compensation from an affiliated CUSO. Over 30 commenters addressed this subsection. While many of the commenters generally agreed with the proposal, there were others that, to a greater or lesser extent, disagreed.

Those in agreement with the proposal stated that to allow FCU directors and committee members to receive compensation from a CUSO would serve as an easy vehicle by which to avoid the prohibitions on compensation contained in sections 111 and 112 of the FCU Act (12 U.S.C. 1761 and 1761a). They also agreed that, without a prohibition, there would be a greater likelihood of conflicts of interest arising to the detriment of the FCU's. Decisions to establish, invest in, or loan to a CUSO, and the determination of the activities and services to be provided would be more a function of what would be most lucrative and provide greater commission income, salaries, etc. for the officials or employees, rather than that which would be most beneficial to the FCU.

Several commenters, on the other hand, expressed the view that this provision was too broad and overly restrictive. Many urged the Board to remove all restrictions on compensation. Those commenters argued that full disclosure and common law remedies (e.g., lawsuits brought against the officials for misappropriating a corporate opportunity of the FCU) would provide adequate protection to FCU's and their members. Some of the commenters agreed with the prohibition with respect to officials and upper level (management) employees but believed that it should not apply to lower level employees. Other commenters stated that the prohibition should not extend to family members of the officials and employees. Still other commenters noted that the prohibition should not apply to newly formed CUSO's.

The Board, after considering the comments, continues to believe that a strong prohibition against conflicts of interest is in the best interest of FCU's, their members, and the NCUSIF. It is axiomatic that the purpose of a CUSO is to provide services and benefits to credit unions and their members. Individuals who serve as officials and employees of Federal credit unions have the responsibility, therefore, when making decisions concerning the formation and operation of CUSO's, to base those decisions on the best interests of the credit union and its members. Motivations of personal financial gain from CUSO activities would present an inherent conflict of interest. These types of motivations have been a factor in most of the problem-case CUSO's that NCUA has encountered. Examples have included personal gain by officials from the sale and leaseback of an FCU's fixed assets, personal receipt of insurance commission income, preferential loans to CUSO's partially owned by credit union officials, and receipt by credit union officials, through a CUSO, of various types of fee income, including income on real estate closings, title searches and appraisals.

Considering the broad range of innovative services and activities permitted by the final rule, including real estate, insurance and securities services, the Board believes it is essential to ensure that the focus remain one of benefitting credit unions and their members. A clear prohibition against conflicts of interest is consistent with the cooperative nature of credit unions and longstanding principles of volunteer service by credit union officials. It will ensure that Federal credit union involvement with CUSO's does not lead to the types of problems that have arisen in some instances in the past, and that have recently marred the thrift industry in Maryland and elsewhere, related to self-dealing within affiliated businesses. At the same time, *nonvolunteer* officials and employees of the credit union properly can and should be compensated *by the credit union* based on their contribution to the overall performance of the credit union.

The Board does recognize the need of CUSO's, especially those that are newly formed, to have low cost help. The prohibitions imposed by 701.27(d)(6) would *not* preclude an FCU official or employee from working for a CUSO, provided the individual is not compensated by the CUSO. Further, the rule would not bar the CUSO from reimbursing the FCU for the services provided to it by such individual(s). Language has been added to the final rule clarifying this point. With respect to such practices, it should be noted that care should be taken to ensure that an official or employee that works for the CUSO is responsible to and takes direction from the CUSO's management when working at the CUSO.

The conflict of interest provision has been slightly modified to close some potential loopholes. The rule now provides that officials and employees may not receive direct or indirect compensation from the CUSO and that they may not receive compensation *from persons being served through the CUSO.* Thus, the rule now clearly prohibits credit union officials and employees, and their family members, from receiving commission or fee income or other compensation from the credit union's members in connection with the members' use of the CUSO.

Section 701.27(d)(7)—Accounting Procedures; Access to Information

The provisions contained in this section appeared in §§ 701.27(i)(1)–(4) of the proposed rule. The section has been reorganized but the requirements remain essentially unchanged.

The proposed and final regulation require FCU's to follow generally accepted accounting principles (GAAP) in connection with their involvement with CUSO's. Additionally, FCU's are required to obtain quarterly financial statements and an annual certified public accountant (CPA) audit report from CUSO's in which they have an outstanding investment or loan. The rule further requires that affiliated FCU's obtain written agreements from their CUSO's that they will follow GAAP *and* grant NCUA access to their books and records. The preamble to the proposed discussed certain requirements of GAAP (e.g., when filing of consolidated financial statements is necessary).

A total of twenty-three commenters addressed this subsection. The majority of the commenters agreed with the rule. Several commenters stated that the requirements of this subsection would provide protection for FCU's and the NCUSIF, but some felt that not all of the requirements were necessary (e.g., they agreed with the GAAP requirements, but believed the submission of quarterly financial reports was unnecessary). The provision of the proposed rule related to NCUA access to CUSO books and records engendered substantial controversy. Several commenters questioned the Board's authority to require access to a CUSO's books and records. One commenter inquired as to who will bear the cost of examination. Two commenters suggested that NCUA should only have access to CUSO records to the extent that they have access to records of other FCU investments.

The NCUA Board considers the requirements set forth in the rule to be necessary for the safety and soundness of FCU's and ultimately the NCUSIF. The Board believes that it has properly exercised its authority in reserving access to a CUSO's books and record. Section 204(a) of the FCU Act, 12 U.S.C. 1784(a), authorizes the NCUA Board to examine any insured credit union. Examiners are authorized to "make a thorough examination of all the affairs of the credit union. . . . " Section 204(b) of the FCU Act, 12 U.S.C. 1784(b), further authorizes the NCUA Board or its representatives to "take and preserve testimony under oath as to *any matter in respect to the affairs of any such [insured] credit union*, and to issue subpenas and subpenas duces tecum. . . ." (Emphasis added.) Such subpenas are to be enforced by the United States District Court "where the *principal office* of the credit union is located or *in which the witness* resides or *carries on business.*" (Emphasis added.)

It is clear that FCU investments in and loans to CUSO's are matters within the "affairs of the credit union." Pursuant to sections 204 (a) and (b) of the Act, NCUA is authorized to examine such credit union affairs, and if testimony and records cannot be obtained through such examination, to issue subpenas and subpenas duces tecum. This authority extends to those individuals (entities) who are involved with insured credit unions, as evidenced by the reference to "principal office. . . in which the witness. . . carries on business" in section 204(b). Therefore, in conjunction with the Board's authority to promulgate regulations (*see* sections 120(a) and 209(a)(11) of the Act), examine insured credit unions, and issue subpenas and subpenas duces tecum, the Board is within its authority to require, by regulation, the FCU's with investments in or loans to a CUSO obtain a written agreement granting NCUA access to the CUSO's books and records.

In response to the issues raised by the commenters, the cost of an examination of a CUSO's books and records would be borne by NCUA. The indirect effect, of course, is that the cost is borne by insured credit unions through the operating fees (FCU's) and insurance fees (all insured credit unions) assessed by the Agency. With respect to the issue of different treatment for this investment as compared to other FCU investments, the Board notes that the CUSO may be integrally involved in the daily operations of the investing credit union(s) and therefore, the CUSO's sound and efficient operation has significant implications for those credit unions with whom it does business. For these reasons, and others, the Board believes that different treatment is justified.

As to the requirement of following GAAP, the Board again notes that GAAP requires that entities (FCU's) holding a fifty percent or greater financial interest in another company (e.g., a CUSO) file consolidated financial statements with their subsidiary (e.g., CUSO). FCU's that do not control more than a fifty percent interest but that have sufficient control to influence the operation of financial decisions of a CUSO are advised to use the equity method of accounting. In both cases (consolidated financial statements and the equity method), inter-company transactions should be eliminated. While these specific requirements are not made a part of the final rule, they are required under GAAP. They are noted here because of their importance in representing the relationship between a CUSO and its affiliated FCU(s).

Section 701.27(d)(8)—Preexisting Credit Union Service Organizations

The proposed regulation (§ 701.27(j)) stated that FCU's affiliated with CUSO's that were not in compliance with the new final rule would have one year to come into compliance with it.

Only three commenters addressed this subsection. Two of the commenters suggested that the provision be changed to a permanent grandfather clause rather than a one year phase out. The third commenter suggested that the subsection contain a specific provision for hardship cases.

The subsection has been slightly modified. It now provides for a one year phase out and an extension for hardship cases with prior Board approval. Further, the rule differentiates between FCU investments in and loans to CUSO's. Section 701.27(d)(8) has been divided into two subparts, subpart (i) addressing FCU investments in CUSO's and subpart (ii) addressing FCU loans to CUSO's.

If an FCU's investments in a CUSO were in conformance with the prior CUSO regulation, but are not in conformance with the new final rule (e.g., FCU is a general partner of a CUSO), the FCU must divest within one year of the effective date of the new final rule or the investment must come into compliance within the year unless the FCU applies for and is granted an extension by the NCUA Board within the one year period. FCU loans to CUSO's made prior to the effective date of this final rule must conform with the rule unless the FCU applies for approval to extend the loan and such approval is granted by the NCUA Board, or the FCU cannot accelerate payment of the loan without breaching its loan contract with the CUSO. It is not the Board's intent to force FCU's to breach their loan contracts with CUSO's. A provision has been added to the final rule to clarify this position. FCU's are, however, required to accelerate repayment of these loans, if at all possible, within the terms and conditions of their loan contracts.

Section 701.27(e)—Other Laws

Section 701.27(g)(3) of the proposed rule stated that CUSO services and activities would be subject to compliance with applicable state and local laws. Several commenters noted that CUSO compliance with other laws, in addition to the FCU Act and the NCUA Rules and Regulations, is not

only relevant to services and activities, but to all aspects of CUSO operation (e.g., compliance with chartering procedure under a state corporation law for a corporate CUSO). For this reason, the provision has been removed from the services and activities section and is now in a separate section, § 701.27(e), which applies to all aspects of the final rule. Commenters also noted that other *Federal* laws, in addition to state and local laws, would be applicable to CUSO's. For example, CUSO's involved in brokerage services must comply with Federal, as well as state, securities laws. The Board agrees and has revised the rule accordingly.

Federally Insured State Chartered Credit Unions

Although this rule has direct applicability only to Federal credit unions, it may indirectly affect federally insured state chartered credit unions (FISCU's), as explained below.

Several states have provisions in their credit union statutes or regulations that allow their state chartered credit unions to make loans and/or investments that conform with the FCU Act and Regulations. FISCU's chartered under state acts having such a "wildcard" provision will, in most instances, be required under operation of state law to comply with this CUSO regulation.

A second instance where this rule may be applicable to FISCU's involves the Agreement for Insurance of Accounts (Agreement) that all FISCU's enter into with NCUA to obtain share insurance from the NCUSIF. Paragraph 8 of the Agreement requires that a FISCU establish and maintain an Investment Valuation Reserve Account for all of its investments except loans to its members or obligations or investments expressly authorized in Title I of the FCU Act. The Agreement specifies that the Reserve Account must be in an amount at least equal to the net excess of book value over current market value of the investments. If the market value cannot be determined, the Agreement requires that an amount equal to the full book value be established. FISCU's making loans to and investments in CUSO's that are not in conformance with this regulation (which implements sections 107 (5)(D) and (7)(I) of Title I of the FCU Act) must establish and maintain such Reserve Accounts.

Regulatory Procedures

Regulatory Flexibility Act

The NCUA Board hereby certifies that the final rule will not have a significant impact on a substantial number of small credit unions. According to information available to NCUA, less than 300 FCU's are involved in CUSO's. Accordingly, the Board has determined that a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

The preamble to the proposed regulation noted the collection of information requirements found in the proposal ("agree in writing"—proposal §§ 701.27(i) (3) and (4); in the final rule, the requirements are "obtain written agreements"—final rule § 701.27(d)(7)(ii)). The collection requirements were submitted to the Office of Management and Budget (OMB). The NCUA received notification from OMB that the requirements are exempt from the Paperwork Reduction Act and implementing regulation due to that fact that they are affirmations that entail no burden. (*See* 5 CFR 1320.7(k)(1).)

List of Subjects in 12 CFR Part 701

Credit unions, Credit union service organizations.

By the National Credit Union Administration Board on March 18, 1986.

Rosemary Brady,

Secretary of the Board.

PART 701—[AMENDED]

Accordingly, NCUA has amended Part 701 as follows:

1. **Authority:** The authority citation for Part 701 is revised to read as follows and the authority citations following all the sections in Part 701 are removed:

Authority: 12 U.S.C. 1755, 12 U.S.C. 1756, 12 U.S.C. 1757, 12 U.S.C. 1759, 12 U.S.C. 1761a, 12 U.S.C. 1761b, 12 U.S.C. 1766, 12 U.S.C. 1767, 12 U.S.C. 1782, 12 U.S.C. 1784, 12 U.S.C. 1787, 12 U.S.C. 1789, and 12 U.S.C. 1798.

In addition, § 701.31 is also authorized by 15 U.S.C. 1601, et seq., 42 U.S.C. 1981 and 42 U.S.C. 3601–3610.

2. Section 701.27 is revised to read as follows:

§ 701.27 Investments in and Loans to Credit Union Service Organizations.

(a) *Scope.* Sections 107(7)(I) and 107(5)(D) of the Federal Credit Union Act (12 U.S.C. 1757(7)(I) and 1757(5)(D)) authorize Federal credit unions to invest in and make loans to credit union service organizations. This regulation implements those sections by addressing various issues, including monetary limits on loans and investments, the structure of credit union service organizations, their customer base, and the range of services and activities that they may provide. The regulation also establishes prudential standards for Federal credit union involvement with credit union service organizations, through provisions concerning conflicts of interest, accounting practices, and NCUA access to books and records. The regulation applies only in cases where one or more Federal credit unions have invested in or made loans to an organization pursuant to section 107(7)(I) or 107(5)(D). The regulation does not regulate credit union service organizations directly but rather establishes conditions of Federal credit union investments in and loans to such organizations.

(b) *Limits imposed by the Federal Credit Union Act.* (1) Section 107(7)(I) of the Act:

(i) Authorizes a Federal credit union to invest in shares, stock or obligations of credit union service organizations in amounts not exceeding, in the aggregate, 1% of the credit unions's paid-in and unimpaired capital and surplus;

(ii) Limits credit union service organizations to providing services associated with the routine operations of credit unions; and

(iii) Prohibits a Federal credit union from utilizing this authority to acquire control, directly or indirectly, of another financial institution, or to invest in shares, stocks or obligations of an insurance company, trade association, liquidity facility, or other similar organization.

(2) Section 107(5)(D) of the Act:

(i) Authorizes a Federal credit union to make loans to credit union service organizations in amounts not exceeding, in the aggregate, 1% of its paid-in and unimparied capital and surplus (this is independent of the 1% investment limit pursuant to section 107(7)(I));

(ii) Requires that credit union service organizations exist primarily to meet the needs of their member credit unions; and

(iii) Limits credit union service organizations to business relating to the daily operations of the credit unions they serve.

(c) *Definitions.*— (1) *Affiliated credit unions* means those credit unions that have either invested in or made loans to a credit union service organization.

(2) *Official* means any director or committee member.

(3) *Immediate family member* means a spouse, or a child, parent, grandchild, grandparent, brother or sister, or the spouse of any such individual.

(4) *Paid-in and unimpaired capital and surplus* means shares and undivided earnings.

(d) *Regulatory provisions.*—(1) *Limits on funding.* A Federal credit union by itself, with other credit unions and/or

with non-credit union parties, may invest in and/or loan to a credit union service organization. A Federal credit union's investments in credit union service organizations may not exceed, in the aggregate, 1% of the Federal credit union's paid-in and unimpaired capital and surplus as of its last calendar year-end financial report. A Federal credit union's loans to credit union service organizations may not exceed, in the aggregate, 1% of the Federal credit union's paid-in and unimpaired capital and surplus as of its last calendar year-end financial report.

(2) *Structure.* A Federal credit union may invest in or loan to a credit union service organization only if the organization is structured as either a corporation or limited partnership.

(i) *Corporation.* A credit union service organization chartered as a corporation must be adequately capitalized and operated as a separate entity. A Federal credit union investing in or making loans to such a corporation must take those steps necessary to ensure that it will not be held liable for obligations of the corporation.

(ii) *Limited partnership.* A Federal credit union may participate only as a limited partner in a credit union service organization structured as a limited partnership. As a limited partner, the Federal credit union must not engage in those activities (e.g., control, management, decisionmaking), which, under state law, would cause the credit union to lose its status as limited partner, and correspondingly its limited liability, and be treated as a general partner.

(3) *Legal opinion.* A Federal credit union making an investment in or loan to a credit union service organization must obtain written legal advice as to whether the credit union service organization is established in a manner that will limit the credit union's potential exposure to no more than the loss of funds invested in or lent to the credit union service organization.

(4) *Customer base.* A Federal credit union may invest in or loan to a credit union service organization only if the organization primarily serves credit unions and/or the membership of affiliated credit unions (as defined in paragraph (c)(1) of this section).

(5) *Permissible services and activities.* A Federal credit union may invest in and/or loan to those credit union service organizations that provide only one or more of the following services and activities:

(i) *Operational services.* Credit card and debit card services; check cashing and wire transfers; internal audits for credit unions; ATM services; EFT services; accounting services; data processing; shared credit union branch (service center) operations; sale of repossessed collateral; management, development, sale or lease of fixed assets; sale, lease or servicing of computer hardware or software; management and personnel training and support; payment item processing; locator services; marketing services; research services; record retention and storage; microfilm and microfiche services; alarm-monitoring and other security services; debt collection services; credit analysis; consumer mortgage loan origination; loan processing, servicing and sales; coin and currency services; provision of forms and supplies.

(ii) *Financial services.* Financial planning and counseling; retirement counseling; investment counseling; securities brokerage services; estate planning; income tax preparation; acting as administrator for prepaid legal service plans; developing and administering IRA, Keogh, deferred compensation, and other personnel benefit plans; trust services; acting as trustee, guardian, conservator, estate administrator, or in any other fiduciary capacity; real estate brokerage services; travel agency services; agent for sale of insurance; personal property leasing; and provision of vehicle warranty programs.

(iii) *NCUA approval of other services.* Any service or activity which is not authorized in paragraph (d)(5)(i) or (ii) of this section must receive NCUA Board approval before a Federal credit union may invest in and/or loan to the credit union service organization that offers the service or activity. Any request for NCUA Board approval of a new service or activity should include a full explanation and complete documentation of the service or activity and how that service or activity is associated with routine credit union operations. The request should be submitted to the appropriate NCUA Regional Office. The request will be treated as a petition to amend paragraph (d)(5)(i) or (ii) of this section and NCUA will request public comment or otherwise act on the petition within 60 days after receipt.

(6) *Conflict of interest.* Individuals who serve as officials of, or are employed by, an affiliated Federal credit union (as defined in (c)(1)), and immediate family members of such individuals, may not receive any salary, commission, investment income, or other income or compensation from a credit union service organization either directly or indirectly, or from any person being served through the credit union service organization. This provision does not prohibit an official or employee of a Federal credit union from assisting in the operation of a credit union service organization, provided the individual is not compensated by the credit union service organization. Further, the credit union service organization may reimburse the Federal credit union for the services provided by the individual.

(7) *Accounting Procedures; Access to information.*—(i) *Federal credit union accounting.* A Federal credit union must follow generally accepted accounting principles (GAAP) in its involvement with credit union service organizations.

(ii) *Credit union service organization Accounting; audits and financial statements; NCUA access to books and Records.* An affiliated Federal credit union must obtain written agreements from a credit union service organization, prior to investing in or lending to the organization, that the organization will:

(A) Follow GAAP,

(B) Render financial statements (balance sheet and income statement) at least quarterly and obtain a Certified Public Accountant audit annually and provide copies of such to the affiliated Federal credit union, and

(C) Provide the NCUA Board, or its representatives, with complete access to any books and records of the credit union service organization, as deemed necessary by the Board in carrying out its responsibilities under the Federal Credit Union Act.

(8) *Preexisting credit union service organizations.* (i) Any Federal credit union investments in existence prior to the effective date of this regulation, May 27, 1986, must conform with this regulation not later than May 27, 1987, unless the NCUA Board grants its prior approval to continue such investment for a stated period.

(ii) Any Federal credit union loans in existence prior to the effective date of this regulation must conform with this regulation not later than May 27, 1987, unless:

(A) The NCUA Board grants its prior approval to continue the loan for a stated period, or

(B) Under the terms of its loan agreement the Federal credit union cannot require accelerated repayment without breaching the agreement.

(e) *Other laws.* A credit union service organization must comply with applicable Federal, state and local laws.

[FR Doc. 86-6476 Filed 3-25-86; 8:45 am]

BILLING CODE 7535-01-M