

Small Business Investment Companies: An Investment Option for Banks A Web and Telephone Seminar

Hosted by the Office of the Comptroller of the Currency (OCC)
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During the seminar, participants submitted questions by phone and online regarding Small Business Investment Companies (SBIC), privately owned and managed investment firms licensed and regulated by the Small Business Administration (SBA). Most of the questions focused on two SBIC-related topics: the Volcker Rule and the Community Reinvestment Act (CRA). Background on each topic and questions and answers relating to them follow.

Volcker Rule Background

On November 7, 2011, the OCC, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission published for comment a joint notice of proposed rulemaking implementing section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010.

Section 619, also known as the Volcker Rule, and its implementing proposal prohibit a banking entity from acquiring or retaining any ownership interest in or sponsoring a hedge fund or private equity fund (together, referred to as a “covered fund”), unless an exception applies. In addition, the proposal prohibits a banking entity that manages, sponsors, or advises a covered fund from entering into a “covered transaction” with the covered fund.

The comment period on the proposal closed on February 13, 2012. The agencies are in the process of reviewing and analyzing the more than 18,000 comment letters received. The agencies plan to begin work on a final rule after the review is completed. Due to the ongoing rulemaking, the OCC is unable to express views on the merits of any of the questions raised or provide interpretive advice on provisions of the proposal.

The following answers presume that the fund in question is a covered fund, as defined by the proposal, and therefore is subject to section 619 and the implementing proposal. A covered fund generally includes any issuer of securities that would be an investment company but except for sections 3(c)(1) or 3(c)(7) of the Investment Company Act, a commodity pool, and certain foreign funds.

Volcker Rule Questions

Q1: Are strategic relationships between banks and SBICs permitted under the Volcker Rule? What are the limitations on referrals and similar business relationships?

A1: The answer depends on the nature of the strategic relationship, including the nature of services provided by the bank to an SBIC, and any transactions between the bank and the SBIC. The proposal prohibits a bank that advises, manages, or sponsors an SBIC from entering into a transaction with the SBIC that 1) qualifies as a “covered transaction” as defined in section 23A of the Federal Reserve Act (12 USC 371(c)),¹ except for certain prime brokerage transactions, and 2) is not on market terms in accordance with section 23B of the Federal Reserve Act (12 USC 371(c)(1)). The agencies solicited and received comments on the proposed implementation of these prohibitions, including their applicability to the relationship a bank has with an SBIC, and will consider all comments received in finalizing the proposal.

Q2: Are all SBICs covered by the Volcker Rule?

A2: The prohibition in the Volcker Rule on investing in and sponsoring a covered fund does not apply to a bank’s investment in any SBIC, as defined in section 102 of the Small Business Investment Act of 1958 (15 USC 662).

Q3: What does it mean for a bank to “sponsor” an SBIC for purposes of the restriction on covered transactions between a bank and an SBIC?

A3: A bank sponsors an SBIC, as defined by section 619 and the implementing proposal, if the bank serves as the general partner, managing member, or trustee of the SBIC; selects or controls a majority of the directors, trustees, or management of the SBIC; or shares the same name with the SBIC. Under section 619 and its implementing proposal, a bank’s investment in or sponsorship of the SBIC is a permitted activity.

¹ A covered transaction generally includes: 1) a loan or extension of credit to a covered fund; 2) a purchase of or an investment in securities issued by the covered fund; 3) a purchase of assets (other than some excepted real and personal property) from the covered fund; 4) the acceptance of securities or other debt obligations issued by the covered fund as collateral security for a loan or extension of credit to any person or company; 5) the issuance of a guarantee, acceptance, or letter of credit on behalf of the covered fund; 6) certain securities lending or borrowing transactions with the covered fund; or 7) certain derivative transactions with the covered fund.

Q4: If a non-SBIC fund issues a side letter to a bank stating that the fund will invest in the same sized companies as an SBIC, can it receive CRA consideration and be considered eligible for the Volcker Rule exemption? Similarly, must the non-SBIC fund have a low- to moderate-income (LMI) designation in its PPM or LPA for CRA eligibility and the Volcker Rule exemption?

A4: Under the Volcker Rule, the prohibition on acquiring or retaining an ownership interest in, or sponsoring, a covered fund does not apply to an investment in the SBIC, as defined in section 102 of the Small Business Investment Act of 1958 (15 USC 662). The prohibition also does not apply to an investment designed primarily to promote the public welfare, as permitted by 12 USC 24 (Eleventh), including the welfare of low- and moderate-income communities or families. The agencies will consider any comments received on the scope of this exemption.

Q5: Does the Volcker Rule apply to Low Income Housing Tax Credit Equity Fund Investments?

A5: Under section 619 and the implementing proposal, the prohibition on investing in and sponsoring a covered fund does not apply to any investment that is designed primarily to promote the public welfare of the type permitted under 12 USC 24 (Eleventh), including the welfare of low- and moderate-income communities or families (such as providing housing, services or jobs). Section 619 and the implementing proposal, however, prohibit a bank that advises, manages, or sponsors a public welfare investment from entering into any covered transactions with the public welfare investment. The agencies solicited and received several comments on the proposed implementation of the covered transaction prohibitions, including their relationship to a bank's public welfare investments. The agencies plan to carefully consider all comments received in finalizing the proposal.

Q6: How are investments in an SBIC risk weighted?

A6: Typically, bank investments in an SBIC are risk weighted at 100 percent—provided the investment does not exceed 15 percent of Tier 1 capital under the general risk-based capital rules, or 10 percent of Tier 1 and Tier 2 capital under the advanced capital rules.

Q7: What is the capital treatment for bank investments in SBA debentures?

A7: Bank investments in SBA-issued SBIC debentures are generally risk weighted at zero percent, as long as those debentures are unconditionally backed by the full faith and credit of the U.S. government.

Community Reinvestment Act Background

The CRA was enacted in 1977 to encourage banks and federal saving associations to meet the credit, investment, and service needs of the local communities in which they are chartered, and to be consistent with safe and sound banking practices. SBIC investments by banks receive special treatment under the CRA.

To provide further clarification on some CRA-related topics, questions and answers were added, without change, from the interagency notice in the *Federal Register* (Vol. 75, No. 47, Thursday, March 11, 2010). The notice by the OCC, Board of Governors of the Federal Reserve, FDIC, and Office of Thrift Supervision (now integrated into the OCC), announced the adoption of final Interagency Questions and Answers Regarding Community Reinvestment proposed on January 6, 2009. (Hereafter, excerpts from this *Federal Register* notice are cited as *Fed. Reg.* and with the appropriate citation.)

In and Out of Assessment Area

Q1: How does an investment in an SBIC meet the geographic requirements for CRA investments when many of the SBIC portfolio companies are located outside the designated geographic service area? To receive CRA consideration, must the fund's portfolio companies be located in the bank's CRA assessment area?

A1: Investments in an SBIC may receive consideration under CRA if the SBIC's market area includes the bank's assessment area(s) or a broader statewide or regional area that includes one or more of the bank's assessment area(s). Businesses funded by an SBIC do not necessarily need to be located in the bank's assessment area in order for the bank to receive consideration for the investment. Investments that provide direct benefit to the assessment area by funding businesses located in or serving the bank's assessment area, however, will generally be considered more responsive.

Q1(a): May an institution, regardless of examination type, receive consideration under the CRA regulations if it invests indirectly through a fund, the purpose of which is community development, as that is defined in the CRA regulations? (*Fed. Reg.* __.23(a)—1)

A1(a): Yes, the direct or indirect nature of the qualified investment does not affect whether an institution will receive consideration under the CRA regulations because the regulations do not distinguish between "direct" and "indirect" investments. Thus, an institution's investment in an equity fund that, in turn, invests in projects that, for example, provide affordable housing to low- and moderate-income individuals, would receive consideration as a qualified investment under the CRA regulations, provided the investment benefits one or more of the institution's assessment area(s) or a broader statewide or regional area(s) that includes one or more of the institution's assessment area(s). Similarly, an institution may receive consideration for a direct qualified investment in a nonprofit organization that, for example, supports affordable housing

for low- and moderate-income individuals in the institution's assessment area(s) or a broader statewide or regional area(s) that includes the institution's assessment area(s).
(*Fed. Reg.* __.23(a)—1)

CRA Questions: Evaluating Investments in a Fund

Q2: How much interpretative flexibility do the examiners have in deciding how much CRA consideration to provide for an SBIC investment? In other words, if a bank's assessment area is a part of the broader geography in which an SBIC plans to invest, does the bank automatically get full consideration, and if not, why not? Additionally, if a national bank invests in an SBIC with a region that includes the bank's footprint, and the SBIC reviews companies within that footprint, will the bank receive investment test consideration for its metropolitan statistical area (MSA) absent other investments in the specific MSA or will the bank only receive investment test consideration if it also has other types of investments in the MSA? Is CRA consideration contingent on marketing—or investing—of the SBIC in a bank investor's CRA market?

A2: Consideration for community development activities under CRA is not dependent upon whether the SBIC fund is marketed to a particular geographic area. A bank will receive consideration for the full dollar amount of any investment in an SBIC that serves the bank's assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s), whether or not the SBIC invests directly in the bank's assessment area. Investments that do not directly benefit the bank's assessment area, however, may be considered less responsive than investments that provide a direct benefit to persons or businesses in the bank's assessment area. Examiners will determine the extent to which the investment is considered in the bank's overall performance based on the responsiveness to community needs; the complexity or innovativeness of the investment; and whether the investment is routinely provided by private investors.

Q2(a): How do examiners evaluate an institution's qualified investment in a fund, the primary purpose of which is community development, as defined in the CRA regulations?
(*Fed. Reg.* __.23(e)—2)

A2(a): When evaluating qualified investments that benefit an institution's assessment area(s) or a broader statewide or regional area that includes its assessment area(s), examiners will look at the following four performance criteria:

- 1) The dollar amount of qualified investments.
- 2) The innovativeness or complexity of qualified investments.
- 3) The responsiveness of qualified investments to credit and community development needs.
- 4) The degree to which the qualified investments are not routinely provided by private investors.

With respect to the first criterion, examiners determine the dollar amount of qualified investments by relying on figures recorded by the institution according to generally accepted accounting principles (GAAP).

The extent to which qualified investments receive consideration, however, depends on how examiners evaluate the investments under the remaining three performance criteria—innovativeness and complexity, responsiveness, and degree to which the investment is not routinely provided by private investors. Examiners also will consider factors relevant to the institution's CRA performance context, such as the effect of outstanding long-term qualified investments, the pay-in schedule, and the amount of any cash call, on the capacity of the institution to make new investments. (*Fed. Reg.* __.23(e)—2)

Q2(b): When applying the four performance criteria of 12 CFR __.23(e), may an examiner distinguish among qualified investments based on how much of the investment actually supports the underlying community development purpose? (*Fed. Reg.* __.23(e)—1)

A2(b): Yes. By applying all the criteria, a qualified investment of a lower dollar amount may be weighed more heavily under the investment test than a qualified investment with a higher dollar amount that has fewer qualitative enhancements. The criteria permit an examiner to qualitatively weight certain investments differently or to make other appropriate distinctions when evaluating an institution's record of making qualified investments. For instance, an examiner should take into account that a targeted mortgage-backed security that qualifies as an affordable housing issue that has only 60 percent of its face value supported by loans to low- or moderate-income borrowers would not provide as much affordable housing for low- and moderate-income individuals as a targeted mortgage-backed security with 100 percent of its face value supported by affordable housing loans to low- and moderate-income borrowers. The examiner should describe any differential weighting (or other adjustment), and its basis in the Performance Evaluation. See also Q&A __.12(t)—8 for a discussion about the qualitative consideration of prior period investments. (*Fed. Reg.* __.23(e)—1)

CRA: Unfunded Commitments

Q3: If an unfunded commitment is not on a bank's balance sheet, is CRA consideration given only when the commitment is funded?

A3: Examiners will give consideration to unfunded commitments that are legally binding and recognized on the bank's financial records according to GAAP. Commitments that are not legally binding or not reflected on the bank's financial records will be recognized as they are funded.

Q3(a): How do examiners evaluate an institution's qualified investment in a fund, the primary purpose of which is community development, as defined in the CRA regulations?
(*Fed. Reg.* __.23(e)—2)

A3(a): Examiners will determine the dollar amount of qualified investments by relying on the figures recorded by the institution according to generally accepted accounting principles (GAAP). Although institutions may exercise a range of investment strategies, including short-term investments, long-term investments, investments that are immediately funded, and investments with a binding, up-front commitment that are funded over a period of time, institutions making the same dollar amount of investments over the same number of years, all other performance criteria being equal, would receive the same level of consideration. Examiners will include both new and outstanding investments in this determination. The dollar amount of qualified investments also will include the dollar amount of legally binding commitments recorded by the institution according to GAAP. (*Fed. Reg.* __.23(e)—2)

CRA Questions: Immediate or Direct Benefit

Q4: Can you clarify what is meant by an SBIC "investing in" an area and what it means that the assessment area "need not receive an immediate or direct benefit" from the SBIC investments? Does this mean that the headquarters of the company has to be there, or that the services provided by the company have to be used there? Does the area have to be an LMI census tract? Can you give examples of what exactly a bank has to show in its exam to prove that the investments made by the SBIC qualify for a specific geography?

A4: Investing in an area generally means investing in an entity located within the bank's assessment area(s) or an entity that provides direct benefit to the bank's assessment area(s). The phrase "need not receive an immediate or direct benefit" refers to loans to, investments in, or services for community development organizations that operate on a statewide or even multistate basis with a purpose, mandate, or function that includes serving the areas or individuals located within the bank's assessment areas. Banks may receive consideration for investments in an SBIC regardless of its location, provided that the SBIC serves an area that includes the bank's

assessment area or a broader statewide or regional area that includes the bank's assessment area(s).

Q4(a): Must there be some immediate or direct benefit to the institution's assessment area(s) to satisfy the regulations' requirement that qualified investments and community development loans or services benefit an institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s)? (*Fed. Reg.* __.12(h)—6)

A4(a): No. The regulations recognize that community development organizations and programs are efficient and effective ways for institutions to promote community development. These organizations and programs often operate on a statewide or even multistate basis. Therefore, an institution's activity is considered a community development loan or service or a qualified investment if it supports an organization or activity that covers an area that is larger than, but includes, the institution's assessment area(s). The institution's assessment area(s) need not receive an immediate or direct benefit from the institution's specific participation in the broader organization or activity, provided that the purpose, mandate, or function of the organization or activity includes serving geographies or individuals located within the institution's assessment area(s). (*Fed. Reg.* __.12(h)—6)

Consideration Under More Than One Test

Q5: Can a bank get service-, lending-, and investment-test consideration under the CRA for the same SBIC investment?

A5: A bank may receive full consideration for an SBIC investment under one test or partial consideration under several tests, depending upon the nature of the activity. A bank may receive consideration under the service test for services it provides to an SBIC if those services have a primary purpose of community development.

Q5(a): Even though the regulations state that an activity that is considered under the lending or service tests cannot also be considered under the investment test, may parts of an activity be considered under one test and other parts be considered under another test? (*Fed. Reg.* __.23(b)—1)

A5(a): Yes, in some instances the nature of an activity may make it eligible for consideration under more than one of the performance tests. For example, certain investments and related support provided by a large retail institution to a community development corporation (CDC) may be evaluated under the lending, investment, and service tests. Under the service test, the institution may receive consideration for any community development services that it provides to the CDC, such as service by an executive of the institution on the CDC's board of directors.

If the institution makes an investment in the CDC that the CDC uses to make community development loans, the institution may receive consideration under the lending test for its pro-

rata share of community development loans made by the CDC. Alternatively, the institution's investment may be considered under the investment test, assuming it is a qualified investment. In addition, an institution may elect to have a part of its investment considered under the lending test and the remaining part considered under the investment test. If the investing institution opts to have a portion of its investment evaluated under the lending test by claiming its pro rata share of the CDC's community development loans, the amount of investment considered under the investment test will be offset by that portion. Thus, the institution would receive consideration under the investment test for only the amount of its investment multiplied by the percentage of the CDC's assets that meet the definition of a qualified investment. (*Fed. Reg.* __.23(b)—1)

Documenting Benefits to the Assessment Area

Q6: If an SBIC fund states that its target market is nationwide, does that meet the criteria of statewide or regional area? Additionally, must bank investors receive investment-by-investment CRA allocation letters from the general partners in order to receive investment test consideration for the SBIC investment? If so, is there a specific format for these letters? Have the various bank regulators agreed to a consistent approach to this? Is there a single source where a general partner can view this standard policy, for example the Federal Financial Institutions Examination Council (FFIEC)?

A6: A bank must be able to demonstrate that an investment in a fund has the potential to directly or indirectly benefit the bank's assessment area or a broader statewide or regional area that includes the bank's assessment area. Investment-by-investment allocation letters are not required in order to receive consideration for an investment in an SBIC, but this may be helpful in demonstrating benefit to the bank's assessment area or the broader statewide or regional area that includes the bank's assessment area. Examiners will consider any information the bank chooses to provide, including the fund's prospectus, or other documents provided prior to or at the time of the bank's investment.

Q6(a): In order to receive CRA consideration, what information may an institution provide that would demonstrate that an investment in a nationwide fund with a primary purpose of community development will directly or indirectly benefit one or more of the institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s)? (*Fed. Reg.* __.23(a)—2)

A6(b): There are several ways to demonstrate that the institution's investment in a nationwide fund meets the geographic requirements, and the agencies will employ appropriate flexibility in this regard in reviewing information the institution provides that reasonably supports this determination. As an initial matter, in making this determination, the agencies would consider whether the purpose, mandate, or function of the fund includes serving geographies or individuals located within the institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s). Typically, information about where a fund's investments are expected to be made or targeted will be found in the fund's prospectus, or other documents provided by the fund prior to or at the time of the institution's investment, and

the institution, at its option, may provide such documentation in connection with its CRA evaluation.

At the institution's option, written documentation provided by fund managers in connection with the institution's investment indicating that the fund will use its best efforts to invest in a qualifying activity that meets the institution's geographic requirements also may be used for these purposes. Similarly, at the institution's option, information that a fund has explicitly earmarked its projects or investments to its investors and their specific assessment area(s) or broader statewide or regional areas that include the assessment area(s) also may be used for these purposes. (If any documentation that has been provided at the institution's option as described above clearly indicates that the fund "double-counts" investments, by earmarking the same dollars or the same portions of projects or investments in a particular geography to more than one investor, the investment may be determined not to meet the geographic requirements of the CRA regulations.) In addition, at the institution's option, an allocation method may be used to permit the institution to claim a pro-rata share of each project of the fund. (*Fed. Reg.* __.23(a)—2)