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CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

Investments under Government Code 53601(k) – Focus on Foreign Issuers

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INTRODUCTION

California local agencies, seeking to address today's low interest rate environment, may be deliberating adding foreign issuer medium-term notes denominated in United States dollars to their investment portfolios. Before doing so, however, each agency must determine whether such instruments are qualified investments under state law.

Permissible medium-term notes are defined under Section 53601(k) of the California Government Code as:

"[a]ll corporate and depository institution debt securities with a maximum remaining maturity of <u>five years or less</u>, issued by <u>corporations organized and operating within the United States</u> or by <u>depository institutions licensed by the United States or any state and operating within the United States</u>. Notes eligible for investment under this subdivision shall be <u>rated "A" or better</u> by an NRSRO. Purchases of medium-term notes shall not include other instruments authorized by this section and <u>may not exceed 30 percent</u> of the agency's moneys that may be invested pursuant to this section."[1]

The purpose of this brief is to assist local agencies in deciding whether a foreign issuer medium-term note meets the requirements of Section 53601(k). In this regard, the brief identifies ways local agencies can determine whether a note issued by a foreign or supranational entity is appropriately *organized, operating, and licensed in the United States.*

WHAT IS FOREIGN ISSUER DEBT?

Dollar-denominated debt securities issued by foreign entities in the United States are often referred to as "Yankee Bonds". These bonds are issued by foreign corporations, banks, and sovereign nations. The Securities and Exchange Commission (SEC) registration requirements for foreign issuer bonds are very similar to those for domestic bonds—they are rated by a nationally recognized statistical rating organization, make coupon payments twice a year, and commit to making market disclosures in compliance with securities laws and regulations.

SUPRANATIONAL DEBT

A supranational organization is formed by a group of countries through an international treaty with specific objectives, such as promoting economic development. Supranational organizations also issue debt in the United States. The most commonly recognized supranational debt is issued by the World Bank. The supranational bond market is well established and most bonds carry the highest credit rating assigned by the major rating agencies. The outstanding dollar equivalent debt issued by global agencies, sovereigns, and supranational organizations approached $1.3 trillion by the end of 2012.[2] Although supranational medium term notes do not meet the organized and operating requirements of Section 53601(k), they may be used as collateral for local agency bank deposits over the $250,000 FDIC limits.

INTERPRETING GOVERNMENT CODE SECTION 53601(k)

Section 53601(k) categorizes medium-term notes as securities issued by either a corporation or depository institution with a maximum maturity of five years or less. Each category of debt maintains its own qualifying criteria.

Public agencies may purchase debt issued by a corporation if it is *organized and operating* in the United States. They may purchase debt issued by a depository institution if it is *operating in and licensed* by the United States or any state. The terms organized, operating, and licensed are not specifically defined by statutes nor are they legal terms that hold a specific meaning.

For the purpose of applying Section 53601(k), CDIAC interprets these terms based upon usage and context to mean:

- ORGANIZED-An entity organized as a corporation in the United States.
- OPERATING-Engaged in business activities for which it was organized, and maintaining a functioning office (other than a representative office).
- LICENSED-Permitted by the appropriate regulatory agency to operate and conduct business in the United States (federal license) or a specific state (state license).

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[1] Emphasis added.

[2] http://dmi.thomsonreuters.com/Content/Files/4Q2012_Global_Debt_Capital_Markets_Review.pdf

APPLYING SECTION 53601(k) TO THE SELECTION OF MEDIUM-TERM NOTES

The "A" rating and 30 percent restrictions are explicit and easily applied to the selection of suitable investments. But investors may be uncertain about how organized, operating, and licensed apply to specific investment choices. The best way to reduce this uncertainty is through examples. Let's consider the case of two well-known global entities, *Toyota Corporation* and *Credit Suisse Group AG*, selling four different securities in the United States.[3]

Toyota Corporation is a household name with a large presence in the United States, but is incorporated in Japan; therefore, its securities issued in the United States do not meet the *organized* requirement of Section 53601(k). In contrast, *Toyota Motor Credit Corporation* (the financing arm of Toyota) is incorporated in the United States and meets the *organized* requirement. Local agencies in California may purchase securities issued by *Toyota Motor Credit Corporation* as long as these securities meet other statutory requirements.

A more complex example involves a financial institution. *Credit Suisse Group* is a global banking and financial institution which has operations in the United States. One of its subsidiaries is *Credit Suisse USA*, a New York licensed domestic entity engaged in banking activities that meets the operating and licensed requirements of a depository institution under Section 53601(k). Its other subsidiary, *Credit Suisse NY*, operates in the United States and also is licensed by the State of New York as an uninsured branch of a foreign banking organization. Because *Credit Suisse NY* does not accept retail deposits, it might not qualify as a depository institution as defined by the Federal Reserve System.[4] Securities issued by this entity may not be allowable investments for California local agencies.

The determination of incorporation and license status can typically be found through public records such as annual reports, state filings, and the issuer's own website. In addition, resellers of financial data such as Thomson Reuters and Bloomberg provide data identifying the country and state of incorporation for investment products in their databases. In some cases, financial institutions with complex licensing and regulatory characteristics might need additional research and legal interpretation. In these cases, the local agency should weigh the benefits and risks of purchasing securities from these institutions with the benefits and risks of choosing a domestic investment alternative. Figure 1 outlines some resources local agencies can use to determine whether a foreign issuing entity meets the minimum requirements of Section 53601(k).

SUMMARY

Prior to purchasing a medium-term note pursuant to Section 53601(k), local agencies must determine whether the note meets certain criteria. Although the maturity, credit rating, and portfolio allocation requirements are straightforward, the legal and regulatory complexities inherent in financial institution licensing and organization structure can present challenges in determining a clear definition of depository institution, and, at times, may need a more thorough legal analysis. Local agencies, in consultation with legal counsel, should establish a method of determining whether non-U.S. financial institutions meet the Section 53601(k) requirements before purchasing securities from these institutions. In addition, local agency investment staff should evaluate the risks and benefits of instruments issued by financial institutions with unclear depository or licensing status and compare them to those that clearly meet the requirements of Section 53601(k).

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[3] The SEC maintains a list of registered and reporting foreign companies doing business in the U.S. by country of incorporation and updates the list on an annual basis. While in many cases the foreign corporations identified in the SEC list are industrial or financial giants, the listed companies are incorporated outside the U.S. and, therefore, not authorized under Section 53601(k).

[4] The Federal Reserve Sytem defines a depository institution as: "A financial institution that is legally permitted to accept deposits from individuals. Depository institutions include savings banks, commercial banks, savings and loan associations, and credit unions."

FIGURE 1

SOURCE OF INFORMATION TO DETERMINE COMPLIANCE WITH 53601(k)

FOREIGN CORPORATIONS (NON-FINANCIAL)	
Is the corporation organized (incorporated) in the United States?	Review the Securities and Exchange Commission's (SEC) list of foreign corporations operating in the United States and reporting to SEC. www.sec.gov/divisions/corpfin/internatl/foreignalpha2012.pdf If the corporation is on this list, it is not an eligible medium term note under 53601(k)
Is the corporation operating in the United States?	This information may not be available at a single source. Check organization website, Bloomberg, ThomsonReuters, etc. for locational information.
FOREIGN DEPOSITORY INSTITUTIONS (FINANCIAL)	
Is the financial institution operating in the United States?	Use the National Information Center to review basic information about the entity.[5] www.ffiec.gov/nicpubweb/nicweb/nichome.aspx Review the yearly Uniform Bank Performance Report (UBPR) financial institutions submit to the Federal Financial Institutions Examination Council (FFIEC 002 report). This report would help determine the United States operations of institutions as well as valuable information about the overall financial health of the entity. www.ffiec.gov/ubpr.htm
Is the financial Institution licensed in the United States?	Check state licensing departments. In California, the Department of Business Oversight regulates and issues licenses for foreign banks operating in the state. www.dbo.ca.gov In New York, the Department of Financial Services licenses foreign banks. www.dfs.ny.gov/about/whowesupervise/sifbranc.htm The Office of the Comptroller of Currency (OCC) charters and regulates national banks and savings association. A list of these entities can be found at: www.occ.gov/topics/licensing/national-bank-lists/index-active-bank-lists.html The National Information Center provides basic information about financial institutions and their licensing agency. www.ffiec.gov/nicpubweb/nicweb/nichome.aspx.
Does the financial institution qualify as a depository institution?	If the entity accepts retail deposits and is FDIC insured it qualifies as a depository institution as determined by the FDIC and Federal Reserve System. If the entity does not accept retail deposits seek legal advice to determine whether the entity qualifies as a depository institution. The National Information Center provides information to help determine whether an issuing entity is an "insured" or "uninsured" branch or agency. www.ffiec.gov/nicpubweb/nicweb/NicHome.aspx.

[5] The National Information Center (maintained by the U.S. Federal Reserve System) is a central repository of data about banks and other financial institutions, including both domestic and foreign banking organizations, operating in the U.S. When searching for foreign institutions make sure to use the USBA window which allows one to search for U.S. Branches and Agencies (USBAs) of Foreign Banking Organizations (FBOs).