BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

October 24, 2006

John A. Buchman, Esq.
General Counsel
E*TRADE Bank
671 North Glebe Road
Arlington, Virginia 22203

Dear Mr. Buchman:

This is in response to the request by E*TRADE Bank ("Bank"), Arlington, Virginia, for an exemption from section 23A of the Federal Reserve Act and the Board's Regulation W to permit Bank's parent company, E*TRADE Financial Corporation ("ETFC"), New York, New York, to contribute to Bank all its equity interest in E*TRADE Clearing LLC ("Clearing"), New York, New York.[1] Bank also has requested an exemption that would permit Clearing, after it becomes a wholly owned subsidiary of Bank, to continue to make margin loans to customers, the proceeds of which would be transferred to affiliates of Bank.

Background

ETFC is a publicly traded savings and loan holding company supervised by the Office of Thrift Supervision ("OTS"). ETFC's principal subsidiaries include (i) Bank, an OTS-regulated federal savings association; (ii) E*Trade Securities ("Securities"), New York, New York, an SEC-registered broker-dealer that acts primarily as an introducing broker for ETFC's retail investor client base; (iii) Clearing, an SEC-registered broker-dealer that performs traditional clearing, settlement, and related functions and extends margin credit primarily in connection with securities transactions by clients of ETFC; and

[1] 12 U.S.C. § 371c; 12 CFR part 223.

(iv) E*Trade Capital Markets and E*Trade Capital Markets—Execution Services (the "Affiliated Market Makers"), New York, New York, SEC-registered broker-dealers that make markets in a wide variety of securities and act as introducing brokers to ETFC's institutional investor client base (when acting as introducing brokers, together with Securities, the "Affiliated Introducing Brokers").

A principal function of Clearing is to clear and settle securities transactions and provide related back-office services for the brokerage customers of the Affiliated Introducing Brokers. Clearing also provides margin loans to customers of the Affiliated Introducing Brokers. Clearing currently funds its margin loans using customers' free credit balances and the proceeds of borrowings from affiliated and unaffiliated lenders.[2] Clearing does not currently receive any extensions of credit or other funding from Bank, and Bank does not make any margin loans to Clearing's customers. Clearing does not engage in securities dealing, market making, or underwriting; and Clearing does not purchase securities for its own account except in very limited circumstances.

The Affiliated Introducing Brokers clear and settle substantially all of their customer securities transactions through Clearing. In addition, although the Affiliated Introducing Brokers route customer orders to several different market centers and market makers in the ordinary course of business, the majority of customer orders are routed to the Affiliated Market Makers.[3]

As part of an internal reorganization, ETFC now proposes to contribute all its equity interest in Clearing to Bank. Bank has filed a notice with the OTS and the Federal Deposit Insurance Corporation ("FDIC") to acquire Clearing from ETFC and establish it as a wholly owned operating subsidiary. The OTS has expressed no concerns about the reorganization, and the FDIC has no objection to granting the requested section 23A exemptions.

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[2] A free credit balance is cash held in a brokerage account that the customer, without restriction, may withdraw or use to acquire additional securities.

[3] **[XXXXX]**

Bank anticipates that the proposed reorganization would result in cost savings and financial benefits to ETFC by reducing Bank's interest-rate risk (and associated hedging costs), lowering the funding costs for Clearing, and integrating the balance sheets of Bank and Clearing for bank regulatory capital purposes.

Legal Background

Section 23A and Regulation W limit the amount of "covered transactions" between a bank (including a federal savings association) and any single affiliate to 10 percent of the bank's capital stock and surplus and limit the amount of covered transactions between a bank and all its affiliates to 20 percent of the bank's capital stock and surplus. "Covered transactions" include a bank's purchase of assets from an affiliate and a bank's extension of credit to an affiliate. The statute and regulation also require a bank to secure its extensions of credit to, and certain other covered transactions with, affiliates with prescribed amounts of collateral.

In addition, section 23A and Regulation W contain an attribution rule, which provides that a transaction between a bank and a third party will be treated as a transaction between the bank and an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or are transferred to, an affiliate of the bank. The attribution rule is intended, among other things, to prevent a bank from evading the restrictions in the statute and rule by using intermediaries and to limit the exposure that a bank has to customers of its affiliates.[4]

Section 23A and Regulation W also specifically authorize the Board to exempt, in its discretion, transactions or relationships from the requirements of the statute and rule if the Board finds such exemptions to be in the public interest and consistent with the purposes of section 23A.

The Reorganization Exemption

Regulation W provides that a bank's acquisition of securities issued by a company that was an affiliate of the bank before the acquisition is treated as a purchase of assets by the bank from an affiliate if (i) the company becomes an

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[4] See 67 Federal Register 76,576 (Dec. 12, 2002).

operating subsidiary of the bank as a result of the transaction and (ii) the company has liabilities at the time of the acquisition.[5] Clearing is currently an affiliate of Bank. Clearing would be an operating subsidiary of Bank immediately after the reorganization, and Clearing would have liabilities at the time of the reorganization. Accordingly, ETFC's contribution of all the equity interests of Clearing to Bank would be an asset purchase subject to the quantitative and qualitative limitations of section 23A and Regulation W. The value of the covered transaction under Regulation W would be approximately $6.5 billion – the total liabilities of Clearing at the time of the reorganization. Because the capital stock and surplus of Bank is approximately $2.2 billion, Bank's quantitative limit per affiliate is approximately $220 million, and the proposed covered transaction would exceed Bank's quantitative limits under section 23A and Regulation W.

Bank has requested that the Board exempt the reorganization from section 23A and Regulation W. Although the Board has routinely granted exemptions for one-time corporate reorganizations,[6] the Board has not previously approved a section 23A exemption request that primarily facilitated the transfer of an SEC-regulated broker-dealer or of a company principally engaged in securities clearing when the transferred company would become a subsidiary of a bank.

The reorganization would expose Bank to the credit, market, and operational risks associated with securities clearing. Securities clearing activities generate counterparty credit risks for the clearing firm. When a clearing firm clears a securities transaction on behalf of a customer, the firm commits on the trade date to the relevant securities clearinghouse either (i) to pay for the securities on the settlement date in the case of a purchase of securities by the firm's customer or (ii) to deliver the securities on the settlement date in the case of a sale of securities by the customer. In other words, the clearing firm must either advance funds or securities on the settlement date regardless of whether the firm's customer has provided the funds or delivered the securities to the clearing firm. Because of fluctuations in securities prices, the clearing firm may not be able to make itself

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[5] 12 CFR 223.31(a).

[6] See, e.g., Board letters dated December 22, 2004, to Winthrop N. Brown, Esq. (HSBC Bank); and February 27, 2003, and August 28, 2001, to Carl Howard, Esq. (Citigroup).

whole if a customer fails to deliver. Securities clearing firms are also exposed to substantial levels of operational risk.

The reorganization also would result in a substantial portion of Bank's assets residing in an SEC-regulated broker-dealer operating subsidiary. SEC-regulated broker-dealers are subject to the SEC's prudential supervision and regulatory capital requirements. As a result, Bank may be unable to withdraw resources from Clearing if Bank suffers losses unrelated to Clearing. Bank is unlikely to have the same access to the capital invested in Clearing as Bank would have to the capital invested in an unregulated subsidiary.

Although the type of entity proposed to become an operating subsidiary of Bank raises novel issues, the proposal is generally consistent with Board precedent. As in previous cases reviewed by the Board, the proposed transaction is part of a one-time internal reorganization. In addition, ETFC has committed that none of the assets transferred to Bank will be low-quality assets within the meaning of section 23A and Regulation W. ETFC also has committed that, for a two-year period following consummation of the proposal, it will make quarterly cash contributions to Bank equal to the full book value plus any write-downs taken by Bank of any transferred asset that becomes a low-quality asset during the quarter. Moreover, as discussed below, ETFC has committed that, without a time limit, the Affiliated Introducing Brokers will indemnify Clearing for all losses incurred by Clearing on margin loans made to their respective customers. This perpetual margin-loan indemnity goes well beyond the traditional two-year buyback commitment that the Board typically requires from holding companies in connection with internal reorganization exemptions.

Clearing also has taken steps to mitigate the risk of its securities clearing activities. Most importantly, Clearing only provides clearing services to introducing brokers that either require customers to have sufficient cash or securities in their accounts before executing a cash transaction or operate on a "delivery versus payment" basis. Moreover, in the event of loss upon customer default, Clearing has access to several accounts that the Affiliated Introducing Brokers have established with Clearing to indemnify Clearing for such losses. In addition, although Clearing provides clearing and settlement services to two unaffiliated broker-dealers, these broker-dealers execute securities transactions only for others rather than for their own account. As a condition of the reorganization exemption, Clearing must continue to refrain from clearing securities transactions for broker-dealers trading for their own accounts.

Furthermore, Bank is well capitalized and well managed and would remain so on consummation of the proposal. Even if Bank deconsolidates Clearing and deducts from its tier 1 capital its equity investment in Clearing to reflect the difficulties Bank may have in withdrawing resources from Clearing if Bank is in financial distress, Bank would remain well capitalized.[7] As a condition of this exemption, Bank must remain well capitalized based on both (i) full consolidation of Clearing and (ii) deconsolidation of Clearing and deduction of Bank's investment in Clearing (that is, a full deduction of Clearing's assets from Bank's balance sheet and a full deduction of Bank's investment in Clearing from Bank's tier 1 capital).[8] As a final condition of the reorganization exemption, Clearing must inform its customers that customer funds held at Clearing are not covered by FDIC insurance to avoid customer confusion after Clearing becomes a subsidiary of Bank.

The Margin-Loan Exemption

As noted above, section 23A and Regulation W impose quantitative and qualitative limits on covered transactions between a bank and its affiliates and on covered transactions between a bank and any third party to the extent that the proceeds of the transactions are used for the benefit of, or transferred to, an affiliate of the bank. If Clearing becomes an operating subsidiary of Bank (and, accordingly, part of Bank for section 23A purposes), Clearing's margin loans will generate covered transactions in the two situations discussed below. Clearing has requested exemptions for both of these covered transactions on an ongoing basis because it would be unable to continue its current volume of margin lending without the exemptions.

The first covered transaction would occur when Clearing makes a margin loan to a customer who uses the loan proceeds to purchase securities from

[7] Bank also would remain well capitalized if Bank consolidated Clearing but deducted an amount from its tier 1 capital equal to the amount of Clearing's SEC capital requirement.

[8] In determining Bank's risk-based capital ratios under the "deconsolidate and deduct" approach, Clearing's off-balance-sheet exposures also would not be included in Bank's risk-weighted assets.

an Affiliated Market Maker, which will fill the order with securities from its inventory. In this case, the proceeds of Clearing's loan would be transferred to both (i) the Affiliated Market Maker, which would receive most of the proceeds of the loan as consideration for its sale of securities out of inventory to the customer, and (ii) the Affiliated Introducing Broker, which would receive a brokerage commission out of the loan proceeds. The second covered transaction would occur when Clearing makes a margin loan to a customer who uses the loan proceeds to purchase ETFC common stock in the secondary market (from a dealer other than the Affiliated Market Makers). In this case, a small portion of the proceeds of Clearing's loan would be transferred to the Affiliated Introducing Broker in the form of a brokerage commission.[9]

As discussed above, section 23A and Regulation W limit the amount of covered transactions between a bank and any single affiliate to 10 percent of the bank's capital stock and surplus and limit the amount of covered transactions between a bank and all its affiliates to 20 percent of the bank's capital stock and surplus. As of June 30, 2006, Bank's capital stock and surplus was approximately $2.2 billion, which would limit the Bank's covered transactions with a single affiliate to $220 million and with all affiliates to $440 million. Given that Clearing's margin-loan portfolio was approximately $6.7 billion as of June 30, 2006, and that Bank expects approximately **[XXX]** percent of its margin loans to generate covered transactions,[10] Bank's $**[XXX]** of margin-loan covered

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[9] Clearing's margin loans for the purchase of ETFC common stock would generate covered transactions only to the extent that a portion of the proceeds of the loan flow to an Affiliated Introducing Broker as a commission. Because customers are only allowed to use a Clearing margin loan to buy affiliate-issued securities <u>in the secondary market</u>, the proceeds of these loans would never flow to the affiliated issuer of the securities. In addition, because neither Affiliated Market Maker makes a market in ETFC common stock (or any other affiliate-issued security), the proceeds of these loans would never flow to the Affiliated Market Makers.

[10] **[XXXXX]**

transactions after the reorganization would represent about **[XXX]** percent of the bank's capital stock and surplus. Accordingly, Bank has requested an exemption from the quantitative limits of section 23A and Regulation W for these ongoing transactions.

The principal affiliate risk to Bank from Clearing's margin-loan covered transactions is that Clearing might relax its margin-credit underwriting standards or lower its price of margin credit to generate revenues for, or otherwise provide support to, affiliates. In particular, Clearing could have incentives to extend imprudent margin credit to generate additional transaction fees for the Affiliated Market Makers or additional brokerage commissions for the Affiliated Introducing Brokers. Clearing also could have incentives to extend credit to help the Affiliated Market Makers liquidate undesirable inventory positions.

In evaluating these potential risks, the Board has considered that (i) margin lending is a low-risk, highly collateralized form of lending; (ii) the bank's credit exposure would be to thousands of unaffiliated investors (not to an affiliate); (iii) Clearing must abide by the best-execution rule under federal securities laws, which would help prevent Clearing from routing customer trades to an Affiliated Market Maker unless such routing produces the highest quality transaction for the customer; and (iv) the Affiliated Market Makers deal in highly liquid securities and rarely maintain overnight positions.

Regulations governing the extension of margin loans by an SEC-registered broker-dealer (such as Clearing) mitigate the credit and market risks of those loans. The amount of leverage available to the customer is limited by the Board's Regulation T (12 CFR part 220) and the margin-maintenance rule of the New York Stock Exchange (NYSE Rule 431).[11] For example, a customer who purchases $100 of equity securities in a margin account may borrow only $50 against those securities from the broker-dealer. If this is the only transaction in the margin account, the loan will be 200 percent collateralized at the time of the purchase of the securities because the market value of the securities is twice that of the margin loan. If, on a daily basis, the equity in the account falls below the required NYSE margin maintenance of 25 percent – that is, if the value of the

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[11] If the broker-dealer is not a member of the NYSE, the margin-maintenance rule of the NASD (NASD Rule 2520) generally would apply instead. Both rules impose the same leverage limitations.

collateral falls below 133 percent of the loan – the customer is required to post additional cash or securities as collateral to eliminate the margin deficiency.[12] If the customer does not meet the margin call within the required time, the broker-dealer must sell sufficient securities in the account to increase the account equity to the required maintenance level.

Regulation T margin loans are typically collateralized by liquid and readily marketable securities and can be terminated on demand at any time by the broker-dealer lender. In addition, because of special provisions in the U.S. Bankruptcy Code for certain securities financing transactions, the collateral for a Regulation T margin loan should be available to the broker-dealer for prompt liquidation even in the event of the borrower's bankruptcy.[13] As noted above, Bank estimates that its average annual write-offs of margin loans have amounted to **[XXX]** percent during the last five years.[14]

The risk of loss is further mitigated by the fact that Clearing's introducing brokers are required, under their respective clearing agreements, to cover losses incurred by Clearing on margin loans made to their customers. Each clearing agreement provides Clearing with three levels of protection against margin-loan losses. First, the introducing broker is required to maintain an escrow deposit account with Clearing to ensure payment for Clearing's clearing services and also to ensure that Clearing does not suffer losses on margin loans to the introducing broker's customers. Second, the clearing agreement provides that Clearing may net any margin-loan losses from the substantial amounts Clearing owes the introducing broker on a periodic basis. Finally, Clearing would have an unsecured claim against the introducing broker for any residual margin-loan losses.

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[12] The initial margin requirements of Regulation T, as well as the margin-maintenance requirements of the NYSE, for debt securities and options may differ from those applicable to equity securities.

[13] <u>See</u> Section 901(b) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005; H.R. Rep. 109-31, 109th Cong., 1st Sess., p. 119 (2005); <u>In re Weisberg</u>, 136 F.3d 655, 659 (9th Cir. 1998).

[14] **[XXXXX]**

Furthermore, the additional risks that result from affiliate involvement in Clearing's margin-loan covered transactions are minimal. Importantly, the margin-loan covered transactions are not loans directly to an affiliate. As a consequence, Clearing does not have direct affiliate credit risk; rather, Clearing's credit risk is dispersed among thousands of unaffiliated investors.

Moreover, because ETFC does not provide investment advice to its securities brokerage customers, Clearing and the Affiliated Introducing Brokers would not be in a position to direct customers to purchase certain securities to help liquidate the specific inventory of an Affiliated Market Maker or to purchase additional securities more generally to generate commissions for its affiliates. In addition, because Clearing and Securities are SEC-registered broker-dealers and members of the NASD, they must comply with the best-execution rule, which prohibits them from steering orders to the Affiliated Market Makers if it is not in a customer's best interest.[15] Finally, **[XXXXX]**[16] **[XXXXX]**[17] **[XXXXX]**[18]

Although margin lending does involve some risk, the Board has granted exemptions from section 23A and Regulation W for similar highly

[15] NASD Rule 2320(a).

[16] **[XXXXX]**

[17] **[XXXXX]**

[18] **[XXXXX]**

collateralized securities-financing transactions with affiliates. In particular, the Board has provided exemptions for securities-borrowing and securities-lending transactions between a bank and an affiliate.[19] In this case, the risks are mitigated in part by the fact that the margin-loan covered transactions expose the bank to the diversified credit risk of thousands of unaffiliated borrowers rather than to a single borrower and that the margin-loan covered transactions generally are subject to a higher margin-maintenance requirement than in the securities-borrowing and securities-lending transactions.

The Board also notes that section 23A and Regulation W contain an exemption for the purchase by a bank from an affiliate of assets that have a readily identifiable and publicly available market quotation. This statutory exemption does not apply by its terms to Bank's margin-loan covered transactions because the bank is making a loan to fund a third party's purchase of an asset from an affiliate rather than directly purchasing an asset from an affiliate. Nevertheless, this exemption evidences a Congressional intent not to impede bank-affiliate transactions involving liquid assets.

Approval of this request for an ongoing exemption is subject to the condition that the exemption applies only to margin loans (i) made by Clearing (not Bank or any other affiliate); (ii) subject to the initial margin requirements of Regulation T; and (iii) subject to the ongoing margin-maintenance requirements of NYSE Rule 431. Because Clearing would have significant levels of margin-loan covered transactions after the reorganization, the exemption also would be conditioned on Bank's remaining well capitalized based both on a full consolidation of Clearing and a deconsolidation of Clearing and deduction of Bank's investment in Clearing (as discussed above).

Conclusion

Granting the exemptions would benefit the public because cost and operational efficiencies would result from Bank's maintaining Clearing as a subsidiary. ETFC has stated that it would be able to pass on a portion of those

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[19] See Board letters dated June 7, 2005, to John H. Huffstutler, Esq. (Bank of America Corporation); May 5, 2005, to Michael M. Wiseman, Sullivan & Cromwell LLP (The Bank of New York Company); and October 31, 2001, to Marjorie Gross, Esq. (J.P. Morgan Chase & Co.).

savings to customers in the form of lower brokerage commissions, higher yields on deposit products, additional product innovation, or enhanced product functionality and customer service.

In light of these considerations and all the facts presented, the transactions appear to be consistent with safe and sound banking practices and the purposes of section 23A. Accordingly, the Board hereby grants the requested exemptions, subject to the conditions and limits discussed above and in your correspondence with the Board.

The determinations above are specifically conditioned on compliance by ETFC and Bank with all the commitments and representations made to the Board in connection with the exemption requests. These commitments and representations are deemed to be conditions imposed in writing by the Board in connection with granting the requests and, as such, may be enforced in proceedings under applicable law. The determinations are based on the specific facts and circumstances of the transactions described in your correspondence and this letter. Any material change in those facts and circumstances or failure by ETFC or Bank to observe any of the commitments or representations may result in a different determination or in the revocation of the exemptions.

Very truly yours,

(signed)

Robert deV. Frierson
Deputy Secretary of the Board

cc: Federal Reserve Bank of Richmond
Office of Thrift Supervision
Federal Deposit Insurance Corporation