STATE OF MICHIGAN
DEPARTMENT OF CONSUMER AND INDUSTRY SERVICES
OFFICE OF FINANCIAL AND INSURANCE SERVICES

Before the Commissioner of Financial and Insurance Services

IN THE MATTER OF: Request by Varnum Riddering Schmidt Howlett, LLP, for a declaratory ruling on bank acceptance of stock warrants as consideration for loans and authority to subsequently transfer the warrants
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Ruling No. 05-044-BT

Issued and entered
this 6th day of September, 2005
by
Linda A. Watters
Commissioner

DECLARATORY RULING authorizing banks to accept and to transfer stock warrants held as additional consideration for loans

I
BACKGROUND

Section 63[1] of the Administrative Procedures Act of 1969 allows an agency to issue a declaratory ruling, upon request by an interested person, as to how a statute administered by the agency would be applied to an actual state of facts. Section 2101[2] of the Banking Code of 1999[3] (Code) created a financial institutions bureau to "have jurisdiction over and administer the laws relating to financial institutions transacting business in this state" and named the commissioner of the financial institutions bureau as its head. Section 2204[4] of the Code authorizes the commissioner of the financial institutions bureau to issue orders and declaratory rulings. Executive Order 2000-4, effective April 3, 2000, transferred the powers of the Financial Institutions Bureau to the Office of Financial and Insurance Services and the powers of the Commissioner of the Financial Institutions Bureau to the Commissioner of Financial and Insurance Services.

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[1] MCL 24.263
[2] MCL 487.12101(1)
[3] MCL 487.11101 et seq.
[4] MCL 487.12204

Thus, the Commissioner of the Office of Financial and Insurance Services has authority to issue a declaratory ruling regarding the applicability of the Code to an actual state of facts. The July 27, 2005 request letter sets forth a statement of facts sufficient to enable the Commissioner to issue a declaratory ruling regarding the applicability of the Act to the stated facts.

II
FACTS

University Bank (Bank) is a state-chartered bank located in Michigan and chartered under the Code.

The Office of the Comptroller of the Currency (OCC) has issued a regulation authorizing national banks to "take as consideration for a loan a stock warrant issued by a business enterprise of a borrower, provided that the bank does not exercise the warrant."[5] The OCC subsequently issued an interpretive letter that allowed a national bank acquiring stock warrants in conformance with the aforementioned regulation to "exercise the warrants and immediately sell the resulting shares of the borrower's common stock."[6]

III
ISSUE

The Commissioner has been asked to issue "an order allowing the Bank to accept stock warrants as additional consideration for a loan and to transfer such stock warrants for value either directly to a third party or indirectly through a cashless exercise." Authority sought is identical to that granted to national banks by the Office of the Comptroller of the Currency under 12 CFR 7.1006 and Interpretive Letter #992.

IV
ANALYSIS

[5] 12 CFR 7.1006, in pertinent part
[6] Interpretive Letter #992, Office of the Comptroller of the Currency, May 10, 2004.

The proposed activity involves the making of a commercial loan "using normal due diligence and underwriting procedures", which loan is "fairly and appropriately priced without taking into account any stock warrants," and for which loan the Bank receives "additional consideration" consisting of stock warrants issued by a business enterprise of the borrower. It is represented that the Bank would not rely for repayment of the loan on any value that may materialize with respect to such stock warrants. The proposed direct or indirect transfers of the warrants would occur at such times as market prices were favorable, whether during or subsequent to the term of the associated credit, and not at a fixed time or predictable interval.

In receiving the warrants as "additional consideration" for a loan, the bank would expend no assets for the warrants. The holding of stock warrants in this situation is not an investment activity, does not put bank assets at risk, and is not a prohibited transaction in shares of corporate capital stock pursuant to section 4304(1) of the Code[7]. National banks have authority to hold stock warrants under these circumstances[8].

The Bank also wishes to be able to secure any value that may accrue in the subject warrants by directly or indirectly transferring the warrants, for value, to third parties. Sale of such warrants directly to a purchaser for value—without exercising the warrants—is permissible as incidental to the bank's business. Exercise of the warrants and sale of the underlying shares, however, is prohibited as "engag[ing] in a transaction with respect to shares of the capital stock of a corporation unless specifically authorized by this act or by order or declaratory ruling of the commissioner under this act."[9]

The Bank seeks authority to obtain the value of the warrants in a proposed activity described by the requester as follows:

> "In a cashless exercise, a brokerage firm sells the shares delineated under the stock warrants in the market and lends, at no interest, to the holder of the stock warrants the funds required for the purchase of the shares from the corporation that issued the warrants. The issuing organization's transfer agent delivers the shares to the account of the brokerage firm that sold the shares. The sale of the shares is settled, and the holder of the stock warrants receives the difference between the exercise price of the stock warrants and the market price for the

[7] MCL 487.14304(1)
[8] 12 CFR 7.1006
[9] MCL 487.14304(1)

shares. This process occurs very quickly and usually involves only electronic transfers of money and ownership.

At no time does the Bank take possession or control of the shares, and the Bank holds title to the shares only momentarily. . .The Bank . . . receives cash at the close of the transaction sufficient to repay the broker's loan and generate a profit."

Section 4101 of the Code permits the Commissioner to authorize state banks to exercise additional powers by issuing orders or declaratory rulings.[10] Section 2204 of the Code, in addition to granting the Commissioner authority to "issue declaratory rulings and orders on applications for new powers, requires the Commissioner, in exercising that authority, to "consider the ability of banks to exercise any additional power in a safe and sound manner, the authority of depository institutions operating under state or federal law or regulation, the powers of other competing entities providing financial services, and any specific limitations on bank powers contained in this act or in any other law of this state." [11]

The proposed activity does not represent an investment of bank assets. In the transaction described, the bank has none of the attributes of an investor except the momentary holding of title to the stock certificates. The bank holds the stock only for the instant it takes the borrower's transfer agent to transfer the shares of stock from the name of the Bank to the name of the selling broker and only for the purpose of effecting the transfer of the shares from the issuer to the market purchaser. The bank has not expended its assets to acquire the warrants or the stock, it never takes possession or control of the shares, and it acquires no voting rights. The proposed transaction would take place only when it is determined that the warrants have value. The brokerage loan is made and warrants are exercised only after a buyer for the stock has been identified. The loan is repaid immediately from the proceeds of the sale of the stock. There is no evidence that the proposed activity would threaten the safety and soundness of the warrant-holding bank or otherwise be harmful to the public.

National banks, competitors of Bank, have authority to engage in the proposed activity. The Commissioner is required to implement the Code to "maximize the capacity of banks to offer

[10] MCL 487.14101
[11] MCL 487.12204

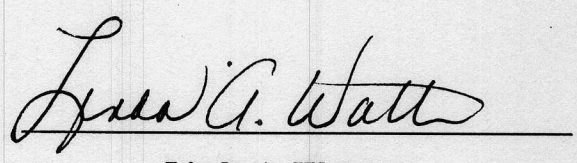
convenient and efficient financial services, to promote economic development, and to ensure that banks remain competitive with other types of financial service providers."[12]

In conclusion, the proposed activity does not pose a threat to the safety and soundness of Bank. National banks already have authority to engage in the proposed activity. Authorization to engage in the proposed activity will help Michigan state-chartered banks to remain competitive with other financial service providers. Michigan law does not elsewhere limit a bank's authority to engage in the proposed activity if approved by order or declaratory ruling of the Commissioner as envisioned under MCL 487.14304(1).

V
RULING

IT IS MY RULING that:

1. A Michigan state-chartered bank may accept as additional consideration for a loan stock warrants issued by a business enterprise of a commercial borrower when the loan meets the Bank's normal underwriting criteria and is fairly priced without consideration of the warrants.
2. A Michigan state-chartered bank may transfer stock warrants acquired as in 1, above, directly to a purchaser for value.
3. A Michigan state-chartered bank may exercise the stock warrants acquired as in 1, above, in order to immediately sell the resulting shares of stock in a transaction conducted as described herein as "the proposed activity."



Linda A. Watters
Commissioner

[12] MCL 487.12102