Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

October 25, 2007

Interpretive Letter #1090
November 2007

Subject: Permissible Financial Intermediation Transactions Involving Equity Securities

Dear **[ ]**:

This responds to your request on behalf of **[ ]**, ("Bank") that the Office of the Comptroller of the Currency ("OCC") confirm that the Bank may purchase and hold certain assets to hedge bank permissible equity derivative transactions. Specifically, the Bank seeks to verify that it may engage in customer-driven,[1] bank permissible equity derivative transactions and then purchase and hold the following securities to hedge the transactions: common stock,[2] preferred stock,[3] convertible securities,[4] exchangeable

[1] A "customer driven" transaction is one entered into for a customer's valid and independent business purpose. *See* OCC Interpretive Letter No. 892 (September 13, 2000) ("IL No. 892").

[2] "Common stocks" are securities that represent equity ownership in a corporation, provide voting rights, and entitle the holder to a share of the company's success through dividends and/or capital appreciation. In the event of liquidation, common stockholders have rights to a company's assets only after bondholders, other debt holders, and preferred stockholders have been satisfied. *See, e.g.,* http://www.investorwords.com/986/common_stock.html.

[3] "Preferred stock" is capital stock that provides a specific dividend that is paid before any dividends are paid to common stockholders. Like common stock, preferred stocks represent ownership in a company, although preferred stock shareholders do not enjoy any of the voting rights of common stockholders. Unlike common stock, a preferred stock pays a fixed dividend that does not fluctuate, although the company does not have to pay this dividend if it lacks the financial ability to do so. The main benefit to owning preferred stock is that the investor has a greater claim on the company's assets than common stockholders. Preferred shareholders always receive their dividends first and, in the event the company goes bankrupt, preferred shareholders are paid off before common stockholders. *See, e.g.,* http://www.investorwords.com/3778/preferred_stock.html.

[4] A "convertible security" is a security, usually a bond or a preferred stock, which can be converted into a different security - typically shares of the company's common stock. In most cases, the holder of the convertible security determines whether and when a conversion occurs. In other cases, the company may retain the right to determine when the conversion occurs. *See, e.g.,* http://www.sec.gov/answers/convertibles.htm.

securities,[5] master limited partnership interests ("MLPs"),[6] limited partnership interests,[7] limited liability corporation ("LLC") interests,[8] depositary receipts (including American ("ADRs")[9] and Global ("GDRs")[10]), closed-[11] and open-end[12] mutual funds, exchange

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[5] An "exchangeable security" is a security that grants the holder the right to exchange the security for the common stock of a company other than the issuer. *See, e.g.,* http://www.investorwords.com/1798/exchangeable_security.html.

[6] An "MLP" is a limited partnership that is publicly traded on a securities exchange. It combines the tax benefits of a limited partnership with the liquidity of publicly traded securities. The U.S. Tax Code limits MLP status to enterprises that engage in certain businesses, mostly those pertaining to the use of natural resources, such as petroleum and natural gas extraction and transportation. *See, e.g.,* http://www.investorwords.com/3004/master_limited_partnership.html; http://en.wikipedia.org/wiki/Master_limited_partnership.

[7] A "limited partnership interest" is an interest in a business organization that has one or more general partners, who manage the business and assume legal debts and obligations, and one or more limited partners, who are liable only to the extent of their investments. Limited partners also enjoy rights to the partnership's cash flow, but are not liable for company obligations. The holders of limited partnership interests are liable only to the extent of their investments in a limited partnership. *See, e.g.,* http://www.investorwords.com/2818/limited_partnership.html.

[8] An "LLC interest" is an interest in a type of company whose owners and managers receive the limited liability and (usually) tax benefits of an S Corporation without having to conform to the restrictions of an S Corporation. http://www.investorwords.com/2817/Limited_Liability_Company.html. An S Corporation (also called a Subchapter S Corporation) is a corporation allowed by the IRS for most companies with 75 or fewer shareholders, which enables the company to enjoy the benefits of incorporation and taxation as if it were a partnership. *See, e.g.,* http://www.investorwords.com/4411/S_Corporation.html.

[9] An "ADR" is a negotiable certificate issued by a U.S. depositary bank that represents ownership in foreign corporate stock. The stocks of most foreign companies that trade in the U.S. markets are traded as ADRs. ADRs are denominated in U.S. dollars. The security underlying an ADR is held by a U.S. financial institution overseas. An ADR is a right to obtain the foreign stock it represents, but U.S. investors typically hold the ADR. *See, e.g.,* http://www.sec.gov/answers/adrs.htm; http://www.investopedia.com/terms/a/adr.asp.

[10] A "GDR" is a negotiable certificate held in the bank of one country representing a specific number of shares of a stock traded on an exchange of another country. GDRs are offered to investors in two or more markets outside the issuer's home country. GDRs are usually traded on major international exchanges outside the United States, mainly the London Stock Exchange, and in the U.S. over-the-counter market. *See, e.g.,* http://rru.worldbank.org/Documents/PublicPolicy Journal/140musta.pdf; http://www.investorwords.com/2155/GDR.html.

[11] A "closed-end mutual fund" is a form of investment company that does not generally continuously offer its shares for sale. Rather, these funds sell a fixed number of shares at one time (in the initial public offering), after which the shares typically trade on a secondary market, such as the New York Stock Exchange ("NYSE") or the Nasdaq Stock Market ("Nasdaq"). Closed-end funds are managed by separate entities called investment advisers that are registered with the SEC, offer shares that are not redeemable, and invest in a greater amount of illiquid securities than open-end funds. *See, e.g.,* http://www.sec.gov/answers/mfclose.htm.

[12] An "open-end mutual fund" is an investment company that sells redeemable shares on a continuous basis, managed by SEC-registered investment advisers. Investors purchase mutual fund shares from the

traded funds ("ETFs"),[13] and real estate investment trusts ("REITs").[14] [15]

Representative examples of the proposed transactions follow:

Example 1: A customer holds a stock portfolio comprised of a large number of stocks that make up the S&P 500 Index. To mitigate the risk that the value of the customer's stock portfolio may decrease in value, the customer enters into a swap transaction with the Bank that ties payment obligations to the increase or decrease in the value of the shares of an ETF that replicates the return of the S&P 500 Index. Under the swap, the customer agrees to make a payment to the Bank in the event the value of the ETF shares increases. In turn, the Bank agrees to make a payment to the customer in the event that the ETF shares decline in value (plus a floating rate of interest). The Bank short sells the ETF shares underlying the swap as an efficient means of hedging its payment obligations under the swap.

Example 2: A U.S. customer wants to obtain exposure to the stock of a foreign company. The customer enters into a call option with the Bank on the foreign company's ADRs. The customer prefers to obtain exposure to the stock though a derivative on the company's ADR rather than purchase the company's stock because ADRs are more liquid instruments in the U.S. The customer purchases a call option on the company's ADRs because the customer wants the potential upside benefit if the ADRs increase in value, without risking more than the cost of the option (*i.e.*, option premium). The Bank would hedge the derivative by purchasing or selling ADRs.

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fund itself (or through a broker for the fund), but are not able to purchase the shares from other investors on a secondary market, such as the NYSE or Nasdaq. *See, e.g.*, http://www.sec.gov/answers/mutfund.htm.

[13] "ETFs" are a type of investment company that holds investment portfolios that are designed to replicate a designated market index and achieve a similar or better investment return than that index. ETFs are traded on a stock exchange and can be bought and sold throughout the day through a broker-dealer. The price of an ETF depends on the forces of supply and demand in the market and on the performance of the underlying index. The performance of the underlying fund is determined by the performance of each component stock. *See, e.g.*, http://www.investopedia.com/articles/01/082901.asp.

[14] "REITs" are entities that invest in different kinds of real estate or real estate related assets, including shopping centers, office buildings, hotels, and mortgages secured by real estate. There are basically three types of REITs: (1) equity REITs that invest in or own real estate and make money for investors from the rents they collect; (2) mortgage REITs that lend money to owners and developers or invest in financial instruments secured by mortgages on real estate; and (3) hybrid REITs that are a combination of equity and mortgage REITs. *See, e.g.*, http://www.sec.gov/answers/reits.htm. The Bank's request is limited to mortgage REITs, except in limited circumstances when the Bank will use equity and hybrid REITs to hedge individual components of broad-based indices referenced in customer-driven equity derivative transactions where components of such indices include equity and hybrid REITs. The Bank's request also does not include any type of interest in a hedge fund or investments in real estate.

[15] The securities would be acquired and held for customer-driven derivative transactions, as described herein, and not for any other purpose. In particular, the Bank has represented that it will not seek to exercise or influence control of the issuer of the securities.

Example 3: An investor has a large portion of its net worth invested in an oil MLP. The investor does not want to reduce the size of the investment, but wishes to limit any potential downside exposure in the event of a decline in the price of the oil MLP. The oil MLP owner enters into a collar with the Bank, purchasing a put option and selling the Bank a call option with a higher exercise price. In essence, the oil MLP owner has placed a limit on the potential increase in value of the oil MLP in order to limit the downside risk. By establishing a collar, a minimum and maximum market value is created around the investor's equity position until the expiration of the options. The Bank would hedge the collar by purchasing or short selling MLPs.

For the reasons discussed below, based on the facts and representations provided by the Bank, we conclude that the proposed transactions are permissible for the Bank under prior legal authorizations. Before the Bank may engage in physical hedges involving these equity securities for which it has not received a supervisory no-objection, the Bank must notify its examiner-in-charge ("EIC"), in writing, and must receive written notification of the EIC's supervisory no-objection. The no-objection is based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems and controls to enable the Bank to engage in the proposed activities involving these equity securities on a safe and sound basis, and the EIC's evaluation of any other supervisory considerations relevant to the particular proposal.

Discussion

National banks may engage in customer-driven equity derivative transactions, including options, forwards and swaps, as part of bank permissible financial intermediation activity.[16] National banks may also hedge the risks in their equity derivative transactions with offsetting cash-settled equity derivative transactions under this authority.[17] Furthermore, because equity holdings provide cost-effective hedges for risks arising from permissible equity derivatives transactions, the OCC has found that where banks establish appropriate risk management processes, they may hold equities to manage those risks.[18]

Through derivative and hedging activities, national banks serve as financial intermediaries, which is a traditional and permissible banking function. Financial intermediation includes, for example, engaging in swap transactions and assuming offsetting swap positions and hedges. In assuming offsetting swaps or hedging, a bank protects itself against risks arising from an established, permissible banking activity and acts as a financial intermediary by interposing itself between customers initiating swaps and customers providing offsetting cash flows or returns. Hedging is an integral part of financial intermediation services permissible for national banks.[19]

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[16] OCC Interpretive Letter No. 935 (May 14, 2002) ("IL No. 935"), IL No. 892, *supra*, and OCC Interpretive Letter No. 652 (September 13, 1994) ("IL No. 652").

[17] *Id.*

[18] OCC IL Nos. 935 and 892, *supra*.

[19] *See, e.g.*, IL No. 892, *supra*.

Banks, through their equity derivative transactions and hedging activities, are better able to meet customer needs by offering financial instruments that serve important risk management and other financial needs. National banks have benefited from equity derivative transactions and hedges that enable them to diversify, expand their customer base, and operate more cost effectively.[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.[21]

As early as 1988, the OCC determined that national banks could engage in equity derivative transactions as a permissible financial intermediation activity.[22] In *MII Deposit*, the OCC concluded that a national bank may offer time deposits with interest payable at a rate tied to the S&P 500 Index and hedge the deposits with futures contracts on that index. In reaching that conclusion, the OCC recognized that the activities were permissible banking activities fully within a national bank's expressly authorized powers to receive deposits and make loans -- permissible traditional bank financial intermediation functions. Based on this line of reasoning, the OCC later determined that national banks may offer time deposits that pay interest at a rate based on the performance of depositary receipts and UITs and hedge the deposits with options on those equity securities.[23] The OCC has also relied on this authority to conclude that cash-settled options and forwards on any equity security or group of equity securities may be permissible hedges for equity derivative transactions, if a bank has an appropriate risk measurement and management process in place for its derivative and hedging activities.[24]

In 1994, the OCC permitted national banks to engage in perfectly-matched, unmatched, and portfolio hedged, cash-settled equity derivative swaps and offsetting equity derivative hedges as bank permissible financial intermediation activity.[25] In 2000, relying on the financial intermediation authority of banks, the OCC determined that national banks may take positions in an equity security solely to hedge customer-driven

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[20] OCC Interpretive Letter No. 1033 (June 14, 2005) and IL No. 892, *supra.*

[21] *Id.*

[22] *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*") and *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).

[23] Letter from Ellen Broadman, Director, Securities and Corporate Practices Division, OCC, to Barbara Monheit, Regional Counsel, FDIC (October 29, 1998).

[24] OCC Interpretive Letter No. 949 (May 14, 2002).

[25] IL No. 652, *supra*

equity derivative transactions.[26] In 2002, the OCC confirmed that national banks may hedge risks arising from bank permissible equity derivative transactions with either long or short positions in an equity security or basket of equity securities.[27] The OCC also concluded in IL No. 935 that national banks may use equity securities for cross-hedging, provided that bank management can justify that the instruments used provide a reasonable substitute for the exposure arising from the hedged derivative.

Safety and Soundness Requirements

The permissibility of the activities addressed in IL Nos. 892 and 935 was conditioned on the bank establishing to the satisfaction of its EIC that the bank had adequate systems and controls to conduct the activities on a safe and sound basis. To that end, these precedents provide that before a national bank establishes an equity hedging program, where it takes positions in equity securities or baskets of equity securities for hedging purposes, the bank must submit written documentation to its EIC evidencing compliance with the following standards and must obtain the EIC's written supervisory no-objection. The documentation should establish to the satisfaction of the EIC that:

1. The bank will hold the securities solely to hedge risks arising from bank permissible derivative transactions originated by customers for the customers' valid and independent business purposes;

2. The bank will not hold the securities for speculative purposes;

3. The securities will offer a cost-effective means to hedge risks arising from permissible banking activities;

4. The bank will not take anticipatory, or maintain residual positions in the non-qualifying securities except as necessary for the orderly establishment or unwinding of a hedging position.

5. The bank will not acquire equity securities for hedging purposes that constitute more than 5% of a class of securities of any issuer; and

6. The bank has an appropriate risk measurement and management process in place, satisfactory to the EIC, for its hedging activities.

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[26] IL No. 892, *supra*. The Government Accountability Office ("GAO") has reviewed and affirmed the OCC's determination in IL No. 892, *supra. GAO Report on Equity Hedging No. 01-945* (August 16, 2001). In its report, the GAO stated that it agreed with the OCC's conclusion that national banks, subject to supervisory no-objection, have authority under the National Bank Act to own corporate stock to hedge their customer-driven equity derivative transactions. The GAO found that the OCC had reasonably determined that dealing in equity derivatives and managing the risks of that activity are part of the business of banking.

[27] IL No. 935, *supra.*

As detailed further in the *OCC Handbook: Risk Management of Financial Derivatives*[28] and Banking Circular 277,[29] an effective risk measurement and management process includes board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function that oversees and ensures the appropriateness of the risk management process. A bank's risk control processes should include the bank's compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income and generally accepted accounting principles.

In implementing these policies, procedures, and controls, a bank shall commit to conducting a full evaluation of: (i) pricing, hedging, processing, recordkeeping, documentation, accounting, "back office" and risk management; (ii) the development of adequate knowledge, staff, oversight management and technology (including contingency planning) to accommodate the activity; (iii) the implementation of appropriate controls; (iv) the establishment, implementation and monitoring of appropriate risk management limits with respect to various types of risks (*e.g.,* credit and market risk); and (v) Compliance Department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. Risk Control, Operations, Accounting, Legal, Compliance, Audit and Senior and Line Management will all be involved in assuring that the risks undertaken by the bank are comparable to, and are addressed in ways comparable to those applicable to, the bank's existing derivatives business.

In addition to a satisfactory risk management program, a bank's process must include an independent compliance-monitoring program to ensure ongoing compliance with the specific commitments made by the bank to purchase and hold equity securities to hedge its customer-driven and non-proprietary derivative business. The compliance-monitoring program should also ensure that the bank has a supervisory framework that protects against manipulative practices of any kind. An adequate and effective compliance-monitoring program will include policies, training, independent surveillance and well-defined exception approval and reporting procedures.

Conclusion

The Bank has a well-established equity derivatives business and hedges the risks arising from this business with equity derivative transactions and physical positions on equity securities, based upon prior OCC legal interpretations described herein and supervisory no-objections. The Bank now seeks confirmation that prior OCC legal authorizations permit the Bank to hedge equity derivative transactions with physical hedges on common and preferred stock, convertible and exchangeable securities, MLPs and limited partnership interests, LLC interests, depositary receipts (including ADRs and GDRs),

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[28] *OCC Handbook*: *Risk Management of Financial Derivatives* (January 1997).

[29] OCC Banking Circular No. 277 (October 27, 1993).

closed- and open-end mutual funds, ETFs, and REITs. We conclude that, as more specifically described above, it is legally permissible under national banking law for the Bank to engage in physical hedges involving these equity securities under prior OCC legal interpretations. Before the Bank engages in transactions involving these equity securities for which it has not received a supervisory no-objection, the Bank must notify its EIC, in writing, of the proposed activities and receive written notification of the EIC's supervisory no-objection. The no-objection is based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems and controls to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC's evaluation of any other supervisory considerations relevant to the particular proposal.

Our conclusions are specifically based on the facts and circumstances described herein. Any change in the facts or circumstances could result in different conclusions. If you have any questions concerning this letter, please contact Tena M. Alexander, Special Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel