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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Trust Preferred Securities

A number of bank holding companies have issued trust preferred securities and continue to utilize trust preferred securities for a number of reasons. The issuance of trust preferred securities must be approved by the Federal Reserve Bank in the district in which the bank holding company is located. Trust preferred securities are typically issued as non-perpetual cumulative preferred stock and are issued by a wholly-owned trust subsidiary of a bank holding company. Revenue from the sale of the trust preferred securities by the trust subsidiary is exchanged for junior subordinated debentures issued by the bank holding company. The debentures feature a coupon payment and term to maturity, which are identical to those of the trust preferred securities. The guidelines of the Federal Reserve provide that the subordinated debt and the trust preferred securities must have maturity of not less than thirty (30) years and the subordinated debt must be subordinate to all other debt of the bank holding company. The bank holding company has the option to call the subordinated debt and the trust preferred securities after ten (10) years but not prior to the expiration of five (5) years. Both the subordinated debt and the trust preferred securities must allow for a consecutive five (5) year deferral on interest and dividends, respectively. The bank holding company must guarantee the distribution, liquidation, and redemption rights of the trust preferred securities. Any redemption of the trust preferred securities must be approved by the Federal Reserve. Payments on the subordinated debt and the trust preferred securities are "interest only" until maturity. Trust preferred securities are useful for bank holding companies that are Subchapter S corporations. Although a Subchapter S corporation cannot have more than one class of stock, trust preferred securities are not considered a separate class of stock and purchasers of trust preferred securities will not be counted as additional shareholders. In Interpretive Letter No. 908, the Office of the Comptroller of Currency ("OCC") held that trust preferred securities may be purchased and treated as loans by national banks. The OCC noted that trust preferred securities are instruments that possess characteristics particularly associated with debt securities. Like debt holders, the holders of the trust preferred securities do not have voting rights in the management or the ordinary course of business of the trust. In addition, holders of the trust preferred securities do not share in any appreciation in the value of the trust and are protected from changes in the value of the principal of the instruments except for credit risk. Since the trust's only source of revenue for the dividends on the trust preferred securities is the interest on the underlying subordinated debt, the trust preferred securities must be redeemed upon redemption of the subordinated debt. Before purchasing trust preferred securities as loans, the OCC noted that a national bank should conduct a complete review of relevant credit information and loan administration practices, and determine that the purchase meets the bank's own internal loan underwriting standards.

The interpretive ruling by the OCC provides a vehicle for a bank holding company to convert debt to equity while allowing a bank purchaser of the trust preferred securities to treat the purchases as loans. In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation 46, entitled *Consolidation of Variable Interest Entities* ("Interpretation 46"). Interpretation 46 attempts to assign risks among various users of complex structures, including the sponsors, agents, companies transferring assets and other investors. Interpretation 46 has raised the issue of how trust preferred securities should be treated. For instance, under Interpretation 46 a bank holding company may not be able to consolidate the trust that issues the preferred stock. In such an event, this would leave the bank holding company with the subordinated debt issued to the trust and without the benefit of the preferred stock on its balance sheet. The Federal Reserve Board has continued to advise bank holding companies to report trust preferred securities just as they have been reported in the past. One possible alternative in the application of Interpretation 46 would be that trust preferred securities would be grandfathered and continue to be treated by bank holding companies as in the past.

Regulation of National Banks by States

The Office of the Comptroller of the Currency ("OCC") issued Advisory Letter AL 2002-9 which reflects the position of the OCC that it has exclusive authority over national banks. The Advisory Letter informs national banks to consult with the OCC in the event a state authority seeks the enforcement of state laws over a national bank. The OCC has also issued a proposal, Docket No. 03-16, which would clarify that the OCC has sole authority over national banks. The proposal does allow courts to require national banks to produce witnesses or information, however the exception for courts does not permit a state to inspect, regulate, or supervise national banks. The North American Securities Administrators Association has requested that the proposal by the OCC be modified to clarify that state securities regulators have the authority to investigate national banks and their affiliates in connection with securities or securities transactions. Depending on the final rule to be adopted by the OCC, the exclusive authority of the OCC over national banks may be subject to interpretation by a court of law because of the controversial nature of state versus federal regulation.

Cases, Releases & Rulings

The North American Securities Administrators Association ("NASAA") has made available on its web site an online *Senior Investor Resource Center* to assist and educate senior citizens and protect them from investment fraud in connection with volatile stock markets, record low interest rates, rising health care costs and increasing life expectancy. The online information is available on the web site of NASAA at *www.nasaa.org.*

The Securities and Exchange Commission ("SEC") has released the SEC staff report entitled *The Implications of the Growth of Hedge Funds* which details a fact-finding investigation into the operations and practices of the hedge fund industry. The SEC staff report noted that there is more than $600 billion invested in hedge funds presently, and this figure is expected to exceed $1 trillion in the next five to ten years. In its report, the SEC staff identified a number of areas of concern which arise from the unregulated status of hedge funds. The report also contains a number of recommendations to improve the regulation and oversight of the hedge fund industry. The staff's primary recommendation is that the SEC consider revising its rules to require that hedge fund advisers register under the Investment Advisers Act. The staff's report and recommendations are available on the web site of the SEC at *www.sec.gov*.

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