Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 8, 2000

The Honorable James A. Leach
Chairman
Committee on Banking & Financial Services
2129 Rayburn House Office Building
Washington, D. C. 20515-6050

Dear Chairman Leach:

I am writing in response to your letter of today's date in which you raise concerns about an OCC determination concerning bank holdings of securities to hedge customer-driven, bank permissible equity derivative transactions.[1] You had noted this point when we discussed this matter at some length on Wednesday of this week, and I offered to have OCC staff fully brief you and your staff on the issue. I regret that we were not afforded the opportunity to provide this briefing, which would have addressed the misunderstandings that were unfortunately reflected in your letter to me. In particular, I believe it would have been clear from such a briefing that these carefully limited transactions have no implications at all for bank involvement in merchant banking or for breaching the wall between banking and commerce -- matters that I know well are of concern to you.

In brief, the OCC determined, in the case of three national banks, that the banks could take positions in equity securities solely to hedge bank permissible equity derivative transactions originated by customers for their valid and independent business purposes. The banks committed that they will use equities solely for hedging and not for speculative purposes. The banks will not take anticipatory, or maintain residual positions in equities except as necessary to the orderly establishment or unwinding of a hedging position. Moreover, the banks may not acquire equities for hedging purposes that constitute more than 5% of a class of stock of any issuer.

Based on the representations and commitments made by the banks and an extensive review by supervisory staff of (1) the banks' derivative transactions, (2) proposed hedging of risks arising from those transactions, including an analysis of how equity holdings reduce risks and enhance the efficiency of the hedging, and (3) internal risk management systems, we concluded the banks

[1] The term "equity derivative transactions" means transactions in which a portion of the return (including interest, principal or payment streams) is linked to the price of a particular equity security or to an index of such securities. Equity derivative transactions include equity and equity index swaps, equity index deposits, equity-linked loans and debt issues, and other bank permissible equity derivative products.

may hold equities to hedge customer-driven, bank permissible equity derivative transactions as an activity that is incidental to the business of banking. National banks interested in using equities to hedge customer-driven, bank permissible equity derivative transactions must consult with the examiner-in-charge of the bank and obtain OCC supervisory approval prior to engaging in the activity. Before the OCC will consider approving the activity for a national bank, the bank must provide the OCC information about its derivative business and proposed hedging activities, including their effectiveness and efficiency in reducing risks. Banks will also need to establish that they have an appropriate risk management process in place. As detailed further in the Comptroller's Handbook "*Risk Management of Financial Derivatives*" (January 1997) and OCC Banking Circular 277,[2] an effective risk management process will include Board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification, measurement and management information systems, as well as effective risk control functions that oversee and ensure the continuing appropriateness of the risk management process. It is unsafe and unsound for a national bank to engage in equity hedging activities without an appropriate risk management process in place.

I. Background

Currently, the banks enter into bank permissible, customer-driven equity derivative transactions that they book directly. The banks hedge the equity derivative transactions with equity derivatives or through mirror transactions with nonbank affiliates. The terms of the "mirror" transactions between the banks and nonbank affiliates exactly offset the terms of customer-driven equity derivative transactions. The affiliates hedge the mirror transactions by taking physical positions in equities.

To illustrate, in a "long" equity swap transaction with a customer, the bank agrees to pay the customer the appreciation, over a set period of time, in the value of a notional principal investment in the underlying equity. The bank may also agree to pay the customer amounts equal to dividends on the underlying equity. In return, the customer agrees to pay the bank if there is any decrease in value of the notional principal investment in the underlying equity, and an agreed upon rate of interest applied to that investment.[3]

The bank hedges its long swap transaction by entering into a mirror transaction with a nonbank affiliate. Under the mirror transaction, the nonbank affiliate agrees to pay the bank the appreciation in, and dividends on, the same notional principal investment in the same underlying equity under the same terms as the bank's initial transaction with the customer. The bank, in turn, agrees to pay the nonbank affiliate depreciation in, and the rate of interest applied to, the value of the underlying equity.

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[2] OCC Banking Circular 277 (October 27, 1993) (BC-277).

[3] This type of equity swap transaction is a total rate of return swap because the parties exchange the total return on the asset for another cash-flow.

The nonbank affiliate then hedges its obligations to the bank by purchasing the equity in an amount equal to the notional principal investment in that equity under the swap transaction between the bank and the customer.[4] The banks represent that engaging in customer-driven equity derivative transactions in this fashion effectively moves revenues from the banks to the relevant nonbank affiliate. The banks prefer to eliminate the "mirror" portion of their equity derivative transactions and internally book the physical hedges.

The banks demonstrated that equity holdings provide substantial financial advantages. The banks' represented that eliminating the mirror transactions enables them to downsize the staff currently used to support the processing, reconciliation, accounting, reporting, and funding for all the internal transactions between the banks, their holding companies, and their nonbank affiliates, resulting in significant cost savings on an annual basis. The banks also established that equity hedging will allow the banks to retain the revenue and profits generated by the in-house equity derivative transactions and hedges. Finally, the banks represented that a reduction in net interest expense results from eliminating the mirror transactions, which are funded at the borrowing rate of their holding companies, rather than the more favorable rate enjoyed by the banks. The banks projected that their increase in annualized savings as the business and related funding requirements continue to grow.

The banks also established that the equity hedges provide significant operational advantages. Upon eliminating the mirror transactions and moving the physical hedges into the banks, the banks expect a significant potential reduction in trading, risk management, compliance, and operation risks that currently result from the back-to-back booking of the mirror transactions.

The banks committed that they will use physical equities only to hedge risks arising from customer-driven, bank permissible equity derivative transactions and will not engage in any speculation. The banks further committed that they will not maintain any residual positions in equities that are not directly for the purpose of hedging individual equity derivative transactions or a portfolio of equity derivative transactions. Finally, the banks may not acquire equities for hedging purposes that constitute more than 5% of a class of stock of any issuer.

Our determination that the activity in question was permissible for these particular banks was dependent on the facts and circumstances of each situation and our supervisory knowledge and experience with the banks involved, and did not represent a conclusion that the activity was generally permissible for all national banks. Thus, the conclusion was conveyed as a supervisory matter to those institutions rather than a generally applicable legal interpretation. As discussed above, the OCC will permit equity hedging programs only after a careful review by our examination staff of each bank's program, only where the bank can establish equity holdings are solely for hedging purposes and offer benefits to the bank, and only where the bank has an appropriate risks management process in place. National banks are not generally authorized to conduct these activities based on our response to these particular banks.

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[4] Alternatively, the affiliate could hedge a portfolio of swap transactions using a basket of securities having a close correlation with the Bank's underlying exposure.

II. Discussion

National banks may engage in customer-driven equity derivative transactions as part of the business of banking. Hedging risks arising from these permissible banking activities is an essential and integral part of those banking activities. The banks' use of equities to hedge permissible equity derivative transactions provides the most accurate, least costly hedges, and thus is convenient and useful in conducting permissible banking activities, and incidental to the business of banking. National banks are not banned from holding equities in all circumstances and, in fact, hold equities in a variety of contexts in connection with their banking business. The equity hedging activity is not prohibited by Section 16 of the Banking Act of 1933.[5]

A. The National Bank Act ("Act")

A national bank may engage in activities pursuant to 12 U.S.C. § 24(Seventh) if the activities are part of, or incidental to, the business of banking. Section 24(Seventh) expressly provides that national banks shall have the power:

> To exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.[6]

The Supreme Court has rejected a narrow view of the bank powers clause that would interpret the Act as granting to national banks only the five specified powers and such ancillary powers needed to perform those five.

The powers clause is a broad grant of the power to engage in the business of banking, including, but not limited to, the five specifically recited powers and such other powers that are reasonably necessary to perform not just the enumerated powers, but the business of banking as a whole.[7] Many activities that are not included in the enumerated powers, including equity derivative transactions and risk management activities such as hedging risks arising from banking activities, also are part of the business of banking.[8]

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[5] 48 Stat. 162 *et seq.* ("1933 Act").

[6] The cited language will be referred to later in this memorandum as the "powers clause."

[7] *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995)("*VALIC*").

[8] Judicial cases affirming OCC interpretations establish that an activity is within the scope of the "business of banking" if the activity: [1] is functionally equivalent to or a logical outgrowth of a traditional banking activity; [2] would respond to customer needs or otherwise benefit the bank or its customers; and [3] involves risks similar to those already assumed by banks. *See, e.g., Merchant Bank v. State Bank*, 77 U.S. 604 (1871); *M & M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978); *American Insurance Assn. v. Clarke*, 865 F.2d 278, 282 (2d Cir. 1988). In *IAA v. Hawke*, ___ F.3d (D.C. Cir. May 16, 2000), the court expressed the position that the "logical outgrowth" rational needed to be kept within bounds, but endorsed the "functional equivalent" component of the test.

National banks are also authorized to engage in an activity that is incidental to the performance of the five powers enumerated in Section 24(Seventh) *or* incidental to the performance of an activity that is part of the business of banking. Incidental activities are activities that are permissible for national banks, not because they are part of the powers expressly authorized for banks or the "business of banking," but rather because they are "convenient" or "useful" to those activities.[9]

In addition to the above authorizations, national banks are expressly authorized to enter into contracts under 12 U.S.C. § 24(Third).

B. Equity Derivative Transactions are Authorized under Express Authorities in the National Bank Act and as Part of the Business of Banking

Congress has recognized the authority of national banks to engage in equity derivative transactions. Under the Gramm-Leach-Bliley Act[10] banks may offer "identified banking products" without registration under the Securities Exchange Act of 1934,[11] subject only to banking law requirements. "Identified banking products" include certain swap agreements, defined as "any individually negotiated contract, agreement, warrant, note or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets.[12] The GLBA conference report further observes that these products are among the "activities in which banks have traditionally engaged."[13] Congress' recognition that banks engage in equity derivative transactions and exemption of these activities from certain securities regulations, provides confirmation for the OCC's longstanding position that equity derivative transactions are permissible activities for national banks.

The OCC has found equity derivative transactions permissible under the express statutory authority granted to national banks to accept deposits, make loans, and enter into contracts and as part of the business of banking as a financial intermediation activity. As early as 1988, the OCC

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[9] *VALIC*; *Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972) ("*Arnold Tours*"); OCC Interpretive Letter No. 742 (August 19, 1996), *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-106; OCC Interpretive Letter No. 737 (August 19, 1996), *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-101; OCC Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

[10] Pub. L. No. 106-102 (1990)(effective May 12, 2001)(GLBA).

[11] 15 U.S.C. § 78c.

[12] Section 206 of Title II, Subtitle A of GLBA. (emphasis added). The definition of "swap agreement" is also defined broadly in the Federal Deposit Insurance Act and U.S. Bankruptcy Code. 12 U.S.C. § 1821(e)(8)(D)(vi)(I); 11 U.S.C. § 101(53B).

[13] H.R. Rep. No. 106-434 at 163 (1999)(Summary of Title II in Managers' Statement).

determined that national banks could engage in equity derivative transactions.[14] In *MII Deposit*, the OCC concluded that a national bank may offer a non-transferable time deposit contract with interest payable at a rate tied to the S&P 500 Index.[15] In reaching that conclusion, the OCC recognized that the deposit was a permissible banking activity fully within a national bank's expressly authorized power to receive deposits and make loans and as part of the "business of banking" under 12 U.S.C. § 24(Seventh). More recently, the OCC determined that national banks may offer time deposit accounts or certificates of deposit that pay interest at a rate based on the gain in designated equity indices.[16] The OCC concluded that the deposits were authorized under the express authority of national banks to receive deposits and enter into contracts under 12 U.S.C. §§ 24(Seventh) and (Third) and as part of the business of banking as a financial intermediation activity.

In 1994, the OCC addressed the legal permissibility of national banks engaging in swap activities tied to equities and equity indices.[17] The OCC recognized that swap contracts are, in some respects, direct descendants of traditional deposit contracts because payments under the contacts are similar to the receipt of deposits and the payment of interest on deposits.[18] Based, in part, on that lineage, the OCC concluded that national banks may make payments to, or receive payments from, equity and equity index swap customers in the event of a gain or loss in a designated

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[14] *Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A. to Offer the Chase Market Index Investment Deposit Account* (Comptroller concludes that a national bank may buy and sell futures on the S&P 500 Index to hedge deposits with interest rates tied to the S&P 500 Index)(1988)("*MII Deposit*"); *Investment Company Institute v. Ludwig*, 884 F. Supp. 4 (D.D.C. 1995) (upholding Comptroller's decision that the hedged deposit in *MII Deposit* is a bank permissible product that does not violate the Glass-Steagall Act).

[15] *MII Deposit, supra.*

[16] Letter from Ellen Broadman, Director, Securities and Corporate Practices Division, OCC, to Barbara Moheit, Regional Counsel, FDIC (October 29, 1998)(unpublished)("*Broadman Letter*").

[17] OCC Interpretive Letter No. 652 (September 13, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600. The OCC has recognized the ability of banks to engage in swap products for a number of years. In the 1980's the OCC opined on the permissibility of national banks engaging in interest rate, currency, and commodity price index swaps and caps. OCC No-Objection Letter No. 87-5 (July 20, 1987), *reprinted in* [1988 - 1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034; OCC Interpretive Letter No. 462 (December 19, 1988), *reprinted in* Fed. Banking Law Rep. (CCH) ¶ 85,686; OCC Letter from J. Michael Shepherd, Senior Deputy Comptroller, Corporate and Economic Programs (July 7, 1988)(unpublished). Then, in the 1990's, the OCC recognized that national banks may advise, structure, arrange, and execute transactions, as agent or principal, in connection with interest rate, basis rate, currency, currency coupon, and cash-settled commodity swaps; swaptions, captions, and other option-like products; forward rate agreements, rate locks and spread locks, as well as similar products that national banks are permitted to originate and trade in and in which they may make markets. OCC Interpretive Letter No. 725 (May 10, 1996), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,040; OCC Letter from Jimmy F. Barton, Deputy Comptroller Multinational Banking, to Carl Howard, Associate General Counsel, Citibank, N.A. (May 13, 1992)(unpublished); OCC Letter from Horace G. Sneed, Senior Attorney, Legal Advisory Services Division (March 2, 1992)(unpublished); OCC No-Objection Letter No. 90-1 (February 16, 1990), *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095.

[18] OCC Interpretive Letter No. 652, *supra.*

equity or equity index. The OCC further recognized that equity and equity index swap activities are permissible for national banks as a financial intermediation activity.[19] In such arrangements, national banks act as financial intermediaries between customers that want to manage risks resulting from the variations in a particular equity or equity index. Customers do not deal directly with one another, but instead make payments through the intermediary bank.

Banks, through their equity derivative transactions, are better able to meet customer needs by offering financial instruments that serve important risk management and other financial functions. National banks have benefited from equity derivative transactions that enable them to diversify, expand their customer base, and increase revenues.[20] Equity derivative transactions pose risks similar to those inherent in other types of banking activities that national banks are familiar with and manage, *e.g.*, interest rate, liquidity, credit, and compliance risks.

C. Hedging Risks Arising from Bank Permissible Banking Activities is Integral to Those Permissible Activities

It is axiomatic that managing the risks arising from permissible banking activities is integral to the business of banking; this principle is equally valid whether the activity is deposit-taking or derivatives.[21] Entering into deposit, loan, and other contracts with customers, and engaging in other bank permissible activities involve risks that banks must manage as part of the business of banking.[22] A bank must manage the risk in those activities to operate profitably and may engage in hedging activities to do so.[23] Indeed, the OCC recognizes that national banks may sell forwards to hedge against potential fluctuations in the price of silver as an integral part of the explicit statutory authority of national banks to buy and sell coins.[24] National banks may

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[19] OCC Interpretive Letter No. 652, *supra*. OCC Interpretive Letter No. 652 pre-dates *VALIC* and characterized swaps as a financial intermediary activity incidental to a bank's express power to engage in deposit and lending activities under 12 U.S.C. § 24(Seventh). Upon re-examination, the OCC since has concluded that swap and funds intermediation activities are part of the business of banking. *Broadman Letter*.

[20] OCC Bank Derivatives Report, Second Quarter (2000).

[21] *Broadman Letter*; OCC Interpretive Letter No. 684 (August 4, 1995), *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,632; OCC Interpretive Letter No. 632 (June 30, 1993), *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,516.

[22] OCC *"Bank Supervision Process Booklet"* Comptroller's Handbook for National Bank Examiners (April 1996). In fact, a 1992 decision by an Indiana court and a class action filed in 1991 in the U.S. District Court of the Southern District of Texas suggest that a duty exists for corporations to hedge their exposures to changing commodity prices and currency values. *Brane v. Roth*, 590 N.E. 2d 587 (Ind. Cir. App. 1992); *In re Compaq Securities Litigation*, 848 F. Supp. 1307 (S.D. Tex. 1993). If corporations have a duty to manage those exposures, it reasonably follows that corporations must also hedge the exposures arising from equity derivative transactions.

[23] OCC Interpretive Letter No. 725, *supra*; OCC Interpretive Letter No. 652, *supra*; OCC Interpretive Letter No. 632, *supra*; OCC No-Objection Letter No. 90-1, *supra*; *MII Deposit, supra*; OCC No-Objection Letter No. 87-5 (July 20, 1987), *reprinted in* [1988 - 1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034.

[24] OCC Letter from Kenneth W. Leaf, Chief National Bank Examiner (June 12, 1974).

purchase spot and futures contracts on exchange, coin and bullion to hedge against future price fluctuations intrinsic to those commodities.[25] National banks may also use futures to hedge against the risk of loss due to the interest rate fluctuations inherent in bank loan operations, U.S. Treasury Bills, and certificates of deposit.[26]

Hedging risks arising from permissible equity derivative activities also is an integral part of permissible banking activities. In reviewing the legal permissibility of *MII Deposit*, the OCC authorized a national bank to purchase equity index futures to hedge interest rate risk exposure on deposit accounts having interest payable at a rate tied to the S&P 500 Index. The OCC concluded that the activity was permissible, in part, because the hedge was a necessary component of the bank's deposit-taking activities. The OCC has similarly concluded that hedging interest rate risk on deposits that pay interest at a rate based on the gain in designated equity indices with options is an integral part of traditional bank deposit functions and the authority of banks to enter into contracts.[27] Finally, national banks may hedge swaps, including equity and equity index swaps, to manage the risks in, and as an integral part of, those bank permissible transactions.[28]

Through hedging activities, national banks serve as financial intermediaries, a traditional and permissible banking function.[29] Longstanding OCC precedent recognizes the authority of national banks to act as financial intermediaries, for example, by engaging in swap transactions

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[25] OCC Letter to Republic National Bank from J. T. Watson, Deputy Comptroller of the Currency (March 12, 1975).

[26] OCC Letter to Gregory Crane (October 26, 1976)(national banks may use GNMA futures to hedge the interest rate fluctuation risks inherent in FHA/VA loans as an activity incidental to banking and permissible under 12 U.S.C. § 24(Seventh)); OCC Letter to Alan E. Rothenberg, Vice President, Bank of America, from Robert Bloom, First Deputy Comptroller (Policy)(October 11, 1976)(national banks may hedge the risk of interest rate fluctuations in conventional real estate loans with GNMA futures to reduce interest rate fluctuations as a legally permissible activity under the National Bank Act.). In 1976, the OCC also permitted a national bank to purchase T-bill futures for hedging purposes as part of the authority of national banks to deal in, underwrite, and purchase obligations issued by the U.S. OCC Letter to Michael Sweeney, Vice President, Merchants National Bank and Trust Company of Indianapolis (December 29, 1976); OCC Letter to Senator Huddleston, from Donald A. Melbye, Special Assistant for Congressional Affairs (February 10, 1977) and OCC Banking Circular 79 (November 2, 1976) (BC-79). BC-79 was revised three times, with the latest revision dated April 19, 1983. On October 27, 1993, the OCC issued Banking Circular-277 which provided comprehensive guidance on all forms of financial derivatives and simultaneously rescinded BC-79; OCC Letter to Charles N. Parrott, Associate Counsel, Deposit Guaranty National Bank, from Peter Liebesmann, LASD (February 15, 1983) (citing BC-79 (March 19, 1980)(2d Rev)). This determination specifically addressed the ability of national banks to buy "puts" on the GNMA certificates that would enable the bank to sell the certificates at set prices with a given period of time. If the value of the certificates increased, the puts would not be exercised. If the value declined, the bank would exercise the put and deliver the certificates at the agreed upon price.

[27] *Broadman Letter, supra.*

[28] *See* n.17, *supra.*

[29] *Broadman Letter, supra.*

and assuming offsetting swap positions or hedges.[30] In so doing, the bank protects itself against risks arising from an established, permissible banking activity. As a result of hedging, a bank becomes a financial intermediary in a swap transaction, by interposing itself between customers initiating swap transactions and customers providing offsetting returns. Thus, hedging is an integral part of financial intermediation services permissible for national banks.

D. Banks may Purchase Equity Securities to Hedge Equity Derivative Transactions as an Activity that is Incidental to the Business of Banking

Section 24(Seventh) gives national banks incidental powers to engage in activities that are necessary to carry on enumerated bank powers as well as the broader "business of banking."[31] Prior to *VALIC*, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in *Arnold Tours*.[32] The *Arnold Tours* standard defined an incidental power as one that is "convenient or useful" in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act."[33] Even prior to *VALIC*, the *Arnold Tours* formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act.[34] The *VALIC* decision, however, has established that the *Arnold Tours* formula should be read to provide that an incidental power includes one that is "convenient" or "useful" to the "business of banking," as well as a power incidental to the express powers specifically enumerated in 12 U.S.C. § 24(Seventh). Thus, national banks may take possession of equities for hedging purposes as an activity that is convenient and useful to permissible equity derivative transactions.

The equity hedges enable the banks to protect against loss in banking transactions in the most efficient manner and therefore are convenient and useful to the banks' equity derivative business. Here, the banks represented that physically hedging equity derivative transactions within the banks, rather than through affiliates, will enable them to retain additional revenues from equity derivative activities and enjoy substantial cost savings. Furthermore, when the mirror transactions are eliminated, the revenues and profits generated by the equity derivative transactions and the physical hedges will accrue to the benefit of the banks. Permitting the banks to use equities to hedge risks arising from permissible equity derivative transactions thus will enable the banks to operate more efficiently, compete more effectively with entities that engage in similar optimal hedges, offer customers the least costly and most attractive products and services, and operate profitably.

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[30] *See* n.17, *supra*.

[31] *VALIC*, *supra*, at 258 n.2.

[32] *Arnold Tours*, *supra*.

[33] *Id.* at 432.

[34] *See* n.9, *supra*.

In addition, equity hedging is incidental to banking as a convenient and useful means of reducing the operational risks in its equity derivative business that exist as a result of the mirror transactions between the banks and their nonbank affiliates. In particular, by eliminating the mirror transactions and physically hedging the equity derivative transactions in the banks, the banks expect to see a potential reduction in trading, risk management, compliance, and operation risks that exist from the back-to-back booking of the mirror transactions.

The equity hedges are similar to commodity hedges that are convenient and useful to bank permissible commodity-linked derivative transactions. The OCC has determined that in some instances national banks may take physical delivery of commodities to hedge bank permissible commodity-linked derivative transactions as a convenient and useful means to manage the risks arising from those permissible banking transactions.[35] The OCC permitted the activity, in part, because the commodities provided accurate and precise hedges. The banks' physical possession of equities is similarly a means to manage the risks in bank permissible derivative transactions in a manner that provides precise and cost-effective hedges. Accordingly, the equity hedges benefit the banks by enabling them to more effectively manage risks arising from permissible equity derivative transactions, and thus are convenient and useful to those bank permissible activities.

E. Use of Physical Equity Securities to Hedge Banking Risks is not Prohibited by Section 16 of the 1933 Act

(1) Using Equity Securities to Hedge Equity Derivative Transactions is not Prohibited Underwriting or Dealing under Section 24(Seventh)

Section 24(Seventh) addresses the ability of a national bank to underwrite and deal in securities. Specifically, Section 24(Seventh) provides that "[t]he business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe."[18]

Here, the banks are not "dealing" in or "underwriting" securities as prohibited by Section 24(Seventh). Although "dealing" and "underwriting" are not defined in Section 24(Seventh)[36]

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[35] OCC Interpretive Letter Nos. 632 and 684, *supra*. The OCC also has permitted national banks to physically hedge against the risk of loss from potential payouts on bank permissible employee compensation and benefit plans with incidental life insurance, in order to recover the cost of providing those benefits. OCC Interpretive Letter No. 848 (November 23, 1998), *reprinted in* [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-202; OCC Bulletin 96-51 (September 20, 1996), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 35-491. Most recently, the OCC concluded that it was convenient and useful for a national bank to physically hedge an employee compensation program with bank impermissible insurance company products and investments because the hedge virtually eliminated all the risk arising under the program to the bank. OCC Interpretive Letter No. 878 (December 22, 1999), *reprinted in* [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-373.

[36] Although the securities laws definitions are not dispositive in determining whether a particular type of securities activity is permitted for banks, these definitions provide a useful starting point for characterizing a bank's securities activities. Under section 3 of the Securities Exchange Act of 1934, a "dealer" is defined as "any person engaged in

"dealing" in securities is generally understood to encompass the purchase of securities as principal for resale to others.[37] Dealing is buying and selling as part of a regular business. A dealer typically maintains an inventory of securities and holds itself out to the public as willing to purchase and sell and continuously quote prices.[38] "Underwriting" is generally understood as encompassing the purchase of securities from an issuer for distribution and sale to investors.[39] Case law confirms that one cannot be an underwriter in the absence of a public offering.[40]

Under the above definitions, the banks' purchase of equity securities for hedging customer-driven equity derivative transactions is not "dealing" or "underwriting." The banks committed to holding physical equity securities solely for purposes of hedging. The banks do not hold the securities in order to engage in a regular business of buying and selling them in the secondary market[41] and do not publicly offer the securities to investors.

(2) The Purchase of Equity Securities for Hedging Purposes is not Subject to the Limitations on the Purchase of Investment Securities

The purchase of equities is not an investment in investment securities and therefore is not subject to the limitations placed upon the purchase of those securities in 12 U.S.C. § 24(Seventh) or in 12 C.F.R. Part 1. The statutory definition of investment securities includes "marketable obligations evidencing the indebtedness of any person, copartnership, association or corporation in the form of bonds, notes, and/or debentures, commonly known as 'investment securities'" and gives the Comptroller the authority to define further that term. Accordingly, the OCC issued implementing regulations defining "investment securities" at 12 C.F.R. Part 1. Under Part 1, an investment security is defined as "a 'marketable' debt obligation that is not predominantly speculative in nature."[42] Equity securities do not fall within the Section 16 or Part 1 definitions

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the business of buying and selling securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not part of a regular business." 15 U.S.C. § 78c(a)(5). Under the Securities Act of 1933, an "underwriter" includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." 15 U.S.C. § 77(b)(a)(11).

[37] OCC Interpretive Letter No. 393 (July 5, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,617 (national bank with limited market presence not considered a dealer). *See also* Louis Loss, *Securities Regulation* 2983-84 (3d ed. 1990).

[38] *Citicorp, J.P. Morgan & Co. Inc., Banker Trust New York Corporation*, 73 Fed. Res. Bull. 473 n.4 (1987); OCC Interpretive Letter No. 684, *supra*.

[39] OCC Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1998-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; OCC Interpretive Letter No. 329 (March 4, 1985), *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499.

[40] *SIA v. Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

[41] While the banks may purchase and sell equity securities on a regular basis consistent with its hedging activities, the banks will not act as market-maker in the securities by quoting prices continuously on both sides of the market.

[42] 12 C.F.R. § 1.2(e).

of "investment securities." The basic characteristic of equity securities is a fractional ownership interest in the corporation involved.[43] Equity securities do not represent debt obligations. Accordingly, the provisions contained in Section 24(Seventh) applicable to investment securities do not apply to equity investments held by banks for the purpose of engaging in banking business.

(3) Using Equity Securities to Hedge is not Prohibited by the Fifth Sentence of Section 24(Seventh)

Section 24(Seventh) does not provide a general authorization to national banks to hold equity securities. Instead, national banks may hold equity securities only to the extent such holdings are permissible because, in the situation presented, the holding is authorized as part of, or incidental to, the business of banking (or other specific statutory authority). The language in the fifth sentence of Section 24(Seventh) "nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation" is not a blanket bar on national bank acquisitions of stock. Rather, as discussed below, that language makes clear that the authorization contained in the statute permitting banks to invest in investment securities does not include stock. This proviso does not affect national banks' authority to hold equities, if the holding can qualify as permissible because it is part of or incidental to permissible banking activities.

(a) The Fifth Sentence Clarifies that the Authority to Invest in Investment Securities does not apply to Stock

The language contained in the fifth sentence referenced above is not a complete bar on bank purchases of stock. Rather, as a review of the legislative history of the language reveals, that language references and clarifies provisions in Section 24(Seventh) authorizing the purchase of *investment securities*. Congress' intent was to make clear that the authorization in Section 24(Seventh) for national banks to invest in *investment securities* was not the source of authority for national banks to purchase *stock*. Congress made its intent clear in several respects. First, the authorization to purchase investment securities was the only new *authorization* added to Section 24(Seventh) in 1933. Thus, the caveat in the fifth sentence that the new language does not *authorize* banks to purchase stock logically refers to the *authorization* to purchase investment securities. Second, the two provisions use the same language to describe the *activities* they address. One provision describes *activities* permitted for investment securities and the other clarifies that those same *activities* are not permitted for stock. The similarity in language used in the two provisions today, and in previous statutes, as discussed below, supports reading the fifth sentence to clarify that the authorization to invest in *investment securities* does not include stock.

It is important to appreciate that the 1933 Act was derived from a series of bills introduced in 1932. S. 3215, introduced on January 1, 1932, permitted banks to **"purchase and hold"**

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[43] Fabozzi and Zarb, Handbook of Financial Markets: Securities, Options and Futures, Second Edition (1986), at 251.

investment securities but precluded the **"purchase or holding"** of stock. The bill, however, did not define an "investment security," and by necessity contained a clarification that the authorization to invest in "investment securities" did not include "stock."[44]

As the legislation evolved and the language authorizing investment in investment securities changed, the language in the fifth sentence was revised to mirror the language authorizing investment in investment securities. S. 4412, introduced on January 30, 1932, authorized an association to "**purchase** for its own account investment securities" and clarified that "nothing herein contained shall authorize the **purchase**" of stock. The 1933 Act similarly provided that the association may "**purchase** for its own account investment securities", and clarified that "nothing herein contained shall authorize the **purchase** of stock."[45] The only difference between these two provisions was the use of "for its own account" in the authorizing language, but not in the proviso. That difference was eliminated in the 1935 Amendments which added the "for its own account" to the clarifying provision so that it now reads "nothing herein contained shall authorize the purchase by the association for its own account" of stock. Thus, the 1935 Amendments made the language in the fifth sentence identical to the language authorizing investment securities, providing further confirmation that the fifth sentence clarifies that the authorization to invest in investment securities does not include stock.

What authority that exists for national banks to own stock must be found under other provisions of Section 24(Seventh), as part of, or incidental to, the business of banking.[46] This reading is consistent with other portions of Section 16 of the 1933 Act, enacted simultaneously with this section, which clearly envision that national banks could own stock in connection with banking activities

The 1933 Act recognized in several contexts the preexisting authority of national banks to own stock as authorized under the powers clause. The 1933 Act acknowledged the continuing authority of national banks to hold stock as part of the business of banking by placing restrictions on the amounts of such investments. For example, the provisions limiting the amounts that banks may invest in a safe-deposit business acknowledge a pre-existing separate, but not expressly stated, authority of national banks to invest in such businesses, which arises from the powers clause.[47] Similarly, the provisions limiting amounts a national bank may invest in a

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[44] Further clarification was provided subsequently in S. 4115 which defined "investment securities" to include only debt obligations.

[45] S. 4412, as reported on April, 18, 1932, added "or holding" after the term "purchase" in the clarifying provision, but this language was deleted in the 1933 Act passed by Congress so that the authorizing and qualifying language were the same.

[46] As discussed above, national banks have no general authorization to acquire stock. Other statutory sections may also expressly authorize the acquisition of stock in specific circumstances, *e.g.*, 12 U.S.C. § 24(Eleventh) (stock of community development corporations), 12 U.S.C. § 371d (stock of bank premises corporations), 12 U.S.C. § 1861 *et seq.* (stock of bank service corporations), and 15 U.S.C. § 682(b) (stock of small business investment corporations).

[47] 1933 Act §16, 48 Stat. at 185.

company that holds the bank's premises acknowledges the preexisting authority under the powers clause for national banks to invest in those companies.[48]

The 1933 Act also included a definition of an "affiliate" that recognized a national bank's authority to own stock. Specifically, the 1933 Act definition of an affiliate included any corporation in which a national bank owns or controls a majority of the voting shares. The ability to own or control a majority of the voting shares of a corporation necessarily depends upon there being the preexisting authority of a national bank to hold stock under the powers clause.[49]

(b) National Banks may Hold Equities Based on Existing Precedent

Most notably, nearly 35 years of precedent recognize the authority of national banks to hold stock of operating subsidiaries as part of, or incidental to, the business of banking. As early as the 1960s, the OCC developed a comprehensive scheme for the regulation and supervision of national banks engaging in the business of banking through bank operating subsidiaries based on authorities arising from the powers clause. In 1966, the OCC issued a new regulation and a ruling confirming again the authority of national banks to own stock under the powers clause. Then, in 1971, the regulation was substantially revised to reflect the more comprehensive ruling. Subsequently, in 1983, the regulation was incorporated into 12 C.F.R. 5.34 without substantive change. Today national banks may own equities of operating subsidiaries based on the authorities provided under the powers clause and in accordance with 12 C.F.R § 5.34.[50]

Very recently, Congress affirmed in GLBA that national banks may own stock under Section 24(Seventh) by recognizing that national banks have subsidiaries engaged in activities permissible for the national bank.[51] Notably, rather than reauthorize national banks to own operating subsidiaries in GLBA, Congress instead recognized that preexisting authority.

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[48] 1933 Act §14, 48 Stat. at 184.

[49] As an alternative, the definition may have simply referred to affiliate stock that banks could already hold pursuant to Sections 25 and 25A of the Federal Reserve Act pertaining to Edge Act and Agreement corporations and foreign banks under 12 U.S.C. §§ 601, 611 *et seq*. However, nothing in the language of this definition suggests such a narrow reading.

[50] Since the recent revisions to 12 C.F.R. § 5.34 became effective on March 11, 2000, national banks that qualify as well capitalized and well managed have been permitted to engage through operating subsidiaries in an expanded list of activities by giving the OCC notice after the fact. While all of the activities contained in the new 12 C.F.R. § 5.34 list are ones the OCC has found to be part of, or incidental to, the business of banking, the preamble to the rule makes clear that the list is not all-inclusive, and that the OCC will periodically review and update the list as necessary. *See* Financial and Operating Subsidiaries, 65 Fed. Reg. 12905, 12908 (2000).

[51] Sections 121 and 122 of Title I, Subtitle C of GLBA.

Courts also recognize the power of national banks to own corporate stock in connection with satisfaction of debts previously contracted ("DPC").[52] The OCC similarly recognizes the DPC authority of national banks in its regulations and in its Interpretive and No-Objection Letters.[53] This ability to hold stock arises from the powers of national banks under 12 U.S.C. § 24(Seventh). In *First National Bank of Charlotte*, the Supreme Court made clear that as part of national bank's powers, the bank may hold stock in satisfaction of debt. In that case the Court stated:

> [The] right of a bank to incur liabilities in the regular course of business, as well as to become a creditor to others [must necessarily be implied]. Its own obligations must be met and debts due to it collected or secured. The power to adopt reasonable and appropriate measures for these purposes is an incident to the power to incur the liability or become the creditor. . . . . Banks may do, in this behalf, whatever natural persons could do under like circumstances. . . . In the honest exercise of the power to compromise a doubtful debt owing to a bank, it can hardly be doubted that stocks may be accepted in payment and satisfaction, with a view to subsequent sale or conversion into money so as to make good or reduce anticipated loss. Such a transaction would not amount to a dealing in stocks. . . . Of course, all such transactions must be compromises in good faith, and not mere cloaks or devices to cover unauthorized practices.[54]

Based on the above, it is apparent that Congress, the courts, and the OCC recognize that in some instances, national banks may take physical possession of equities. Banks should similarly be permitted to take physical possession of equities for purposes of hedging the risks associated with permissible banking activities. The activity is permissible under 12 U.S.C. § 24(Seventh) and is not prohibited by Section 16 of the 1933 Act.

III. Conclusion

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[52] *First Nat'l Bank of Charlotte v. Nat'l Exchange Bank of Baltimore*, 92 U.S. 122 (1875) ("*First Nat'l Bank of Charlotte*"); *Atherton v. Anderson*, 86 F.2d 518 (6th Cir. 1936) *rev'd on other grounds*, 302 U.S. 643 (1937); *See also, Bouchelle v. First Nat'l Bank of Birmingham*, 173 So. 83 (Ala. 1937).

[53] 12 C.F.R. §1.7; OCC Interpretive Letter No. 511 (June 20, 1990), *reprinted in* [1990-1991 Transfer Binder] *Fed. Banking L. Rep.* (CCH) ¶ 83,213; OCC Interpretive Letter No. 502 (April 6, 1990), *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,097; OCC No-Objection Letter No. 89-01 (January 25, 1989), *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,009; OCC No-Objection Letter No. 88-7 (May 20, 1988), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,047; OCC No-Objection Letter 87-10 (November 27, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,039; OCC Interpretive Letter No. 395 (August 24, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,619.

[54] *First Nat'l Bank of Charlotte, supra*, at 127.

National banks may hold equity securities to hedge risks arising from permissible banking activities. OCC precedents have long recognized the authority of national banks to engage in derivative transactions, including those that are equity-linked, under express authorities and the broader business of banking powers in Section 24(Seventh). Similarly, OCC precedents recognize that national banks may hedge risks arising from permissible banking activities as an integral part of those activities using a broad range of risk management tools.

The banks' equity hedges are convenient and useful to customer-driven, bank permissible equity derivative transactions. In order to conduct authorized equity derivative transactions, the banks must hedge the transactions to reduce risks, avoid losses, and operate profitably. The equity hedges provide the banks with the most cost-effective, precise means to hedge risks arising from customer-driven equity driven transactions. By physically hedging its equity derivative transactions in-house, the banks enjoy substantial financial and operational advantages. Accordingly, we concluded, in the particular circumstances presented, that the banks' physical possession of equities solely for hedging purposes would be a permissible activity for those banks. Our conclusions were dependent on the facts and circumstances and on our supervisory knowledge of and experience with the banks involved, and did not represent a conclusion that the activity was generally permissible. Thus, the conclusion was communicated as a supervisory matter rather than as a generally applicable legal interpretation.

I trust the foregoing is responsive to the issues raised in your letter, and I reiterate my offer to provide a full briefing on this issue.

Sincerely,

John D. Hawke, Jr.
Comptroller of the Currency