Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 703 and 742

Investment and Deposit Activities and Regulatory Flexibility Program

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule with request for comments.

SUMMARY: NCUA proposes to amend its rule regarding the investment activities of federal credit unions (FCUs). The amendments clarify and reformat the rule to make it easier to read and locate information. The amendments expand FCU investment authority to include purchasing equity-linked options for certain purposes and exempts RegFlex eligible credit unions from several investment restrictions. NCUA also proposes to expand the Regulatory Flexibility Program to conform to the proposed revisions to the investment rule.

DATES: Comments must be received on or before February 25, 2003.

ADDRESSES: Direct comments to Becky Baker, Secretary of the Board. Mail or hand-deliver comments to: National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428. You are encouraged to fax comments to (703) 518–6319, or E-mail comments to *regcomments@NCUA.gov* instead of mailing or hand-delivering them. Whatever method you choose, please send comments by one method only.

FOR FURTHER INFORMATION CONTACT: Scott Hunt, Senior Investment Officer, Office of Strategic Program Support and Planning (OSPSP) at the above address or telephone (703) 518–6620; Dan Gordon, Senior Investment Officer, OSPSP at the above address or telephone (703) 518–6620; Kim Iverson, Program Officer, Office of Examination and Insurance, at the above address or telephone (703) 518–6360; or Frank Kressman, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518–6540.

SUPPLEMENTARY INFORMATION:

A. Background

NCUA identified part 703 as in need of revision. To that end, NCUA issued an advanced notice of proposed rulemaking (ANPR) on October 18, 2001. 66 FR 54168 (October 26, 2001). In the ANPR, NCUA solicited comments as to how it could revise part 703 to make it easier to understand. The ANPR also solicited comments as to how NCUA could provide FCUs with greater flexibility and enhanced investment authorities without sacrificing safety and soundness. NCUA received thirty-eight comment letters: fifteen from FCUs, two from state credit unions, eleven from financial services entities, nine from credit union trade organizations, and one from a banking trade organization. The comments were generally supportive of the ANPR, except for those offered by the banking trade organization. As discussed more fully below, the commenters offered numerous suggestions of ways part 703 could be improved. NCUA has considered these comments, and other issues that have arisen since the ANPR was issued, and is issuing this proposal to amend part 703.

B. Discussion

1. Broker-Dealer Requirements

Section 703.50(a) describes the minimum criteria a broker-dealer must meet for an FCU to conduct business with a broker-dealer. 12 CFR 703.50(a). In general, it requires FCUs to use broker-dealers that are registered with the Securities and Exchange Commission or depository institutions whose broker-dealer activities are regulated by a federal regulatory agency. NCUA believes depository institutions whose broker-dealer activities are regulated by a state regulatory agency are supervised to a similar degree as those regulated by a federal agency. Accordingly, in proposed § 703.8, NCUA proposes to amend this provision to permit FCUs to also use the services of depository institutions whose broker-dealer activities are regulated by a state regulatory agency. This will provide FCUs with greater access to broker-dealers.

NCUA has become increasingly aware of circumstances where broker-dealers have engaged in deceptive practices in the sale of CDs to FCUs, such as misrepresenting yields, providing misleading information about the terms of the CD, and inducing purchases of unsuitable and impermissible CDs. Some FCUs have asked NCUA to intervene and pursue remedies on their behalf in these circumstances.

In recent years, NCUA has issued three Letters to Credit Unions to warn credit unions about the risks associated with certain brokered CDs: 00–CU–05, Investment in Brokered Certificates of Deposit, September 2000; 01–FCU–04, Broker Registration/Short-Term Investments, April 2001; and 01–CU–23, Investments in Brokered Certificates of Deposit sold By Bentley Financial Services, Inc. and Entrust Group, December 2001. NCUA has also issued Interpretive Ruling and Policy Statement 98–2, Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, which describes best practices when making investment decisions. Despite these efforts, NCUA believes further regulatory action is necessary to address the problems associated with brokered CDs.

The ANPR asked whether setting minimum standards for broker-dealers would help prevent deceptive practices by broker-dealers. The ANPR contemplated requiring broker-dealers to have at least one General Securities Representative registered with the National Association of Securities Dealers (NASD). Alternatively, if a depository institution wishes to transact purchases and sales of investments with an FCU, its broker-dealer activities would have to be regulated by a federal or state regulatory agency. The ANPR further suggested that an individual broker-dealer might also have to be registered with the NASD as a General Securities Representative, whether the individual broker-dealer works with a brokerage firm or a federal or state regulated depository institution. NCUA was not contemplating imposing these standards on a broker-dealer acting only as a CD finder. A CD finder provides information about CD offering rates and terms, but does not take custody of the funds or the investment at any time.

Twenty-eight commenters responded to NCUA's statement that it was considering more clearly defining minimum criteria a broker-dealer must

meet for an FCU to buy or sell investments through that broker-dealer. Twenty-one commenters supported NCUA's efforts to clarify and set minimum standards for broker-dealers. In general, the commenters viewed the registration requirements as prudent and did not believe they would significantly impair an FCU's ability to conduct investment activities. Four commenters supported NCUA's intention to provide guidelines to help FCUs make their own evaluation of a broker-dealer's qualifications, but were not in favor of NCUA setting rigid standards. One commenter not only supported NCUA setting the standards, but called for a more restrictive approach than that suggested by the ANPR. One commenter stated the current rule does not need to be changed. The banking trade group commented that it would be unfair for the NCUA to require individual broker-dealers working for a depository institution to be registered with the NASD as a General Securities Representative. It explained that the nature of their employment with the depository institution and NASD rules preclude those individuals from complying with the contemplated registration requirement.

In certain cases, broker-dealer's deceptive practices have caused losses in credit unions, but it is not clear that additional standards on broker-dealers such as those suggested in the ANPR, would have prevented those losses. NCUA has determined that the existing rules represent prudent minimum criteria that a broker-dealer must meet for a credit union to purchase and sell investments through the broker-dealer.

The Board believes that education is the key to mitigating risk by improving credit unions' due diligence regarding the selection and monitoring of brokers-dealers. For this reason, the broker-dealer rules have not been revised to require more stringent broker-dealer requirements. However, NCUA will continue to provide guidance to the industry.

2. Safekeeper Requirements

An FCU may only use the services of a safekeeping firm that meets the minimum criteria provided for in § 703.60. 12 CFR 703.60. A safekeeper secures the FCU's ownership interest in investments without an FCU having to register the securities in its name or take physical possession of investment documents. Safekeepers that do not operate scrupulously, independently from broker-dealers, or under sufficient supervisory oversight can pose a risk to FCUs. NCUA's primary concern about safekeeper activities is in the brokered CD context. NCUA is aware of instances where a safekeeper, working with an unscrupulous broker-dealer, aided the broker-dealer in misleading the FCU about the terms and characteristics of brokered CDs or otherwise failed to fulfill its fiduciary responsibilities. NCUA is not aware of any problems with the safekeeping of other securities such as securities issued by the U.S. Department of the Treasury and other authorized credit union investments. The ANPR suggested the possibility of expanding the current safekeeping requirements to address this problem.

Twenty-six commenters responded to NCUA's statement that it was considering limiting permissible safekeepers to clearing broker-dealers regulated by the Securities and Exchange Commission or depository institutions regulated by a state or federal agency. Twenty-one commenters supported this position. Five commenters were in favor of minimizing risk associated with safekeepers, but did not support the approach contemplated by the ANPR. These commenters preferred allowing FCUs to make their own evaluations of the qualifications of their safekeepers, but supported NCUA guidelines to help FCUs make those determinations. Three commenters wanted to replace depository institutions regulated by a state or federal agency with financial institutions regulated by a state or federal agency to increase the universe of eligible safekeepers.

NCUA has concluded that the more stringent safekeeper standards contemplated in the ANPR would not effectively address the problems associated with brokered CDs. NCUA believes federal credit unions are best served by conducting thorough evaluations of safekeeping firms prior to doing business with them. The current rule requires a federal credit union to investigate a safekeeper's background to determine the safekeeper's reputation and compliance with laws and regulations. The NCUA Board is proposing to add a due diligence requirement that a federal credit union review the safekeeper's financial condition as well. Ascertaining the safekeeper's financial capacity to fulfill its custodial responsibilities is a sound business practice. NCUA will also emphasize education and understanding in the industry. In this regard, NCUA will continue to issue guidance to credit unions and promote due diligence reviews of safekeepers.

Several commenters suggested that NCUA expand permissible safekeepers to include state-regulated trust companies, which are entities created for the purpose of meeting the fiduciary needs of their clients and customers and are subject to regular examinations. NCUA agrees with this suggestion and, in proposed § 703.9, NCUA proposes to permit state-regulated trust companies to be safekeepers for FCUs. In addition, in proposed § 703.4, NCUA proposes to require FCUs to retain the documentation their boards of directors used to approve the use of a safekeeper in the same manner and to the same extent this must be done in the broker-dealer context.

3. Expanded Investment Authorities

The Federal Credit Union Act (Act) enumerates FCU investment powers. 12 U.S.C. 1757. NCUA has adopted regulatory prohibitions against certain investments and investment activities permitted by the Act on the basis of safety and soundness concerns. 12 CFR 703.100 and 703.110. Investments and investment activities prohibited by regulation include financial derivatives, stripped mortgage-backed securities, residual interests in collateralized mortgage obligations/real estate mortgage investment conduits (CMOs/REMICs), commercial mortgage or small business related securities, mortgage servicing rights, short sales, adjusted trading, and variable rate products with indexes tied to foreign interest rates.

The ANPR solicited comments regarding granting FCUs expanded investment authority and possible methods of doing so. Fifteen commenters supported expanded investment authority for FCUs that demonstrate, through an application process, the expertise to manage a particular investment product. Ten commenters supported expanded authority, but objected to an FCU having to apply to NCUA each time it wished to add a new investment product to its portfolio. Five commenters suggested an FCU's CAMEL rating should determine its level of expanded authorities and its application requirements. Many of the commenters noted specific investment products they would like to have available, but there was no discernable consensus in that regard. Two commenters were opposed to granting any expanded investment authority to FCUs.

Section 107(15)(B) of the Act, 12 U.S.C. 1757(15)(B), permits FCUs to purchase mortgage related securities as that term is defined in Section 3(a)(41) of the Securities Exchange Act of 1934. 15 U.S.C. 78c(a)(41). That definition includes mortgage related securities backed solely by residential mortgages, solely by commercial mortgages

(Commercial Mortgage Related Securities or CMRS), and mixed residential and commercial mortgages. Generally speaking, section 107(7)(E) of the Act permits FCUs to purchase investments issued, guaranteed, or sold by government agencies, government corporations and other government enterprises. 12 U.S.C. 1757(7)(E). Although section 107(15)(B) and section 107(7)(E) permit different kinds of investments for FCUs, there is some overlap between the two. Specifically, some CMRS described in section 107(15)(B) also fit the description of investments permitted by section 107(7)(E).

Part 703 currently prohibits the purchase of section 107(15)(B) CMRS that are not otherwise permitted by section 107(7)(E). This is because when part 703 was last revised, the CMRS market was not well established, and NCUA had concerns about liquidity and performance of the market. This market has since grown and seasoned to a point where NCUA believes an expansion of FCU authority in this context is justified. Accordingly, NCUA proposes to permit Regulatory Flexibility Program (RegFlex) eligible FCUs to purchase CMRS, that are not otherwise permitted by section 107(7)(E), subject to certain safety and soundness related restrictions. Specifically, a RegFlex eligible FCU may purchase CMRS, that are not otherwise permitted by section 107(7)(E), if the CMRS: (1) Are rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization; (2) otherwise meet the definitions of mortgage related security as defined in 15 U.S.C. 78c(a)(41) and commercial mortgage related security as defined in proposed section 703.2 and (3) have an underlying pool of loans containing more than 50 loans with no one loan representing more than 10 percent of the pool. A RegFlex eligible FCU is limited to purchasing CMRS that are not otherwise permitted by section 107(7)(E) up to 50 percent of its net worth in the aggregate. As with all investments, FCUs should develop written policies and an understanding of the risks associated with CMRS before purchasing them.

NCUA believes the investment pilot program is the most appropriate system for evaluating and granting expanded investment authority to FCUs. The pilot program's application and approval process gives an FCU the opportunity to demonstrate it has the ability to implement and administer safely an investment activity prohibited by regulation. Not only does the investment pilot program provide flexibility to FCUs, but it is also a useful tool for NCUA to evaluate whether granting additional investment authorities is appropriate. This approach allows NCUA to analyze an FCU's management's abilities and knowledge, and understand how an FCU plans to incorporate an investment activity into its overall investment and risk management strategies. In this regard, NCUA encourages those credit unions that possess the necessary knowledge and expertise to administer investments or investment activities currently prohibited by the regulation, but permitted by the FCU Act (e.g., the purchase of MSRs from other credit unions, stripped mortgage-backed securities) to apply for expanded powers through the pilot program.

Although the purchase of mortgage servicing rights remains an impermissible investment, the proposed rule recognizes that a credit union, as a financial service to a member that is engaged in making mortgage loans, may perform servicing for a member's mortgage loans. For this activity to be permissible as a financial service to a member, the member must continue to own the loan during the time that the credit union provides servicing. In this context, the NCUA Board concludes that providing mortgage servicing is an appropriate exercise of a credit union's incidental powers to provide financial service to a member.

To expedite the investment pilot program application and approval process, NCUA will make available guidelines for participation in approved investment pilot programs. These guidelines will be available on the NCUA website or by contacting the appropriate NCUA regional office. NCUA expects these guidelines will help FCUs better understand NCUA's criteria and will enable FCUs to submit more complete applications. These guidelines may also help FCUs determine where they may need to improve their infrastructure, resources, or knowledge before beginning the application process. Additionally, investment pilot program applicants are encouraged to submit alternative guidelines for NCUA's consideration. NCUA will make minor revisions to the proposed § 703.19 investment pilot program to clarify it and reflect this discussion.

On October 25, 2002, NCUA issued a final rule revising part 704 of its rules regarding corporate credit unions. 67 FR 65640 (October 25, 2002). As part of that final rule, NCUA also revised § 703.100(c). 12 CFR 703.100(c). Specifically, NCUA increased the limit on an FCU's purchase of paid-in capital and membership capital in one corporate to 2 percent of the FCU's assets and 4 percent for purchases in all corporates. The below revisions in proposed § 703.14 conform to the final revisions made in October 2002.

On September 19, 2002, NCUA issued a proposed rule regarding federally-insured credit unions branching outside the United States. 67 FR 60607 (September 26, 2002). In that proposal, NCUA recognized that part 703 may not permit sufficient investment tools for FCUs to manage currency rate risk and other risks associated with conducting business in foreign countries. NCUA has determined that FCUs with foreign branches may apply to NCUA for expanded investment authority to address those risks under the investment pilot program.

4. Discretionary Control of Investments

Section 703.40(c)(6) authorizes an FCU to delegate to an outside third party discretionary control over the purchase and sale of investments up to 100 percent of an FCU's net capital at the time of delegation. 12 CFR 703.40(c)(6). RegFlex. exempts FCUs meeting specific eligibility requirements from the § 703.40(c)(6) cap. 12 CFR 742.4. The ANPR solicited comments on whether this cap should be raised for all FCUs and under what circumstances. Eleven commenters supported raising the cap and did not object to NCUA requiring FCUs to meet certain minimum standards or seek prior approval to exceed the cap. Six commenters supported raising the cap but did not favor a process requiring prior agency approval. Rather, some of these commenters preferred NCUA setting guidelines that an FCU could follow and requiring only that an FCU notify the NCUA when it exceeds the cap. One of these commenters recommended setting minimum standards for investment managers to whom FCUs entrust discretionary control. Nine commenters opposed raising the cap.

NCUA believes that it would not be prudent to raise the cap on discretionary control of investments for all FCUs. NCUA believes that the exemption from this cap for RegFlex eligible FCUs is sufficient relief at this time. NCUA wishes to clarify that the cap on delegating discretionary control over the purchase and sale of investments is not applicable to the purchase or sale of mutual funds.

The Board also believes it is prudent that the cap be evaluated annually so that the amount of investments under discretionary control does not exceed the credit union's net worth subsequent

to the original delegation of investment authority. Therefore, the Board has added the requirement that, should the amount of investments under discretionary control exceed the net worth cap at the time of the annual evaluation, the federal credit union's board of directors must receive notice as soon as possible, but no later than the next regularly scheduled board meeting. The board of directors must notify the appropriate regional director within 5 days after the board meeting. The FCU must also develop a plan to bring the credit union into compliance with the cap. The plan does not need to require divestiture of the investments, but the credit union must be brought back into compliance within a reasonable period of time.

5. Investment Credit Ratings

Currently, an FCU must conduct a credit analysis for any investment that is not issued by or fully guaranteed as to principal and interest by the U.S. government or its agencies, enterprises, or corporations, or fully insured by the NCUA or the Federal Deposit Insurance Corporation. 12 CFR 703.40(d). FCUs are not required to express credit exposure in terms of risk to capital and, except for municipal bonds and privately issued mortgage related securities, FCUs are not required to obtain or monitor credit ratings on the issue or issuer. The ANPR solicited comments as to whether standards should be set.

Six commenters supported NCUA setting regulatory standards for evaluating investment credit risk. Fourteen commenters opposed regulatory standards, but supported NCUA guidelines to assist FCUs in assessing credit risk on their own without hampering their ability to manage their investments according to their individual risk management capabilities. Six commenters suggested that, unless an investment is fully insured or guaranteed by the U.S. government or its agencies, it should only be permissible for FCUs if it meets certain minimum credit ratings as established by a national rating organization such as Moody's or Standard and Poor's. NCUA has determined that the current rule sufficiently encourages FCUs to adopt prudent credit review practices and that no revisions are necessary at this time. Further, if NCUA established specific, minimum criteria such as credit ratings and capital-at-risk levels, it might encourage credit unions to forsake other prudent credit evaluation practices, for example, monitoring pertinent current events and news stories or reviewing financial statements.

6. Borrowing Repurchase Transaction

Borrowing repurchase transactions, presently referred to as reverse repurchase transactions in § 703.100(j), enable an FCU to sell securities under an agreement to repurchase in order to borrow funds. 12 CFR 703.100(j). Section 703.100(j)(2) prohibits an FCU from purchasing an investment with the proceeds from a borrowing repurchase agreement if the purchased investment matures after the maturity of the borrowing repurchase agreement. 12 CFR 703.100(j)(2). Before this restriction, FCUs could incur significant interest rate risk by borrowing funds at short-term interest rates and investing in long-term fixed rate instruments. Problems can result when the spreads between short-term and long-term rates narrow, adversely affecting earnings and capital. NCUA has not imposed similar prohibitions for other borrowing arrangements. For example, if an FCU borrows funds without engaging in a borrowing repurchase agreement, it is not limited by the maturity limit of § 703.100(j)(2) when it invests the proceeds.

The ANPR solicited comments on whether removing this restriction would raise liquidity or safety and soundness concerns and whether an approval process is preferable to removing the restriction. Twenty commenters supported NCUA removing the maturity limit restriction on borrowing repurchase transactions without imposing on FCUs a prior approval requirement. Three commenters stated they did not want the restriction removed.

One of the commenters that opposed removing the restriction stated there are risks associated with this kind of activity and there should be regulatory limitations to mitigate that risk. That commenter further stated that borrowing repurchase transactions are typically used for positive arbitrage opportunities. Interest rate risk is created if the proceeds of the transaction are invested significantly shorter or longer than the borrowing transaction.

The NCUA agrees with this commenter and intends to leave in place the prohibition on purchasing an investment with the proceeds from a borrowing repurchase transaction if the purchased investment matures after the maturity of the borrowing repurchase transaction. To increase flexibility for qualified credit unions, however, the NCUA proposes to expand RegFlex in proposed § 742.4 to include a limited exemption from this restriction. Specifically, RegFlex eligible FCUs will be able to purchase securities with maturities exceeding the maturity of the borrowing repurchase transaction in an amount not to exceed the credit union's net worth.

7. Investment Repurchase Transaction

Section 703.100(i) defines repurchase transactions. 12 CFR 703.100(i). The proposed rule renames them ''investment repurchase transactions'' and conforms the requirements for investment repurchase transactions to those of securities lending transactions. Other than these revisions, the proposal does not make any substantive amendments in this regard.

8. Securities Lending Transaction

Section 703.100(k) addresses securities lending transactions and requires the FCU to take a perfected first priority security interest in all collateral the FCU receives. 12 CFR 703.100(k). Proposed § 703.13 removes the word ''perfected'', but still requires a first priority security interest through possession or control of the collateral. Often, under state law, possession or control of collateral constitutes a perfected security interest. In addition, the proposed rule clarifies that an FCU's agent may act in its place in these transactions.

9. Purchase of Equity-linked Options

Although § 703.110(a) prohibits FCUs from purchasing financial derivatives, including options, 12 CFR 703.110(a), NCUA has approved an investment pilot program permitting a vendor to act as agent for an FCU to purchase equity-linked options for limited purposes. Specifically, under the pilot program, an FCU may offer share certificates where the dividend rate is tied to the performance of the S&P 500 stock index and may purchase equity-linked options to fund the dividend. NCUA has placed limitations on the pilot program to minimize risk and continues to prohibit FCUs from investing in options for their own accounts.

Because of the positive experience with the pilot program, the ANPR stated that NCUA was considering amending the investment regulation to make the purchase of equity-linked options a permissible investment activity for FCUs for the limited purpose of funding equity-linked dividends. The ANPR discussed potential regulatory limitations to this new authority and solicited comments. Fourteen commenters supported FCUs being permitted to purchase equity-linked options for the purpose of offering equity-linked dividends to their

members and also supported the limitations suggested by NCUA. Two commenters opposed FCUs being given permission to purchase equity-linked options.

Proposed § 703.14 expands permissible investment activities for all FCUs to permit them to purchase equity-linked options for the sole purpose of offering equity-linked dividends to their members, subject to limitations including: (1) Maximum shares permitted in the program; (2) minimum counterparty rating; (3) collateral requirements; (4) option proceeds to fund dividend costs only; (5) final maturity of the options coincide with the maturity of the share account; and (6) minimum monthly reporting requirements. FCUs are still prohibited from investing in options for their own accounts.

10. Investment Advisers

Section 703.40(c)(2) currently requires an FCU to analyze an investment adviser's background, including whether there are any enforcement actions against the adviser or the adviser's associated personnel before transacting business with the adviser. 12 CFR 703.40(c)(2). NCUA proposes to amend this provision to clarify that, as part of this background check, an FCU should analyze the background of the firm for whom the investment adviser works, in addition to the investment adviser and associated personnel.

11. Recordkeeping and Generally Accepted Accounting Principles

The Act provides that the accounting principles applicable to reports or statements required to be filed with the NCUA by insured credit unions, except those with total assets of less than $10 million, must be uniform and consistent with generally accepted accounting principles (GAAP). 12 U.S.C. 1782a(a)(6)(C). The accounting standard required in § 703.40(a) only requires FCUs to classify their securities as hold-to-maturity, available-for-sale, or trading, in accordance with GAAP. 12 CFR 703.40(a). Accordingly, in proposed § 703.4, NCUA proposes to revise that rule to clarify that FCUs having total assets of $10 million or more must comply with all GAAP provisions related to the accounting principles applicable to reports or statements required to be filed with the NCUA, not just selected ones. While not mandatory for FCUs with total assets of less than $10 million, NCUA encourages them also to comply with GAAP or to account for their investments consistent with the NCUA Accounting Manual For Federal Credit Unions (Accounting Manual). NCUA recognizes that at the present the Accounting Manual, which can be found on NCUA's web site, is only in draft form.

12. Net Worth

Part 703 defines the term ''net capital'' and uses an FCU's net capital, or percentage of net capital, as the basis for measuring and specifying limits on some of an FCU's investment activities. Amendments to the Act related to prompt corrective action define ''net worth'' and use net worth as its unit of measure instead of net capital. To be consistent, NCUA proposes to replace in the investment rule all references to ''net capital'' with ''net worth.''

13. Format

The ANPR solicited comments as to whether the format of part 703 needs to be changed. Nine commenters stated that the current format of part 703 should be changed to make the rule easier to read and more conducive to finding information quickly. They suggested eliminating the question and answer format and dividing large, cumbersome sections of the rule into smaller, distinct sections with individual topic headings. Two commenters preferred the current format remain unchanged. NCUA agrees with the nine commenters who favor a more user-friendly investment rule and proposes to reformat the rule.

As part of this effort to make the investment rule easier to read and locate information, NCUA proposes to revise the manner in which specific terms are defined. Specifically, the proposed rule adds a number of new definitions, deletes a number of existing definitions, and segregates all definitions into proposed § 703.2 to make the rule easier to understand.

Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a proposed rule may have on a substantial number of small credit unions (those under one million dollars in assets). The proposed rule clarifies the investment authority granted to FCUs and conforms the regulatory flexibility program to the investment rule. The proposed rule would not have a significant economic impact on a substantial number of small credit unions, and, therefore, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

The current Office of Management and Budget control number assigned to Part 703 is 3133–0133. NCUA has determined that the proposed rule would not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. The proposed rule would not have substantial direct effects on the states, on the connection between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. NCUA has determined that this proposed rule does not constitute a policy that has federalism implications for purposes of the executive order.

The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families

The NCUA has determined that this proposed rule would not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Public Law 105–277, 112 Stat. 2681 (1998).

Agency Regulatory Goal

NCUA's goal is to promulgate clear and understandable regulations that impose minimal regulatory burden. We request your comments on whether the proposed rule is understandable and minimally intrusive.

List of Subjects

12 CFR Part 703

Credit unions, Investments.

12 CFR Part 742

Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on December 19, 2002.

Becky Baker,

Secretary of the Board.

Accordingly, NCUA proposes to amend 12 CFR parts 703 and 742 as follows:

PART 703—ORGANIZATION AND OPERATIONS OF FEDERAL CREDIT UNIONS

1. The authority citation for part 703 continues to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757(15).

2. Revise part 703 to read as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

Sec.
703.1 Purpose and scope.
703.2 Definitions.
703.3 Investment policies.
703.4 Recordkeeping and documentation requirements.
703.5 Discretionary control over investments and investment advisers.
703.6 Credit analysis.
703.7 Notice of non-compliant investments.
703.8 Broker-dealers.
703.9 Safekeeping of investments.
703.10 Monitoring non-security investments.
703.11 Valuing securities.
703.12 Monitoring securities.
703.13 Permissible investment activities.
703.14 Permissible investments.
703.15 Prohibited investment activities.
703.16 Prohibited investments.
703.17 Conflicts of interest.
703.18 Grandfathered Investments.
703.19 Investment pilot program.

§ 703.1 Purpose and scope.

(a) This part interprets several of the provisions of sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act (Act), 12 U.S.C. 1757(7), 1757(8), 1757(15), which list those securities, deposits, and other obligations in which a federal credit union may invest. Part 703 identifies certain investments and deposit activities permissible under the Act and prescribes regulations governing those investments and deposit activities on the basis of safety and soundness concerns. Additionally, part 703 identifies and prohibits certain investments and deposit activities. Investments and deposit activities that are permissible under the Act and not prohibited or otherwise regulated by part 703 remain permissible for federal credit unions.

(b) This part does not apply to:

(1) Investment in loans to members and related activities, which is governed by §§ 701.21, 701.22, 701.23, and part 723 of this chapter;

(2) The purchase of real estate-secured loans pursuant to section 107(15)(A) of the Act, which is governed by § 701.23 of this chapter;

(3) Investment in credit union service organizations, which is governed by part 712 of this chapter;

(4) Investment in fixed assets, which is governed by § 701.36 of this chapter;

(5) Investment by corporate credit unions, which is governed by part 704 of this chapter; or

(6) Investment activity by state-chartered credit unions, except as provided in § 741.3(a)(3) of this chapter.

§ 703.2 Definitions.

The following definitions apply to this part:

(a) *Adjusted trading* means selling an investment to a counterparty at a price above its current fair value and simultaneously purchasing or committing to purchase from the counterparty another investment at a price above its current fair value.

(b) *Associated personnel* means a person engaged in the investment banking or securities business who is directly or indirectly controlled by a National Association of Securities Dealers (NASD) member, whether or not this person is registered or exempt from registration with NASD. Associated personnel includes every sole proprietor, partner, officer, director, or branch manager of any NASD member.

(c) *Bank note* means a direct, unconditional, and unsecured general obligation of a bank that ranks equally with all other senior unsecured indebtedness of the bank, except deposit liabilities and other obligations that are subject to any priorities or preferences.

(d) *Banker's acceptance* means a time draft that is drawn on and accepted by a bank and that represents an irrevocable obligation of the bank.

(e) *Borrowing repurchase transaction* means a transaction in which the federal credit union agrees to sell a security to a counterparty and to repurchase the same or an identical security from that counterparty at a specified future date and at a specified price.

(f) *Call* means an option that gives the holder the right to buy the underlying security at a specified price during a fixed time period.

(g) *Collective investment fund* means a fund maintained by a national bank under part 9 of the Comptroller of the Currency's regulations.

(h) *Commercial mortgage related security* means a mortgage related security, as defined below, except that it is collateralized entirely by commercial real estate, such as a warehouse or office building, or a multi-family dwelling consisting of more than four units.

(i) *Counterparty* means the party on the other side of the transaction.

(j) *Custodial agreement* means a contract in which one party agrees to exercise ordinary care in protecting the securities held in safekeeping for others.

(k) *Delivery versus payment* means payment for an investment must occur simultaneously with its delivery.

(l) *Deposit note* means an obligation of a bank that is similar to a certificate of deposit but is rated.

(m) *Derivatives* means financial instruments or other contracts whose value is based on the performance of an underlying financial asset, index or other investment that have the three following characteristics:

(1) It has one or more underlyings and one or more notional amounts or payment provisions or both that determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required;

(2) It requires no initial net investment or an initial net investment that is less than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(3) Its terms require or permit net settlement, it can readily be settled net by means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

(n) *Embedded option* means a characteristic of an investment that gives the issuer or holder the right to alter the level and timing of the cash flows of the investment. Embedded options include call and put provisions and interest rate caps and floors. Since a prepayment option in a mortgage is a type of call provision, a mortgage-backed security composed of mortgages that may be prepaid is an example of an investment with an embedded option.

(o) *Eurodollar deposit* means a U.S. dollar-denominated deposit in a foreign branch of a United States depository institution.

(p) *European financial options contract* means an option that can be exercised only on its expiration date.

(q) *Fair value* means the amount at which an instrument could be exchanged in a current, arms-length transaction between willing parties, as opposed to a forced or liquidation sale.

(r) *Financial options contract* means an agreement to make or take delivery of a standardized financial instrument upon demand by the holder of the contract as specified in the agreement.

(s) *Immediate family member* means a spouse or other family member living in the same household.

(t) *Industry-recognized information provider* means an organization that obtains compensation by providing information to investors and receives no compensation for the purchase or sale of investments.

(u) *Investment* means any security, obligation, account, deposit, or other item authorized for purchase by a federal credit union under sections 107(7), 107(8), or 107(15) of the Act, or this part, other than loans to members.

(v) *Investment repurchase transaction* means a transaction in which an investor agrees to purchase a security from a counterparty and to resell the same or an identical security to that counterparty at a specified future date and at a specified price.

(w) *Maturity* means the date the last principal amount of a security is scheduled to come due and does not mean the call date or the weighted average life of a security.

(x) *Mortgage related security* means a security as defined in section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)), *e.g.,* a privately-issued security backed by first lien mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure, that is rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization.

(y) *Mortgage servicing rights* means a contractual obligation to perform mortgage servicing and the right to receive compensation for performing those services. Mortgage servicing is the administration of a mortgage loan, including collecting monthly payments and fees, providing recordkeeping and escrow functions, and, if necessary curing defaults and foreclosing.

(z) *Negotiable instrument* means an instrument that may be freely transferred from the purchaser to another person or entity by delivery, or endorsement and delivery, with full legal title becoming vested in the transferee.

(aa) *Net worth* means the retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles and as further defined in § 702.2(f) of this chapter.

(bb) *Official* means any member of a federal credit union's board of directors, credit committee, supervisory committee, or investment-related committee.

(cc) *Ordinary care* means the degree of care, which an ordinarily prudent and competent person engaged in the same line of business or endeavor should exercise under similar circumstances.

(dd) *Pair-off transaction* means an investment purchase transaction that is closed or sold on, or before the settlement date. In a pair-off, an investor commits to purchase an investment, but then pairs-off the purchase with a sale of the same investment before or on the settlement date.

(ee) *Put* means a financial options contract that entitles the holder to sell, entirely at the holder's option, a specified quantity of a security at a specified price at any time until the stated expiration date of the contract.

(ff) *Registered investment company* means an investment company that is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a). Examples of registered investment companies are mutual funds and unit investment trusts.

(gg) *Regular way settlement* means delivery of a security from a seller to a buyer within the time frame that the securities industry has established for immediate delivery of that type of security. For example, regular way settlement of a Treasury security includes settlement on the trade date (cash), the business day following the trade date (regular way), and the second business day following the trade date (skip day).

(hh) *Residual interest* means the remainder cash flows from collateralized mortgage obligations/real estate mortgage investment conduits (CMOs/REMICs), or other mortgage-backed security transaction, after payments due bondholders and trust administrative expenses have been satisfied.

(ii) *Securities lending* means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return.

(jj) *Security* means a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that: (1) Either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer; (2) Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and (3) Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

(kk) *Senior management employee* means a federal credit union's chief executive officer (typically this individual holds the title of President or Treasurer/Manager), an assistant chief executive officer, and the chief financial officer.

(ll) *Small business related security* means a security as defined in section 3(a)(53) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(53)), *e.g.,* a security that is rated in 1 of the 4 highest rating categories by at least one nationally recognized statistical rating organization, and represents an interest in 1 or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution, insured credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or a finance company or leasing company. This definition does not include Small Business Administration securities permissible under section 107(7) of the Act.

(mm) *Weighted average life* means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of principal.

(nn) *When-issued trading of securities* means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

(oo) *Yankee dollar deposit* means a deposit in a United States branch of a foreign bank licensed to do business in the state in which it is located, or a deposit in a state-chartered, foreign controlled bank.

(pp) *Zero coupon investment* means an investment that makes no periodic interest payments but instead is sold at a discount from its face value. The holder of a zero coupon investment realizes the rate of return through the gradual appreciation of the investment, which is redeemed at face value on a specified maturity date.

§ 703.3 Investment policies.

A federal credit union's board of directors must establish written investment policies consistent with the Act, this part, and other applicable laws and regulations and must review the policy at least annually. These policies may be part of a broader, asset-liability management policy. Written investment policies must address the following:

(a) The purposes and objectives of the federal credit union's investment activities;

(b) The characteristics of the investments the federal credit union may make including the issuer,

maturity, index, cap, floor, coupon rate, coupon formula, call provision, average life, and interest rate risk;

(c) How the federal credit union will manage interest rate risk;

(d) How the federal credit union will manage liquidity risk;

(e) How the federal credit union will manage credit risk including specifically listing institutions, issuers, and counterparties that may be used, or criteria for their selection, and limits on the amounts that may be invested with each;

(f) How the federal credit union will manage concentration risk, which can result from dealing with a single or related issuers, lack of geographic distribution, holding obligations with similar characteristics like maturities and indexes, holding bonds having the same trustee, and holding securitized loans having the same originator, packager, or guarantor;

(g) Who has investment authority and the extent of that authority. Those with authority must be qualified by education or experience to assess the risk characteristics of investments and investment transactions. Only those individuals with investment authority may be voting members of an investment committee;

(h) The broker-dealers the federal credit union may use;

(i) The safekeepers the federal credit union may use;

(j) How the federal credit union will handle an investment that, after purchase, is outside of board policy or fails a requirement of this part; and

(k) How the federal credit union will conduct investment trading activities, if applicable, including addressing:

(1) Who has purchase and sale authority;

(2) Limits on trading account size;

(3) Allocation of cash flow to trading accounts;

(4) Stop loss or sale provisions;

(5) Dollar size limitations of specific types, quantity and maturity to be purchased;

(6) Limits on the length of time an investment may be inventoried in a trading account; and

(7) Internal controls, including segregation of duties.

§ 703.4 Recordkeeping and documentation requirements.

(a) Federal credit unions with assets of $10,000,000 or greater must comply with all generally accepted accounting principles applicable to reports or statements required to be filed with the NCUA. Federal credit unions with assets less than $10,000,000 are encouraged to do the same, but are not required to do so. Federal credit unions with assets less than $10,000,000 may choose to account for their investments consistent with the NCUA Accounting Manual For Federal Credit Unions.

(b) A federal credit union must maintain documentation for each investment transaction for as long as it holds the investment and until the documentation has been audited in accordance with § 701.12 of this chapter and examined by NCUA. The documentation should include, where applicable, bids and prices at purchase and sale and for periodic updates, relevant disclosure documents or a description of the security from an industry-recognized information provider, financial data, and tests and reports required by the federal credit union's investment policy and this part.

(c) A federal credit union must maintain documentation its board of directors used to approve a broker-dealer or a safekeeper for as long as the broker-dealer or safekeeper is approved and until the documentation has been audited in accordance with § 701.12 of this chapter and examined by NCUA.

(d) A federal credit union must obtain an individual confirmation statement from each broker-dealer for each investment purchased or sold.

§ 703.5 Discretionary control over investments and investment advisers.

(a) Except as provided in paragraph (b) of this section, a federal credit union must retain discretionary control over its purchase and sale of investments. A federal credit union has not delegated discretionary control to an investment adviser when the federal credit union reviews all recommendations from investment advisers and is required to authorize a recommended purchase or sale transaction before its execution.

(b)(1) A federal credit union may delegate discretionary control over the purchase and sale of investments to a person other than a federal credit union official or employee:

(i) Provided the person is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (15 U.S.C. 80b); and

(ii) In an amount up to 100 percent of its net worth in the aggregate at the time of delegation.

(2) At least annually, the federal credit union must adjust the amount of funds held under discretionary control to comply with the 100 percent of net worth cap. The federal credit union's board of directors must receive notice as soon as possible, but no later than the next regularly scheduled board meeting, of the amount exceeding the net worth cap and notify in writing the appropriate regional director within 5 days after the board meeting. The credit union must develop a plan to comply with the cap within a reasonable period of time.

(3) Before transacting business with an investment adviser, a federal credit union must analyze his or her background and information available from state or federal securities regulators, including any enforcement actions against the adviser, associated personnel, and the firm for which the adviser works.

(c) A federal credit union may not compensate an investment adviser with discretionary control over the purchase and sale of investments on a per transaction basis or based on capital gains, capital appreciation, net income, performance relative to an index, or any other incentive basis.

(d) A federal credit union must obtain a report from its investment adviser at least monthly that details the investments under the adviser's control and their performance.

§ 703.6 Credit analysis.

A federal credit union must conduct and document a credit analysis on an investment and the issuing entity before purchasing it, except for investments issued or fully guaranteed as to principal and interest by the U.S. government or its agencies, enterprises, or corporations or fully insured (including accumulated interest) by the National Credit Union Administration or the Federal Deposit Insurance Corporation. A federal credit union must update this analysis at least annually for as long as it holds the investment.

§ 703.7 Notice of non-compliant investments.

A federal credit union's board of directors must receive notice as soon as possible, but no later than the next regularly scheduled board meeting, of any investment that either is outside of board policy after purchase or has failed a requirement of this part. The board of directors must document its action regarding the investment in the minutes of the board meeting, including a detailed explanation of any decision not to sell it. The federal credit union must notify in writing the appropriate regional director of an investment that has failed a requirement of this part within 5 days after the board meeting.

§ 703.8 Broker-dealers.

(a) A federal credit union may purchase and sell investments through a broker-dealer as long as the broker-

dealer is registered as a broker-dealer with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) or is a depository institution whose broker-dealer activities are regulated by a federal or state regulatory agency.

(b) Before purchasing an investment through a broker-dealer, a federal credit union must analyze and annually update the following:

(1) The background of any sales representative with whom the federal credit union is doing business;

(2) Information available from state or federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers and the North American Securities Administrators Association, about any enforcement actions against the broker-dealer, its affiliates, or associated personnel; and

(3) If the broker-dealer is acting as the federal credit union's counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfill commitments, as evidenced by capital strength, liquidity, and operating results. The federal credit union should consider current financial data, annual reports, reports of nationally-recognized statistical rating agencies, relevant disclosure documents, and other sources of financial information.

§ 703.9 Safekeeping of investments.

(a) A federal credit union's purchased investments and repurchase collateral must be in the federal credit union's possession, recorded as owned by the federal credit union through the Federal Reserve Book-Entry System, or held by a board-approved safekeeper under a written custodial agreement that requires the safekeeper to exercise, at least, ordinary care.

(b) Any safekeeper used by a federal credit union must be regulated and supervised by either the Securities and Exchange Commission, a federal or state depository institution regulatory agency, or a state trust company regulatory agency.

(c) A federal credit union must obtain and reconcile monthly a statement of purchased investments and repurchase collateral held in safekeeping.

(d) Annually, the federal credit union must analyze the ability of the safekeeper to fulfill its custodial responsibilities, as evidenced by capital strength, liquidity, and operating results. The federal credit union should consider current financial data, annual reports, reports of nationally-recognized statistical rating agencies, relevant disclosure documents, and other sources of financial information.

§ 703.10 Monitoring non-security investments.

(a) At least quarterly, a federal credit union must prepare a written report listing all of its shares and deposits in banks, credit unions, and other depository institutions, that have one or more of the following features:

(1) Embedded options;

(2) Remaining maturities greater than 3 years; or

(3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

(b) The requirement of paragraph (a) of this section does not apply to shares and deposits that are securities.

(c) If a federal credit union does not have an investment-related committee, then each member of its board of directors must receive a copy of the report described in paragraph (a) of this section. If a federal credit union has an investment-related committee, then each member of the committee must receive a copy of the report, and each member of the board must receive a summary of the information in the report.

§ 703.11 Valuing securities.

(a) Before purchasing or selling a security, a federal credit union must obtain either price quotations on the security from at least two broker-dealers or a price quotation on the security from an industry-recognized information provider. This requirement to obtain price quotations does not apply to new issues purchased at par or at original issue discount.

(b) At least monthly, a federal credit union must determine the fair value of each security it holds. It may determine fair value by obtaining a price quotation on the security from an industry-recognized information provider, a broker-dealer, or a safekeeper.

(c) At least annually, the federal credit union's supervisory committee or its external auditor must independently assess the reliability of monthly price quotations received from a broker-dealer or safekeeper. The federal credit union's supervisory committee or external auditor must follow generally accepted auditing standards, which require either re-computation or reference to market quotations.

(d) If a federal credit union is unable to obtain a price quotation required by this section for a particular security, then it may obtain a quotation for a security with substantially similar characteristics.

§ 703.12 Monitoring securities.

(a) At least monthly, a federal credit union must prepare a written report setting forth, for each security held, the fair value and dollar change since the prior month-end, with summary information for the entire portfolio.

(b) At least quarterly, a federal credit union must prepare a written report setting forth the sum of the fair values of all fixed and variable rate securities held that have one or more of the following features:

(1) Embedded options;

(2) Remaining maturities greater than 3 years; or

(3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

(c) Where the amount calculated in paragraph (b) of this section is greater than a federal credit union's net worth, the report described in that paragraph must provide a reasonable and supportable estimate of the potential impact, in percentage and dollar terms, of an immediate and sustained parallel shift in market interest rates of plus and minus 300 basis points on:

(1) The fair value of each security in the federal credit union's portfolio;

(2) The fair value of the federal credit union's portfolio as a whole; and

(3) The federal credit union's net worth.

(d) If the federal credit union does not have an investment-related committee, then each member of its board of directors must receive a copy of the reports described in paragraphs (a) through (c) of this section. If the federal credit union has an investment-related committee, then each member of the committee must receive copies of the reports, and each member of the board of directors must receive a summary of the information in the reports.

§ 703.13 Permissible investment activities.

(a) Regular way settlement and delivery versus payment basis. A federal credit union may only contract for the purchase or sale of a security as long as the delivery of the security is by regular way settlement and the transaction is accomplished on a delivery versus payment basis.

(b) Federal funds. A federal credit union may sell federal funds to an institution described in Section 107(8) of the Act and credit unions, as long as the interest or other consideration received from the financial institution is at the market rate for federal funds transactions.

(c) Investment repurchase transaction. A federal credit union may enter into an investment repurchase transaction so long as:

(1) Any securities the federal credit union receives are permissible investments for federal credit unions, the federal credit union, or its agent, either takes physical possession or control of the repurchase securities or is recorded as owner of them through the Federal Reserve Book Entry Securities Transfer System, the federal credit union, or its agent, receives a daily assessment of their market value, including accrued interest, and the federal credit union maintains adequate margins that reflect a risk assessment of the securities and the term of the transaction; and

(2) The federal credit union has entered into signed contracts with all approved counterparties.

(d) Borrowing repurchase transaction. A federal credit union may enter into a borrowing repurchase transaction so long as:

(1) The transaction meets the requirements of paragraph (c) of this section;

(2) Any cash the federal credit union receives is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments the federal credit union purchases with that cash are permissible for federal credit unions; and

(3) The investments referenced in paragraph (d)(2) of this section mature no later than the maturity of the borrowing repurchase transaction.

(e) Securities lending transaction. A federal credit union may enter into a securities lending transaction so long as:

(1) The federal credit union receives written confirmation of the loan;

(2) Any collateral the federal credit union receives is a legal investment for federal credit unions, the federal credit union, or its agent, obtains a first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral through the Federal Reserve Book Entry Securities Transfer System; and the federal credit union, or its agent, receives a daily assessment of the market value of the collateral, including accrued interest, and maintains adequate margin that reflects a risk assessment of the collateral and the term of the loan;

(3) Any cash the federal credit union receives is subject to the borrowing limit specified in section 107(9) of the Act, and any investments the federal credit union purchases with that cash are permissible for federal credit unions and mature no later than the maturity of the transaction; and

(4) The federal credit union has executed a written loan and security agreement with the borrower.

(f)(1) Trading securities. A federal credit union may trade securities, including engaging in when-issued trading and pair-off transactions, so long as the federal credit union can show that it has sufficient resources, knowledge, systems, and procedures to handle the risks.

(2) A federal credit union must record any security it purchases or sells for trading purposes at fair value on the trade date. The trade date is the date the federal credit union commits, orally or in writing, to purchase or sell a security.

(3) At least monthly, the federal credit union must give its board of directors or investment-related committee a written report listing all purchase and sale transactions of trading securities and the resulting gain or loss on an individual basis.

§ 703.14 Permissible investments.

(a) Variable rate investment. A federal credit union may invest in a variable rate investment, as long as the index is tied to domestic interest rates and not, for example, to foreign currencies, foreign interest rates, or domestic or foreign commodity prices, equity prices, or inflation rates. For purposes of this part, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is a domestic interest rate.

(b) Corporate credit union shares or deposits. A federal credit union may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified it that the corporate credit union is not operating in compliance with part 704 of this chapter. A federal credit union's aggregate amount of paid-in capital and membership capital, as defined in part 704 of this chapter, in one corporate credit union is limited to two percent of its assets measured at the time of investment or adjustment. A federal credit union's aggregate amount of paid-in capital and membership capital in all corporate credit unions is limited to four percent of its assets measured at the time of investment or adjustment.

(c) Registered investment company. A federal credit union may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for federal credit unions.

(d) Collateralized mortgage obligation/real estate mortgage investment conduit. A federal credit union may invest in a fixed or variable rate collateralized mortgage obligation/real estate mortgage investment conduit.

(e) Municipal security. A federal credit union may purchase and hold a municipal security, as defined in section 107(7)(K) of the Act, only if a nationally-recognized statistical rating organization has rated it in one of the four highest rating categories.

(f) Instruments issued by institutions described in section 107(8) of the Act. A federal credit union may invest in the following instruments issued by an institution described in section 107(8) of the Act:

(1) Yankee dollar deposits;

(2) Eurodollar deposits;

(3) Banker's acceptances;

(4) Deposit notes; and

(5) Bank notes with original weighted average maturities of less than five years.

(g) European financial options contract. A federal credit union may purchase a European financial options contract or a series of European financial options contracts only to fund the payment of dividends on member share certificates where the dividend rate is tied to an equity index provided:

(1) The option and dividend rate are based on a domestic equity index;

(2) Proceeds from the options are used only to fund dividends on the equity-linked share certificates;

(3) Dividends on the share certificates are derived solely from the change in the domestic equity index over a specified period;

(4) The options' expiration dates coincide with the maturity date of the share certificate;

(5) The certificate may be redeemed prior to the maturity date only upon the member's death or termination of the corresponding option;

(6) The total costs associated with the purchase of the option is known by the federal credit union prior to effecting the transaction;

(7) The options are purchased at the same time the certificate is issued to the member.

(8) The counterparty to the transaction is a domestic counterparty and has been approved by the federal credit union's board of directors;

(9) The counterparty to the transaction:

(i) Has a long-term, senior, unsecured debt rating from a nationally-recognized statistical rating organization of AA- (or equivalent) or better at the time of the transaction, and the contract between the counterparty and the federal credit union specifies that if the long-term, senior, unsecured debt rating declines below AA- (or equivalent) then the counterparty agrees to post collateral with an independent party in an amount fully securing the value of the option; or

(ii) Posts collateral with an independent party in an amount fully securing the value of the option if the counterparty does not have a long-term, senior unsecured debt rating from a nationally-recognized statistical rating organization.

(10) Any collateral posted by the counterparty is a permissible investment for federal credit unions and is valued daily by an independent third party along with the value of the option;

(11) The aggregate amount of equity-linked member share certificates does not exceed the credit union's net worth;

(12) The terms of the share certificate include a guarantee that there can be no loss of principal to the member regardless of changes in the value of the option unless the certificate is redeemed prior to maturity; and

(13) The federal credit union provides it board of directors with a monthly report detailing at a minimum:

(i) The dollar amount of outstanding equity-linked share certificates;

(ii) Their maturities; and

(iii) The fair value of the options as determined by an independent third party.

§ 703.15 Prohibited investment activities; adjusted trading or short sales.

A federal credit union may not engage in adjusted trading or short sales.

§ 703.16 Prohibited investments.

(a) Derivatives. A federal credit union may not purchase or sell financial derivatives, such as futures, options, interest rate swaps, or forward rate agreements, except as permitted under §§ 701.21(i) and 703.14(h) of this chapter;

(b) Zero coupon investments. A federal credit union may not purchase a zero coupon investment with a maturity date that is more than 10 years from the settlement date; and

(c) Mortgage servicing rights. A federal credit union may not purchase mortgage servicing rights as an investment but may perform mortgage servicing functions as a financial service for a member as long as the mortgage loan is owned by a member;

(d) A federal credit union may not purchase a commercial mortgage related security that is not otherwise permitted by section 107(7)(E) of the Act.

(e) Other prohibited investments. A federal credit union may not purchase stripped mortgage-backed securities, residual interests in collateralized mortgage obligations/real estate mortgage investment conduits, or small business related securities.

§ 703.17 Conflicts of interest.

(a) A federal credit union's officials and senior management employees, and their immediate family members, may not receive anything of value in connection with its investment transactions. This prohibition also applies to any other employee, such as an investment officer, if the employee is directly involved in investments, unless the federal credit union's board of directors determines that the employee's involvement does not present a conflict of interest. This prohibition does not include compensation for employees.

(b) A federal credit union's officials and employees must conduct all transactions with business associates or family members that are not specifically prohibited by paragraph (a) of this section at arm's length and in the federal credit union's best interest.

§ 703.18 Grandfathered Investments.

(a) Subject to safety and soundness considerations, a federal credit union may hold a CMO/REMIC residual, stripped mortgage-backed securities, or zero coupon security with a maturity greater than 10 years, if it purchased the investment:

(1) Before December 2, 1991; or

(2) On or after December 2, 1991, but before January 1, 1998, if for the purpose of reducing interest rate risk and if the federal credit union meets the following:

(i) The federal credit union has a monitoring and reporting system in place that provides the documentation necessary to evaluate the expected and actual performance of the investment under different interest rate scenarios;

(ii) The federal credit union uses the monitoring and reporting system to conduct and document an analysis that shows, before purchase, that the proposed investment will reduce its interest rate risk;

(iii) After purchase, the federal credit union evaluates the investment at least quarterly to determine whether or not it actually has reduced the interest rate risk; and

(iv) The federal credit union accounts for the investment consistent with generally accepted accounting principles.

(b) All grandfathered investments are subject to the valuation and monitoring requirements of §§ 703.10, 703.11, and 703.12 of this part.

§ 703.19 Investment pilot program.

(a) Under the investment pilot program, NCUA will permit a limited number of federal credit unions to engage in investment activities prohibited by this part but permitted by the Act.

(b) Except as provided in paragraph (c) of this section, before a federal credit union may engage in additional activities, it must obtain written approval from NCUA. To obtain approval, a federal credit union must submit a request to its regional director that addresses the following items:

(1) Certification that the federal credit union is ''well-capitalized'' under part 702 of this chapter;

(2) Board policies approving the activities and establishing limits on them;

(3) A complete description of the activities, with specific examples of how they will benefit the federal credit union and how they will be conducted;

(4) A demonstration of how the activities will affect the federal credit union's financial performance, risk profile, and asset-liability management strategies;

(5) Examples of reports the federal credit union will generate to monitor the activities;

(6) Projections of the associated costs of the activities, including personnel, computer, audit, and so forth;

(7) Descriptions of the internal systems that will measure, monitor, and report the activities;

(8) Qualifications of the staff and officials responsible for implementing and overseeing the activities; and

(9) Internal control procedures that will be implemented, including audit requirements.

(c) A third-party seeking approval of an investment pilot program must submit a request to the Director of the Office of Examination and Insurance that addresses the following items:

(1) A complete description of the activities with specific examples of how a credit union will conduct and account for them, and how they will benefit a federal credit union;

(2) A description of any risks to a federal credit union from participating in the program; and

(3) Contracts that must be executed by the federal credit union.

(d) A federal credit union need not obtain individual written approval to engage in investment activities prohibited by this part but permitted by statute where the activities are part of a third-party investment program that NCUA has approved under this section.

PART 742—REGULATORY FLEXIBILITY PROGRAM

3. The authority citation for part 742 continues to read as follows:

Authority: 12 U.S.C. 1756 and 1766.

4. Revise § 742.4 to read as follows:

§ 742.4 From what NCUA Regulations will I be exempt?

(a) RegFlex credit unions are exempt from the provisions of the following NCUA regulations without restrictions or limitations: § 701.25, § 701.32(b) and (c), § 701.36(a), (b) and (c), § 703.5(b)(1)(ii) and (b)(2), § 703.12(c); and § 703.16(b) of this chapter.

(b) RegFlex credit unions are exempt from the provisions of the following NCUA regulations with certain restrictions or limitations:

(1) § 703.13(d)(3) of this chapter, provided the value of the investments that mature later than the borrowing repurchase transaction does not exceed 100 percent of the federal credit union's net worth; and

(2) § 703.16(d) of this chapter provided,

(i) The issuer of the security is domestic;

(ii) The security is rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization;

(iii) The security meets the definition of mortgage related security as defined in 15 U.S.C. 78c(a)(41) and the definition of commercial mortgage related security as defined in § 703.2 of this chapter;

(iv) The security's underlying pool of loans contains more than 50 loans with no one loan representing more than 10 percent of the pool; and

(v) The aggregate total of commercial mortgage related securities purchased by the federal credit union does not exceed 50 percent of its net worth.

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 2002–NE–35–AD]

RIN 2120–AA64

Airworthiness Directives; General Electric Company CF6–50 Series Turbofan Engines

AGENCY: Federal Aviation Administration, DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: The Federal Aviation Administration (FAA) proposes to adopt a new airworthiness directive (AD) that is applicable to General Electric Company (GE) CF6–50 series turbofan engines. This proposal would require removal from service of eight serial number (SN) low pressure turbine (LPT) stage 1 disks, part number (P/N) 9061M21P03, at the next engine shop visit. This proposal is prompted by a report of the potential for iron-rich inclusions introduced during manufacture in the affected disks. The actions specified by the proposed AD are intended to prevent LPT stage 1 disk cracking, due to iron-rich inclusions introduced during manufacture, leading to uncontained disk failure.

DATES: Comments must be received by February 25, 2003.

ADDRESSES: Submit comments in triplicate to the Federal Aviation Administration (FAA), New England Region, Office of the Regional Counsel, Attention: Rules Docket No. 2002–NE–35–AD, 12 New England Executive Park, Burlington, MA 01803–5299. Comments may be inspected at this location, by appointment, between 8 a.m. and 4:30 p.m., Monday through Friday, except Federal holidays. Comments may also be sent via the Internet using the following address: ''*9-ane-adcomment@faa.gov*''. Comments sent via the Internet must contain the docket number in the subject line.

FOR FURTHER INFORMATION CONTACT: Karen Curtis, Aerospace Engineer, Engine Certification Office, FAA, Engine and Propeller Directorate, 12 New England Executive Park, Burlington, MA 01803–5299; telephone: (781) 238–7192, fax: (781) 238–7199.

SUPPLEMENTARY INFORMATION:

Comments Invited

Interested persons are invited to participate in the making of the proposed rule by submitting such written data, views, or arguments as they may desire. Communications should identify the Rules Docket number and be submitted in triplicate to the address specified above. All communications received on or before the closing date for comments, specified above, will be considered before taking action on the proposed rule. The proposals contained in this action may be changed in light of the comments received.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the proposed rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket for examination by interested persons. A report summarizing each FAA-public contact concerned with the substance of this proposal will be filed in the Rules Docket.

Commenters wishing the FAA to acknowledge receipt of their comments submitted in response to this action must submit a self-addressed, stamped postcard on which the following statement is made: ''Comments to Docket Number 2002–NE–35–AD.'' The postcard will be date stamped and returned to the commenter.

Availability of NPRM's

Any person may obtain a copy of this NPRM by submitting a request to the FAA, New England Region, Office of the Regional Counsel, Attention: Rules Docket No. 2002–NE–35–AD, 12 New England Executive Park, Burlington, MA 01803–5299.

Discussion

In November of 2000, the FAA became aware that a CF6–80C2 engine high pressure turbine disk was rejected at inspection because it was cracked. GE and the disk supplier investigated and determined that the crack resulted from the presence of an iron-rich inclusion that was inadvertently introduced into the lot of INCO 718 disk material during the manufacturing melt process. GE and the disk supplier have since identified another lot that potentially had iron-rich inclusions introduced during the manufacturing melt process. That lot was used to manufacture eight CF6–50 engine LPT stage 1 disks. GE and the disk supplier have since coordinated and implemented corrective actions to prevent inclusions from being introduced in the manufacturing melt process.

On November 30, 2001, GE issued service bulletin (SB) SB 72–1225, requesting that operators remove the eight suspect disks from service at the next engine shop visit. On January 7, 2002, GE issued All Operators Wire No. 02.CF6/002, again informing the operators of the above SB, recommending removal of the suspect disks from service, and requesting report back of the disk removal date to GE. Currently, not all of the eight disks have been reported as having been removed or scheduled for removal. This condition, if not corrected, could result in LPT stage 1 disk cracking, leading to uncontained disk failure.

FAA's Determination of an Unsafe Condition and Proposed Actions

Since an unsafe condition has been identified that is likely to exist or develop on other CF6 series turbofan engines of a similar type design and manufacturing sequence, the proposed AD would require removal from service