



**Office of Thrift Supervision**  
Department of the Treasury

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November 28, 2006

Re: Permissibility of Securities Clearing Activities and Paying  
Interest on Free Credit Balances

Dear :

This responds to your request in connection with the application and notice to establish an operating subsidiary filed by (Association) with the Office of Thrift Supervision (OTS). The operating subsidiary would be a registered broker-dealer, and would not be a depository institution. You request legal determinations concerning two issues. First, you seek OTS's concurrence that certain securities clearing and related activities are permissible activities for a federal savings association and, therefore, would also be permissible for the Association's operating subsidiary. Second, you seek a determination, based on the facts you have presented, that a provision of federal law prohibiting federal savings associations from paying interest on demand accounts would not bar the Association's operating subsidiary from paying interest on its customers' free credit balances.

We conclude that the securities clearing and related activities described in your request are permissible activities for a federal savings association and, therefore, the Association's operating subsidiary would be able to engage in the same permissible activities. We also conclude that the law prohibiting federal savings associations from paying interest on demand accounts would not preclude the Association's operating subsidiary from paying interest on its customers' free credit balances.

**I. Background**

You have provided the following information. The Association is a subsidiary of (Holding Company). (LLC), a wholly owned, indirect subsidiary of Holding Company, is a securities clearing firm. LLC is a broker-dealer registered with the Securities and Exchange Commission (SEC) and is a member of the National Association of Securities Dealers, the New York Stock Exchange, and several exchanges.<sup>1</sup> LLC is a clearing member of the National Securities Clearing Corporation (NSCC),

<sup>1</sup> These include the NASDAQ Stock Exchange, the National Stock Exchange, the International Securities Exchange, the Pacific Stock Exchange, and the Philadelphia Stock Exchange.

Depository Trust Company (DTC), and the Options Clearing Corporation. As a clearing broker-dealer, LLC provides a variety of securities clearing and related services to affiliated and non-affiliated introducing broker-dealers and their brokerage customers. These services include: (i) clearance and settlement services as agent for broker-dealer customers, and not as principal;<sup>2</sup> (ii) custodial services, such as receipt, custody, and delivery of brokerage customers' securities and funds; (iii) margin lending, *i.e.*, making loans to brokerage customers to finance their securities purchases; (iv) order flow, *i.e.*, at the direction of introducing broker-dealers, delivery of trade orders to specific market centers for execution; and (v) recordkeeping. LLC also engages in activities related to the foregoing that clearing broker-dealers often perform, including securities lending to fund brokerage customers' margin loans,<sup>3</sup> stock borrowing,<sup>4</sup> and conduit securities lending.<sup>5</sup>

You represent that LLC does not engage in securities dealing, market making, or underwriting activities, and does not purchase or sell securities when acting in a principal capacity, except for certain securities purchases that are incidental to its securities clearing activities.<sup>6</sup> You also represent that LLC neither provides investment advice to its customers, nor is it a registered investment adviser under the Investment Advisers Act of 1940.<sup>7</sup>

LLC's primary sources of revenue are clearing revenue derived from transaction charges to introducing broker-dealers to compensate LLC for its clearance, settlement, custodial, and routing services; interest revenue from margin lending; and activity-based fees charged by LLC to its introducing broker-dealers for services provided to their customers.<sup>8</sup> Approximately 98%

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<sup>2</sup> The specific clearing services consist of comparing and confirming with counterparties the identity and quantity of securities traded, the transaction price and date, and the identity of the buyer and seller. The settlement services involve LLC, as a member of a clearinghouse, fulfilling trade obligations by paying for securities purchased or delivering securities sold.

<sup>3</sup> According to your request, in a typical transaction, LLC lends shares to another financial institution, receives cash as collateral for those shares, and pays interest on the funds received.

<sup>4</sup> In stock borrowing, LLC borrows stock from another broker-dealer, provides cash collateral for those shares, and receives interest on the cash it provides. LLC "typically borrows stock to fund a customer's short sale and uses the proceeds of the short sale as cash collateral for the stock borrow."

<sup>5</sup> In conduit securities lending, LLC "acts as an intermediary, typically between two other broker-dealers, one wishing to borrow securities, and the other willing to lend" and LLC "typically captures a spread in the transaction, representing the difference in rebate rates paid on each side of the transaction."

<sup>6</sup> As described in your request, these incidental purchases include purchases to make customers whole in failed trades; correction of error and fraud; purchases of essentially worthless securities in customer accounts to reduce third-party custodial charges; liquidation of margin accounts; and purchases or sales in certain securities lending transactions.

<sup>7</sup> 15 U.S.C. §§ 80b *et seq.* (West 1997 & Supp. 2006).

<sup>8</sup> These services include confirmations; statements; wire processing; margin calls; check writing; account transfers; account maintenance; new account processing; and broker-assisted trades.

of LLC's clearing, interest, and other revenue is from its affiliated broker-dealers and their customers.

For a variety of business reasons, the Association wishes to establish LLC as an operating subsidiary (OpSub-LLC) of the Association. You indicate that the Association and its parent companies have identified several financial benefits for the Association, and potentially for LLC's brokerage customers, that would result from reorganizing and having LLC become an operating subsidiary of the Association.<sup>9</sup> However, because an operating subsidiary may only engage in activities that are permissible for a federal savings association, you ask whether LLC may continue its current activities, as described above, if it becomes OpSub-LLC, an operating subsidiary of the Association. In other words, may a federal savings association engage directly in the activities that LLC currently conducts, including serving as a member of a clearing exchange?

You also seek our concurrence that following the proposed reorganization, § 5(b)(1)(B)(i) of the Home Owners' Loan Act (HOLA),<sup>10</sup> which prohibits a federal savings association from paying interest on a demand account, would not apply to OpSub-LLC or to free credit balances held by OpSub-LLC, so that it may continue LLC's current practice of paying interest on customers' free credit balances.<sup>11</sup>

## II. Discussion

### A. Permissibility of Clearing and Settlement Activities

Under OTS regulations, an operating subsidiary may engage in any activity that its parent federal savings association may conduct directly.<sup>12</sup> Accordingly, the relevant inquiry here is whether the activities proposed for OpSub-LLC, and that are currently being conducted by LLC as described above, are permissible for a federal savings association. Federal savings associations have authority to engage in a broad range of securities activities, based on either express authority under the HOLA or the well-established doctrine of incidental powers.

Most of the brokerage activities are customary for a federal savings association that provides securities brokerage or similar services.<sup>13</sup> We have not considered whether serving as a

<sup>9</sup> You indicate that some of these benefits include reduced operating expenses, reduced cost of funds to the Association, and improved customer service. You also suggest that the Association may have an improved capital position and increased earnings when the Association and OpSub-LLC are consolidated for financial reporting purposes.

<sup>10</sup> 12 U.S.C. § 1464(b)(1)(B)(i)(West 2001).

<sup>11</sup> You define the term "free credit balances" to mean "funds in customers' brokerage accounts that are not swept into [Association] sweep deposit accounts or money market mutual funds that are held by [LLC]."

<sup>12</sup> 12 C.F.R. § 559.3(e)(1)(2006).

<sup>13</sup> See, e.g., NASD Rule 3230, which lists the responsibilities of introducing and clearing brokers.

clearing broker with membership in a clearinghouse is permissible for a federal savings association, however.

The activities proposed for OpSub-LLC are customary for a clearing broker. Clearing and introducing brokers that work together divide the responsibilities of a broker between them. While a clearing broker performs “back office functions” with respect to securities transactions, the introducing broker performs the “front office functions.” The introducing broker opens, approves, and monitors customer accounts and later accepts orders and executes transactions. The back office functions of the clearing broker include credit extension; recordkeeping; receipt and delivery of funds and securities; safeguarding of funds and securities; and confirmations and statements.<sup>14</sup> A clearing broker extends credit when it substitutes its credit for that of its customers and becomes liable to a clearinghouse for performance of contracts that it submits. It assumes the risk of default with respect to the exchange, clearinghouse, and counterparties to the trades.<sup>15</sup>

#### *Express Powers*

Section 5(c) of the HOLA expressly authorizes a federal savings association to “invest in, sell, or otherwise deal in” a wide range of securities, such as government securities and mortgage-backed securities.<sup>16</sup> The OTS’s implementing regulation<sup>17</sup> clarifies that section 5(c) authorizes a federal savings association to provide brokerage or warehousing services for all loans and investments allowed under Section 5(c).<sup>18</sup> This express authority includes the power to sell and deal in asset-backed securities where the underlying assets are those in which federal savings associations are authorized to originate, purchase, or invest.<sup>19</sup> In addition, we addressed some aspects of retail securities brokerage by operating subsidiaries of federal savings

<sup>14</sup> SEC Release No. 34-49879, at n.289 (Regulation B: Proposed Rule), 69 Fed. Register 39,682, 39712 n.289 (2004), *citing* National Association of Securities Dealers Rule 3230, “Clearing Agreements,” and New York Stock Exchange Rule 382, “Carrying Agreements” (another term for “clearing agreements”).

<sup>15</sup> *See, e.g.*, NASD Rule 3230; Henry R. Minnerop, *Clearing Arrangements*, 58 Bus. Law. 917 (May 2003).

<sup>16</sup> 12 U.S.C. § 1464(c)(West 2001 & Supp. 2006). Other types of securities include securities issued or fully guaranteed by the Federal National Mortgage Association, the Student Loan Marketing Association, the Government National Mortgage Association, or any agency of the United States, Federal Home Loan Bank securities, state and municipal securities, small business-related securities, and corporate debt securities. 12 U.S.C. § 1464(c)((1)(D), (E), (F), (H), (S), & (2)(D).

<sup>17</sup> In 1996 OTS removed from its implementing regulation a prohibition against savings associations contracting with third parties for brokerage activities. OTS thus has permitted a federal savings association to engage in third party brokerage (networking) arrangements that make securities brokerage services available to the association’s customers by a broker-dealer that leases space on the association’s premises. *See* 61 Fed. Reg. 66,561, 66,568 and 66,570 (Dec. 18, 1996) (preamble).

<sup>18</sup> *See* 12 C.F.R. § 560.30 (2006). Like other insured depository institutions, a federal savings association may use asset securitization to sell any type of loan that it originates or purchases. OTS Op. Chief Counsel P-2004-5, at 3 and n.10 (Sept. 14, 2004), *citing Interagency Guidance on Asset Securitization Activities* (Dec. 13, 1999).

<sup>19</sup> *See* OTS Op. Chief Counsel P-2004-5 (September 14, 2004).

associations in the *Interagency Statement on Retail Sales of Nondeposit Investment Products* (Interagency Statement) issued in 1994.<sup>20</sup> The authority of federal savings associations to provide securities brokerage and related services to customers is not of recent vintage.<sup>21</sup>

Most of the proposed related services are expressly permissible when provided outside the context of securities brokerage, as well as when provided in connection with securities brokerage. In fact, Congress has recognized that these services, in some circumstances, are core banking services that both banks and savings associations provide to customers.<sup>22</sup> OTS fiduciary regulations authorize federal savings associations to act in a variety of capacities that involve securities, such as registrar of stocks and bonds and transfer agent.<sup>23</sup> Federal savings associations have broad authority under Section 5(c) of the HOLA to make a wide variety of loans,<sup>24</sup> and to borrow, subject to regulatory limitations.<sup>25</sup> Margin lending, securities conduit lending, and lending and borrowing securities are permissible pursuant to this authority.<sup>26</sup> Moreover, federal savings associations have express authority to provide order flow and

<sup>20</sup> See Thrift Bulletin 23-2 (Feb. 22, 1994). The Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and OTS issued this statement on February 15, 1994. The Interagency Statement requires disclosure to retail customers that securities sold are not insured by the FDIC; are not deposits or other obligations of, or guaranteed by, a depository institution; and are subject to investment risks. See also *Joint Interpretations of the Interagency Statement*, OTS Thrift Bulletin 23-3 (Oct. 13, 1995).

<sup>21</sup> Guidance on securities lending has an even longer history. The FFIEC Supervisory Policy on Securities Lending, issued in 1985, explained that our predecessor, the Federal Home Loan Bank Board, had already developed rules and regulations (now obsolete) addressing securities lending for institutions that it supervised. See *FFIEC Supervisory Policy: Securities Lending* 8, attached to OCC Banking Issuance BC-196 (May 7, 1985), citing 12 C.F.R. § 545.49 and memoranda R 48 and T 34-5. One of our current regulations, 12 C.F.R. § 560.30 n.12 (2006), supersedes the Federal Home Loan Bank Board regulations and governs securities lending by federal savings associations.

<sup>22</sup> Congress recently enacted legislation that applies to savings associations the same exceptions as to banks from the definitions of “broker” and “dealer” under the Securities Exchange Act of 1934. See Financial Services Regulatory Relief Act of 2006, § 401(a), Pub. L. No. 109-351, to be codified at 15 U.S.C. § 78c(a)(6) (defining “bank” to include savings association); 15 U.S.C. §§ 78c(a)(4) & (5) (definitions of “broker” and “dealer”). These excepted services include, among others, effecting securities transactions in a trust department, providing safekeeping and custody services, and serving as custodian to pension and other benefit plans. 15 U.S.C. § 78c(a)(4).

<sup>23</sup> 12 C.F.R. § 550.30 (2006). A federal savings association may also provide investment advice through a trust department and exercise investment discretion over customer accounts. *Id.* OpSub-LLC would not provide such services, however.

<sup>24</sup> See, e.g., 12 U.S.C. § 1464(c)(2)(A)(commercial loans), (c)(2)(B)(nonresidential real property loans); (c)(2)(D)(consumer loans); (c)(1)(T) and (U)(credit card and educational loans, respectively); and (c)(3)(C)(construction loans for primary residences).

<sup>25</sup> See 12 C.F.R. § 563.80 (2006).

<sup>26</sup> Margin and securities conduit lending would be permissible as either commercial or consumer lending. See 12 U.S.C. § 1464(c)(2)(A)(commercial lending) and (c)(2)(D)(consumer lending). See also 12 C.F.R. § 563.80 (2006)(borrowing authority).

recordkeeping services to both fiduciary and brokerage customers,<sup>27</sup> and to act as custodian of residential mortgage loans documents as part of mortgage servicing.<sup>28</sup> In addition, federal savings associations have express statutory authority to issue passbooks, certificates, or other evidence of deposit accounts,<sup>29</sup> all of which involve recordkeeping activities. Thus, many of the activities proposed for OpSub-LLC are customary and permissible activities for a federal savings association and, therefore, its operating subsidiary.

We therefore conclude that a federal savings association has express authority to provide: (1) clearance and settlement services as agent for broker-dealer customers, and not as principal; (2) custodial services, such as receipt, custody, and delivery of brokerage customers' securities and funds; (3) margin lending, *i.e.*, making loans to brokerage customers to finance their securities purchases; (4) order flow, *i.e.*, at the direction of introducing broker-dealers, delivery of trade orders to specific market centers for execution; and (5) recordkeeping, with respect to any type of securities in which a federal savings association may invest pursuant to section 5(c) of the HOLA. A federal savings association also has express authority to provide services related to the foregoing that clearing broker-dealers often perform, including securities lending to fund brokerage customers' margin loans, stock borrowing, and conduit securities lending.

We have not previously explicitly addressed the authority of a federal savings association to provide, as agent, brokerage and clearing services with respect to types of securities that federal savings associations are not expressly authorized to invest in pursuant to section 5(c) of the HOLA. Moreover, neither the HOLA nor our regulations provide express authority for a federal savings association or its operating subsidiary to serve as a clearing member of a clearinghouse or similar organization. However, our inquiry does not end here.

#### *Incidental Powers*

In addition to express statutory and regulatory authorizations, this Office has recognized that federal savings associations possess extensive powers that are incidental to the express powers granted to federal savings associations by the HOLA.<sup>30</sup> These incidental powers provide

<sup>27</sup> See 12 C.F.R. § 551.20(a) (2006). See also 12 C.F.R. §§ 551.30 (requiring maintenance of effective systems of records and controls regarding customers' securities transactions); 551.50 (specific recordkeeping requirements); 551.60 (how records must be maintained). See also 12 C.F.R. Part 551, Subpart B "Content and Timing of Notice," including confirmations, Subpart C "Settlement of Securities Transactions," and Subpart D "Securities Trading Policies and Procedures" (2006). Section 5(n) of the HOLA, 12 U.S.C. § 1464(n), provides express authority to federal savings associations to act as a fiduciary.

<sup>28</sup> OTS Op. Chief Counsel (Jan. 31, 1994) (concluding that a federal savings association has express authority pursuant to section 5(c)(1)(B) of the HOLA to act as custodian of loan documents for third parties).

<sup>29</sup> 12 U.S.C. § 1464(b)(1)(ii).

<sup>30</sup> OTS Op. Chief Counsel P-2004-5 (Sept. 14, 2004); OTS Op. Chief Counsel (Oct. 29, 2001).

a basis for our conclusions concerning providing clearing and related services in connection with other types of securities, and service as a member of a clearinghouse.

We consider four factors to determine whether a particular activity lies within the scope of an express power under section 5 of the HOLA. These include:

- (1) is the activity consistent with Congressional purpose for federal savings associations; (2) is the activity similar to, or does it facilitate the conduct of, an activity already expressly authorized by Congress; (3) does the activity relate to the financial intermediary role that federal savings associations were intended to fulfill; and (4) is the activity necessary for the federal savings association to remain competitive and relevant in the modern economy?<sup>31</sup>

OTS has determined that federal savings associations have incidental power to conduct diverse securities and securities-related activities. These incidental powers include, for example, conducting certain sweep arrangements,<sup>32</sup> acting as principal in certain interest rate hedges,<sup>33</sup> providing ministerial support services as agent for a trust company,<sup>34</sup> and purchasing Farmer Mac common stock.<sup>35</sup> A federal savings association has incidental power to offer escrow accounts that do not relate to loans that it made.<sup>36</sup>

OTS also has permitted a federal savings association to establish a foreign agency to perform clearinghouse functions that would facilitate trust services provided by the federal savings association to U.S.-based institutional trust customers. OTS permitted the agency to provide global custody services, securities lending services solely on an agency basis, safekeeping, custody, recordkeeping and other ministerial services while acting as a paying agent, and custodial services for securities certificates.<sup>37</sup> These services are substantially similar to the services that OpSub-LLC would provide, except that the agency did not become a member of a clearinghouse.

<sup>31</sup> See, e.g., OTS Op. Chief Counsel P-2004-5, *supra* note 30, at 4.

<sup>32</sup> OTS Op. Chief Counsel (Aug. 1, 2000); OTS Op. Chief Counsel (March 2, 1998).

<sup>33</sup> OTS Op. Chief Counsel (Dec. 30, 1999).

<sup>34</sup> OTS Op. Chief Counsel (Oct. 17, 1995).

<sup>35</sup> OTS Op. Chief Counsel (Oct. 14, 1997).

<sup>36</sup> See, e.g., OTS Op. Chief Counsel (Aug. 19, 1998) (commercial escrow accounts). Moreover, we have recognized that certain activities and services, such as serving as document custodian or providing escrow or recordkeeping services, do not require OTS-conferred trust powers. See, e.g., *id.*; OTS Op. Chief Counsel (Jan. 31, 1994) (escrow, safekeeping, custodial, and similar services). See also 12 C.F.R. Part 550 (2006).

<sup>37</sup> The agency acted as custodian of certificates of CEDEL, a depository organization located in Europe that allowed its members to effect transfers of securities in book entry form. The agency also provided related services, such as

In addition, ministerial, non-discretionary support services “are permissible under a long line of precedent recognizing that federal savings associations have incidental authority to provide such services.”<sup>38</sup> These correspondent services are services that the federal savings association “provides to others that the institution is authorized to generate in-house for itself in the regular course of business.”<sup>39</sup> They typically include clearing checks, collecting debts, participating in large loans, providing legal advice, assisting in building securities portfolios, counseling as to personnel policies, training staff, helping with site selection, auditing, and providing electronic data processing.<sup>40</sup> OTS has not limited permissible correspondent services to those on this list, but, for example, has permitted a federal savings association to provide management and consulting services to foreign financial institutions.<sup>41</sup>

Some of the services that OpSub-LLC would provide for customers are the types of services that OpSub-LLC could perform for itself if it were engaging in the permissible activity of buying and selling certain types of securities for its own account, subject to statutory and regulatory limitations.<sup>42</sup> These include custody, order flow, and recordkeeping services. They are

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authentication of certificates and clipping and presentation of coupons to the fiscal/paying agency for payment. OTS Op. Chief Counsel 94-CC-09, at 4 (June 13, 1994).

The global custody services that OTS permitted the agency to provide to broker/dealers, investment managers, private institutions, and other members of the public included:

reporting to customers regarding their holdings of different types of currencies, analyzing and tracking of claims made to foreign nations for tax refunds; settling customer instructions to purchase and sell securities; collecting dividend interest and other sources of income on behalf of customers, and related processing services; assisting customers in foreign exchange transactions; and providing related recordkeeping, reporting and bookkeeping services.

*Id.* at 2. OTS also permitted the agency at times to provide settlement and intra-day and overnight overdrafts relating to settlement of customer security transactions and to provide safekeeping of securities certificates for customers. *Id.* As agent for its customers, the agency loaned U.S. and foreign securities collateralized by U.S. dollars, letters of credit, or U.S. government securities and assist with related recordkeeping and reporting. *Id.* at 3.

<sup>38</sup> See, e.g., OTS Op. Chief Counsel, *supra* note 34, at 3.

<sup>39</sup> OTS Op. Chief Counsel, *supra* note 34, at 3 (citations omitted).

<sup>40</sup> OTS Op. Chief Counsel, *supra* note 34, at 3, citing *United States v. Citizens & Southern National Bank*, 422 U.S. 86, 115 (1975).

<sup>41</sup> See OTS Op. Chief Counsel, at 9 (May 10, 1995) (advice regarding the internal procedures required to originate pools of loans supporting residential mortgage-backed securities).

<sup>42</sup> See, e.g., 12 U.S.C. §§ 1464(c)(1)(C)(U.S. government securities), 1464(c)(1)(F) and (H)(other government and state securities); 12 C.F.R. Part 560 (2006). An operating subsidiary of a federal savings association may only engage in activities that are permissible for a federal savings association. 12 C.F.R. § 559.3(e)(1)(2006).



correspondent services that are permissible incidental services, in addition to expressly permissible services.

To determine whether providing clearing services for transactions involving a wider range of securities than those referenced in section 5(c) of the HOLA and whether membership as a clearing member of a securities exchange are permissible as incidental activities, the first factor that we consider is whether the activity is consistent with the Congressional purpose for federal savings associations. In recent legislation, Congress accorded savings associations parity with banks with respect to broker-dealer registration requirements.<sup>43</sup> Congress thereby evidenced its belief that savings associations have the power to provide such services and that such power is consistent with the purpose and role Congress envisioned for federal savings associations. During the last several decades, Congress has amended the HOLA to expand the powers of federal savings associations and enhance the ability of federal savings associations to meet the needs of their retail and commercial customers, while strengthening the safety and soundness framework within which associations exercise these powers. The amendments granted or expanded lending or investment authority for additional consumer products, commercial loans, commercial paper, and nonresidential real estate loans, among others. Congress intended to provide federal savings associations “flexibility ... to improve the range of services [that] thrift institutions may provide to their customers.”<sup>44</sup>

Providing clearing services for a broad range of securities, beyond those merely referenced in section 5(c) of the HOLA,<sup>45</sup> is entirely consistent with the role envisioned for federal savings associations. Performing clearing services would not involve holding or underwriting securities. Therefore any associated risks would be similar to acting as agent in performing other activities. This activity therefore would be consistent with the Congressional purpose of federal savings associations, as reflected in the recently enacted legislation. Similarly, the authority to clear and settle securities transactions as a member of a clearinghouse is consistent with the Congressional purpose to permit a federal savings association to remain competitive and relevant. To do so, a federal savings association must be able to provide the full range of services expected of a clearing broker. Granting federal savings associations parity with respect to broker-dealer registration requirements is a clear expression of Congressional intent.

The second factor that we consider is whether serving as a clearing member of a securities exchange is an activity that is similar to, or would facilitate the conduct of, an activity already expressly authorized for federal savings associations. Section 5(c)(1) of the HOLA and the OTS’s implementing regulation provide that a federal savings association has authority to

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<sup>43</sup> Financial Services Regulatory Relief Act of 2006, § 401(b), Pub. L. No. 109-351, (Oct. 13, 2006). See note 22, *supra*.

<sup>44</sup> OTS Op. Chief Counsel P-98-9, at 4 (Aug. 19, 1998), *quoting* S. Conf. Rep. No. 641, 97<sup>th</sup> Cong., 2<sup>nd</sup> Sess. 87 (1982).

<sup>45</sup> These securities are described in note 16, *supra*, and accompanying text.

provide brokerage services for all loans, investments, and securities allowed under Section 5(c).<sup>46</sup> LLC's ability to clear securities transactions by virtue of being a clearing member, and for a wider range of securities than merely those authorized in section 5(c) of the HOLA, clearly facilitates securities brokerage, an activity expressly authorized for federal savings associations.<sup>47</sup>

The third factor that we consider is whether the proposed clearing and settlement services, including membership in a clearinghouse for securities transactions, would relate to the financial intermediary role that federal savings associations were intended to fulfill. The role of a financial intermediary is to facilitate the flow of money and credit among different parts of the economy. It may do so through various means, such as receiving and transmitting funds, borrowing from savers and lending to users, providing financial support for transactions, and participating in the capital markets.<sup>48</sup> The proposed clearing and settlement services, as a member of a clearinghouse, and for a wide range of securities, include extension of credit and receipt and delivery of funds and securities. These services are integral to the role of the financial intermediary.<sup>49</sup>

The fourth and final factor that we consider is whether the clearing and settlement services are necessary for a federal savings association to remain competitive and relevant in the modern economy. We observe that the Board of Governors of the Federal Reserve System (FRB) by regulation permits bank holding companies to provide clearing services on a securities exchange "and incidental activities (including related securities credit activities and custodial services), if the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing."<sup>50</sup> Regulation Y also permits bank holding companies to provide clearing services for any futures contracts and options on futures contracts traded on commodities exchanges subject to two conditions: first, the activity is conducted through a separately incorporated subsidiary, which may engage in other activities; and second, the bank holding company parent does not provide a guarantee or otherwise become liable to the exchange or clearing association other than for trades conducted by the subsidiary for its own account or for the account of any affiliate.<sup>51</sup>

<sup>46</sup> See 12 U.S.C. § 1464(c); 12 C.F.R. § 560.30 (2006).

<sup>47</sup> We note that with respect to clearing transactions involving securities not authorized in HOLA section 5(c), OpSub-LLC would not be making investments for itself or engaging in underwriting.

<sup>48</sup> OTS Op. Chief Counsel P-98-9, at 5 (Aug. 19, 1998), citing *Auten v. United States Nat'l Bank*, 174 U.S. 125, 143 (1899). Accord, OCC Interpretive Letter No. 1014, at 5 ((Jan. 10, 2005)(national banks may become netting members of a clearing corporation, which includes participating in its loss allocation system, and may clear, net, and settle U.S. government securities).

<sup>49</sup> See OCC Interpretive Letter No. 929, 5 (Feb. 11, 2002)(clearing and execution activities are consistent with role of financial intermediaries.).

<sup>50</sup> Regulation Y, 12 C.F.R. § 225.28(b)(7)(i) (2006).

<sup>51</sup> 12 C.F.R. § 225.28(b)(7)(iv) (2006). In a major revision of its Regulation Y in 1997, the FRB determined that permitting the bank holding company to guarantee proprietary trades on a commodities exchange is appropriate. It also determined that it no longer would require review of the rules of a commodities exchange or clearinghouse

National banks are authorized by statute to buy and sell securities upon the order, and for the account of, their customers.<sup>52</sup> The Office of the Comptroller of the Currency (OCC) permits national banks and their operating subsidiaries to be clearing members of securities and commodities exchanges if their potential liability can be limited.<sup>53</sup> In fact, the OCC determined that national banks may be clearing members of, and own stock in, DTC over 30 years ago, and may be clearing members of the Options Clearing Corporation over 20 years ago.<sup>54</sup> The OCC has also permitted national banks to clear and settle trades on the NSCC and own shares of the NSCC.<sup>55</sup>

The OCC has permitted national banks to participate in loss allocation schemes that operate similarly to securities clearing houses if the banks can limit their potential liability.<sup>56</sup> The OCC also has permitted national banks to be netting members in the Loss Allocation System of the Government Securities Division (GSD) of the Fixed Income Clearing Corporation.<sup>57</sup> More recently, the OCC determined that a national bank may be a member of an Independent Systems Operator (ISO), which operates a clearing market for electric power and related products, when the loss allocation formula did not place a cap on the non-defaulting members' potential liability.<sup>58</sup> To remain competitive in the modern economy, a federal savings association, like a bank, requires authority to offer securities clearing services.

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before a bank holding company became a member; instead, it would rely upon its supervision of the risk management systems of the bank holding company. *See* 62 Fed. Reg. 9290, 9309-11 (1997).

<sup>52</sup> 12 U.S.C. § 24 (Seventh) (West 2001).

<sup>53</sup> *See, e.g.*, OCC Interpretive Letter No. 929, at 5 n.26 (Feb. 11, 2002).

<sup>54</sup> *See* OCC Interpretive Letter No. 929, *supra* note 53, at 7 (Options Clearing Corporation) *citing* OCC Interpretive Letter No. 421 (March 14, 1988), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (citing an unpublished letter dated Dec. 19, 1975); OCC Interpretive Letter No. 372 (Nov. 7, 1986) (Options Clearing Corporation).

<sup>55</sup> OCC Interpretive Letter No. 929, *supra* note 53, at 7 (dictum).

<sup>56</sup> The OCC approved an application that permitted a foreign branch of a national bank to join the London Clearinghouse (LCH) as a SwapClear member to clear interest derivative contracts, after finding that a member's original default fund contribution served as a theoretical cap on contingent liability of a non-defaulting member of LCH for the default of other members. *See* OCC Interpretive Letter No. 929, *supra* note 53, at 3.

<sup>57</sup> *See* OCC Interpretive Letter No. 1014, *supra* note 48, at 5. GSD clears, nets, settles and manages risks for its member firms (brokers, dealers, banks and other financial institution) arising from a broad range of U.S. government securities transactions. *If GSD mutualizes loss allocation obligations, a netting member may either pay or terminate its membership. If it terminates, its loss is limited to its required fund deposit. Id.*

<sup>58</sup> OCC Interpretive Letter No. 1071 (Sept. 6, 2006). The OCC's conclusion rested largely upon consideration of steps to mitigate the risk of a default allocation assessment. *Id.* at 4-12.

Whether the authority to engage in activities as a clearing member of a securities exchange derives from express or incidental power, the activities present certain risks and potential liabilities to a federal savings association. We will now discuss some of the protections we want to see in place to insure OpSub-LLC's ability to control risks and liabilities. We consider, for example, that a clearing member of an exchange is subject to two types of liabilities, incidental and contingent. The first type is liability to the exchanges or their clearinghouses for the performance of the trades of customers accepted for clearance by the clearing member. The clearing member must make payment or deliver securities to the exchange even if its customers do not perform. This liability is the functional equivalent of an extension of credit by the clearing broker to its customers, and the clearing broker may seek repayment from defaulting customers. The second type of liability is a partial contingent liability for the obligations of all other clearing members to the clearinghouse. The rules of most clearinghouses provide that, should a clearing member default and its margin and capital (including all deposits made to the clearinghouse's back-up or guaranty funds) be insufficient to cover its obligations, the clearinghouse may reach the guaranty fund deposits of all other clearing members, on a pro rata basis.<sup>59</sup> The clearing member may then become liable for an additional contribution. A limit on this second type of liability is a concern.<sup>60</sup>

Offering securities clearing services as a clearing member of an exchange presents the risk that, for a customer trade that it has accepted, OpSub-LLC must make payment or deliver securities to the clearinghouse even if its customer does not perform. OpSub-LLC would monitor the financial condition of its customers as part of its procedures to measure and monitor risk, and the introducing brokers would institute procedures to ensure that the customers fulfill their obligations.<sup>61</sup> Key to its ability to mitigate its risk, however, is the right of OpSub-LLC under its agreements with its introducing brokers to refuse prospectively to accept a trade for any reason. These agreements also authorize OpSub-LLC to reimburse itself for a loss on a margin loan to a customer through an escrow account that it requires the introducing broker to maintain with OpSub-LLC or through a deduction from money that OpSub-LLC owes the introducing broker for commissions. Without a time limit, its affiliated introducing brokers have agreed to indemnify OpSub-LLC for losses on margin loans made to their respective customers.<sup>62</sup> We conclude that OpSub-LLC would have ample means to control the risk that its clearing customers do not perform.

The authority to offer clearing services presents the risk that OpSub-LLC may be partially liable if another clearing member of the NSCC, DTC, or Options Clearing Corporation

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<sup>59</sup> See OCC Interpretive Letter No. 1071, *supra* note 58, at 4.

<sup>60</sup> See OCC Interpretive Letter No. 929, *supra* note 53, at 4 & n.19.

<sup>61</sup> The introducing brokers would require most customers to have sufficient funds in their brokerage accounts to pay for securities prior to placing the order with OpSub-LLC. In addition, the introducing brokers would require most customers to pay for securities purchased prior to delivery or deliver securities to be sold prior to payment.

<sup>62</sup> OpSub-LLC would not clear securities transactions for broker-dealers trading for their own accounts.

defaults on its obligations to these clearinghouses.<sup>63</sup> Multiple factors mitigate OpSub-LLC's exposure to liability in the event of the default of another clearing member. The SEC and self-regulatory organizations regulate these clearinghouses, which, in turn, regulate their members. They would also act as functional regulators of OpSub-LLC.

You have represented that pursuant to the reorganization, OpSub-LLC would become a member of only three clearinghouses of which LLC is currently a member. You have also reviewed the rules of these clearinghouses and provided an analysis of the potential liability of OpSub-LLC and factors that would limit this liability. Your analysis concludes that the probability is low that any of these clearinghouses would assess OpSub-LLC for the default of another member and thereby threaten the financial stability of the Association. Standard and Poors has accorded all three clearinghouses "AAA" ratings. To date, you have discovered no instances in which any of these clearinghouses assessed clearing members for the default of a clearing member rather than satisfy the liability from assets of the defaulting member or its reserve funds. Furthermore, these clearinghouses are parties to a multi-collateral cross-sharing agreement, which provides that if an individual member of multiple clearinghouses defaults on or otherwise fails to meet its obligations, all collateral maintained by that individual member at multiple clearinghouses would be applied to mitigate the loss caused by that member's default or failure to satisfy its obligations.

In addition, the three clearinghouses would require OpSub-LLC to maintain deposits in reserve funds in amounts that are relatively small compared to the total amount of deposits from members that they hold. These relatively small amounts are a reflection that, if an assessment were necessary, OpSub-LLC's share of any liability would be relatively small.

Furthermore, the proposal does not expose the Association to potential liability to the clearinghouses. The Association's separately incorporated operating subsidiary would be a clearing member, and neither the Association nor any of its affiliates would guarantee the obligations of OpSub-LLC to the clearinghouses.

Despite numerous factors that mitigate the likelihood that a clearinghouse would assess OpSub-LLC for the default of another member, or that the Association would thereby suffer a loss, we must consider the possibility, however unlikely, of catastrophic losses due to huge or numerous defaults. To that end, we have reviewed your analysis of the rules of the three clearinghouses and determined that OpSub-LLC may limit its liability for the default of another clearing member through termination of its memberships in the clearinghouses.

Within ten business days after an assessment by the NSCC, a member may notify the NSCC of its decision to terminate its membership and thus limit its liability to the lesser of the pro rata assessment or its required deposit in the reserve fund. If instead it pays the pro rata assessment and replenishes its required deposit, it may be liable for one or more subsequent pro rata assessments relating to the same loss or liability. The member may then limit its liability for

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<sup>63</sup> Neither the Association nor any other affiliate of OpSub-LLC has guaranteed the obligations of LLC to any clearinghouse or exchange and do not contemplate providing a guarantee for OpSub-LLC's obligations.

future assessments by providing notice of its termination of membership, but its liability would be the greater of the required deposit in the reserve fund or all the pro rata assessments made prior to its notification to the NSCC of termination of its membership.<sup>64</sup> The NSCC also has an addendum to its rules that sets forth its intention to apply at least 25 percent of its retained earnings to cover any loss prior to imposing a pro rata assessment on nondefaulting members.<sup>65</sup> This policy reduces OpSub-LLC's potential liability.

As a member of DTC, OpSub-LLC similarly could limit its obligations to DTC based on the default of another clearing member by providing notice of termination of membership within ten business days of a pro rata assessment. The rules of the DTC differ from those of the NSCC, in part because the DTC requires its members to pay into a reserve fund and purchase its preferred stock. However, by giving notice within the ten-day period, the nondefaulting member of DTC may limit its liability arising from the default of another member to the amount of its required deposits and investment in stock of DTC plus 100 percent of these amounts.<sup>66</sup>

The Options Clearing Corporation, like the NSCC and the DTC, permits a member to limit its liability for losses of another defaulting member through termination of its membership in the clearinghouse. The member can limit its liability to the amount of its required contribution to a reserve fund plus 100 percent of that amount by providing notice of termination within five business days of an assessment.<sup>67</sup>

As the foregoing discussion demonstrates, the proposed clearing activities for a wide range of securities and the proposed clearing memberships in securities clearinghouses meet all of the factors commonly considered in the incidental powers analysis. Accordingly, we conclude that under the incidental powers doctrine a federal savings association may (i) provide securities clearing and related services, including transactions involving securities beyond those in which the association is authorized to invest by section 5(c) of the HOLA, and (ii) serve as a clearing member of the NSCC, DTC, and Options Clearing Corporation. Based on the representations

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<sup>64</sup> See NSCC Rule 4, § 8, available at <http://www.nsccl.com/legal/nscclrules.pdf> (Nov. 8, 2006).

<sup>65</sup> See Addendum E to NSCC Rules, *supra* note 64.

<sup>66</sup> Like the NSCC rules, the DTC rules provide that if the nondefaulting member, instead of giving notice of termination of membership within the ten-day period, pays the pro rata assessment and replenishes its required deposit to the reserve fund, it would be liable for subsequent pro rata assessments relating to the same loss or liability unless and until it provided notice of termination of membership. The member's maximum liability would then be the greater of 1) its required deposit to the reserve fund, plus 100 percent, or 2) all pro rata assessments made prior to its notice of termination of membership. See DTC Rule 4, available at <https://login.dtcc.com/dtcorg/binary/19021DTC%20RULES%20-%206-5-06%20-%20Current.pdf> (Nov. 8, 2006).

<sup>67</sup> See Options Clearing Corporation By-Laws, Article VIII, § 6, available at [http://www.optionsclearing.com/publications/rules\\_bylaws\\_pdf/occ\\_bylaws.pdf](http://www.optionsclearing.com/publications/rules_bylaws_pdf/occ_bylaws.pdf) (Nov. 8, 2006). After providing notice of withdrawal, the member also may not submit any more transactions for clearance through the Options Clearing Corporation and must close out or transfer all open positions that it has with the Options Clearing Corporation. *Id.*

and information you have provided, it appears that there are acceptable controls on any risks associated with clearing memberships in securities clearinghouses.

## **B. Permissibility of Paying Interest on Free Credit Balances**

OTS regulations governing subordinate organizations provide that all federal statutes and regulations apply to operating subsidiaries in the same manner as they apply to federal savings associations, unless otherwise specifically provided by statute, regulation, or OTS policy.<sup>68</sup> Section 5(b)(1)(B)(i) of the HOLA, a provision pertaining to deposit accounts, prohibits a federal savings association from paying interest on a demand account.<sup>69</sup> Pursuant to this provision, the Association may not pay interest on a demand account. You inquire whether this prohibition would apply to LLC after it becomes OpSub-LLC, a registered broker-dealer operating subsidiary of the Association, or whether OpSub-LLC would be able to continue LLC's current practice of paying interest on customers' free credit balances. You indicate that under SEC Rule 15c3-2,<sup>70</sup> customers' free credit balances are required to be payable by LLC on demand.<sup>71</sup> For the reasons set forth below, we conclude that the prohibition against paying interest on a demand account, although applicable to the Association, would not be applicable to LLC after it becomes OpSub-LLC, an operating subsidiary of the Association.

Our conclusion that § 5(b)(1)(B)(i) of the HOLA would not prohibit OpSub-LLC from paying interest on the free credit balances of customers is based on several factors. First, by its terms, § 5(b)(1)(B) applies to "federal savings associations," which are federally insured, depository institutions. The HOLA defines the term "savings association" to mean "a savings association, as defined in Section 1813 of [Title 12 U.S.C.], the deposits of which are insured by the [Federal Deposit Insurance] Corporation" and the term "federal savings association" means "a Federal savings association or a Federal savings bank chartered under section [5 of the HOLA]."<sup>72</sup> Section 1813(b)(1) of Title 12 U.S.C. defines "savings association" to include "any Federal savings association and any state savings association, and defines "Federal savings association" to mean any Federal savings association or Federal savings bank chartered under § 5 of the HOLA. There is no reference in any of these definitions to subsidiaries. Thus, it is only by reason of the OTS's subordinate organizations regulations that a question even arises about

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<sup>68</sup> 12 C.F.R. § 559.3(h) (2006).

<sup>69</sup> Section 5(b)(1)(B) of the HOLA, 12 U.S.C. § 1464(b)(1)(B), provides "[a] Federal savings association may not – (i) pay interest on a demand account; . . ."

<sup>70</sup> 17 C.F.R. § 240.15c3-2 (2006).

<sup>71</sup> You also represent that staff of the SEC "has informally advised [LLC] and the [Association] that the reservation of the right to require prior notice of withdrawal or transfer, which is necessary in order for a bank account to qualify as a NOW or similar interest-bearing transaction account, is inconsistent with SEC Rule 15c3-2."

<sup>72</sup> 12 U.S.C. §§ 1462(4) and (5). *See also* 12 C.F.R. § 561.43 (2006), the OTS regulation that defines "savings association" to mean "a savings association as defined in section 3 of the Federal Deposit Insurance Act, the deposits of which are insured by the [Federal Deposit Insurance] Corporation."

the applicability of the § 5(B)(1)(b)(i) prohibition to an operating subsidiary of a federal savings association.

Second, a customer's free credit balance held by OpSub-LLC would not be a "demand account" within the meaning of HOLA § 5(b)(1)(B) and OTS regulations. Under the HOLA, a "demand account" is a "demand deposit account."<sup>73</sup> Under OTS regulations, a demand account is defined as a non-interest bearing "demand deposit."<sup>74</sup> OTS regulations define "account" to mean a savings account, demand account, certificate account, or several other types of accounts, whether in the form of a deposit or a share, held by an "accontholder" in a savings association.<sup>75</sup> The term "accontholder" is defined as "the holder of an account or accounts *in a savings association insured by the Deposit Insurance Fund*" (DIF).<sup>76</sup> (Emphasis added.) Previously, we have determined that, despite the prohibition on payment of interest on commercial demand deposits, federal savings associations may sweep excess funds from their deposit accounts into investments outside the association, such as government securities repurchase agreements and mutual funds.<sup>77</sup>

Based on your description, LLC is not, and OpSub-LLC will not be, a savings association insured by the DIF. A customer of OpSub-LLC, introduced by an introducing broker, would not be the holder of an account or accounts in a savings association insured by the DIF. Therefore, such a customer would not be an "accontholder" under OTS regulations. Similarly, after OpSub-LLC is established as an operating subsidiary of the Association, OpSub-LLC would not be a DIF-insured savings association and would not have accontholders, *i.e.*, the holders of accounts in a DIF-insured savings association, within the meaning of OTS regulations. A customer's free credit balance held by LLC-OpSub therefore would not be a "demand account" within the meaning of HOLA § 5(b)(1)(B). In our view, the statutory prohibition was not intended to reach funds that are held by an entity that is not a DIF-insured, depository institution.

Third, a free credit balance is not an insured deposit. The Federal Deposit Insurance Act (FDIA)<sup>78</sup> defines an "insured deposit" as a "net amount due to any depositor for deposits in an

<sup>73</sup> Section 5(b)(1)(A) provides that "[s]ubject to the terms of its charter and regulations of the Director, a Federal savings association may – (i) raise funds through such deposit, share, or other accounts, including demand deposit account (hereafter in this section referred to as "accounts"); . . . " 12 U.S.C. § 1464(b)(1)(A).

<sup>74</sup> 12 C.F.R. § 561.16 (2006).

<sup>75</sup> 12 C.F.R. § 561.2 (2006). The HOLA does not define the term "account" as it is used in 5(b)(1)(B). *See* 12 U.S.C. §§ 1461 *et seq.*

<sup>76</sup> 12 C.F.R. § 561.3 (2006) as amended by 71 Fed. Reg. 19810-11 (April 18, 2006).

<sup>77</sup> OTS Op. Chief Counsel P-98-1 (March 2, 1998)(repurchase agreements); OTS Op. Chief Counsel P-2000-10 (August 1, 2000)(mutual funds). A sweep arrangement from a deposit account to another account in a depository institution is impermissible if the accounts are commercial demand accounts, however. *See* OTS Op. Chief Counsel P-98-1 (March 2, 1998).

<sup>78</sup> 12 U.S.C. §§ 1811 *et seq.*



insured depository institution . . .”<sup>79</sup> Because OpSub-LLC would not be an insured depository institution, the free credit balances that it holds would not be insured deposits under the FDIA. Therefore, to the extent the prohibition on payment of interest on demand accounts is related to federal deposit insurance, the HOLA § 5(b)(1)(B)(i) prohibition is inapposite.

We also note that, like LLC, after the proposed reorganization OpSub-LLC would be a registered broker-dealer. Although it would be an operating subsidiary of the Association, OpSub-LLC would be a functionally regulated entity, subject to the supervision, examination, and enforcement authority of the Securities and Exchange Commission (SEC) as its primary regulator, as well as OTS.<sup>80</sup> Thus, SEC Rule 15c3-2 would apply to OpSub-LLC. This rule, which requires that funds arising out of any free credit balances be payable on demand,<sup>81</sup> is predicated upon the assumption that earnings on a free credit balance belong to the customer. If these earnings are considered interest on a demand deposit, Rule 15c3-2 conflicts with HOLA’s prohibition on payment of interest on demand deposits.

Generally, OTS regulation § 559.3(h)(1) would require that a provision in HOLA apply to OpSub-LLC in the same manner as it applies to federal savings associations *unless otherwise provided by statute, policy, or regulation*. In this instance, even if HOLA’s prohibition on payment of interest on demand deposits applies to a broker-dealer operating subsidiary, the SEC’s conflicting Rule 15c3-2 would provide that the HOLA prohibition would not apply.

We note that similar prohibitions against paying interest on demand accounts exist with respect to other types of depository institutions and that other federal banking regulators have construed such prohibitions in a manner that would not preclude the payment of interest on free credit balances in accounts with affiliated broker-dealers.<sup>82</sup> OTS previously has followed interpretations of the FRB and the FDIC regarding the prohibition of payment of interest on demand accounts.<sup>83</sup> Section 19(i) of the Federal Reserve Act prohibits member banks from

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<sup>79</sup> 12 U.S.C. § 1813(l) and (m).

<sup>80</sup> See OTS Holding Companies Handbook Section 200, at 200.2 – 200.4. The Handbook, for example, identifies registered broker-dealers as being regulated by the SEC and the NASD and establishes procedures for purposes of regulatory coordination and communication when a functionally regulated entity is a subsidiary of a thrift.

<sup>81</sup> See 17 C.F.R. § 240.15c3-2 (2006). This rule provides that a broker-dealer may not use earnings on its customer’s free credit balance to operate its business unless, at least once every three months, it provides the customer a written notice stating that the funds are not segregated and may be used to operate the brokerage business. The written notice must also advise the customer that the funds are available upon demand. The rule applies unless the broker or dealer is a banking institution supervised and examined by state or federal authority having supervision over banks. Here OpSub-LLC would not be a “banking institution,” however.

<sup>82</sup> Prohibitions that apply to banks are similar, but not identical, to the prohibition on payment of interest on demand deposits by federal savings associations. In this regard, we note that *other insured depository institutions* may pay interest on *retail* demand deposits. See 12 U.S.C. § 371a (member banks); 12 U.S.C. § 1828(g)(insured nonmember banks and insured branches of foreign banks).

<sup>83</sup> See OTS Op. Chief Counsel, at 3 (May 29, 2003)(federal savings associations may provide reward points to customers who use Visa U.S.A. Inc. debit cards to access demand deposit accounts); Memo. OTS Chief Counsel P-

paying interest on demand deposits except for those held by individuals.<sup>84</sup> The FRB has defined “interest” as “any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit.”<sup>85</sup> For purposes of section 19(i), the FRB has adopted the definition of “deposit” used in its Regulation D, Reserve Requirements of Depository Institutions.<sup>86</sup> A “deposit,” in pertinent part, therefore means:

The unpaid balance of money or its equivalent received or held by a *depository institution* in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to an account, including interest credited, or which is evidenced by an instrument on which *the depository institution* is primarily liable.

(emphasis added).<sup>87</sup> By regulation, the FRB has limited the prohibition on payment of interest on commercial demand deposits to accounts held in depository institutions.<sup>88</sup>

The FRB’s limitation of the prohibition to accounts in depository institutions is evident in its orders that permit nonbank subsidiaries of bank holding companies that are securities broker-dealers to pay interest on credit balances. Without discussion of the prohibition of payment of interest, the FRB determined that carrying customer credit balances awaiting investment and paying interest on them are activities incidental to permissible securities brokerage and thus permissible for a broker-dealer subsidiary of a bank holding company.<sup>89</sup>

The OCC filed a comment letter that strongly supported the FRB’s initial approval of paying interest on credit balances of customers of a brokerage subsidiary of a bank holding

98-1 (March 2, 1998)(reviewing types of sweep accounts that federal banking agencies determined did not violate the prohibition on payment of interest on demand accounts).

<sup>84</sup> See 12 U.S.C. § 371a. See also 12 C.F.R. § 217.3 (2006).

<sup>85</sup> See 12 C.F.R. § 217.2(d) (2006)(Regulation Q) (2006). The definition also provides that “[a] member bank’s absorption of expenses incident to providing a normal banking function or its forbearance from charging a fee in connection with such a service is not considered a payment of interest.” *Id.* Section 19(a) of the Federal Reserve Act, 12 U.S.C. § 461(a), authorizes the FRB to define terms and prescribe regulations to implement section 19(i).

<sup>86</sup> 12 C.F.R. § 217.2(b) (2006)(Regulation Q).

<sup>87</sup> 12 C.F.R. § 204.2(a)(1) (2006)(Regulation D).

<sup>88</sup> See 12 C.F.R. §§ 204.2(a) and 217.2(b) (2006).

<sup>89</sup> See, e.g., *United Jersey Banks*, 69 Federal Reserve Bulletin 565 n.6 (1983)(acquisition of discount broker Richard Blackman & Co., which would pay interest on some credit balances awaiting investment); *BankAmerica Corp.*, 69 Federal Reserve Bulletin 105, n.11 (1983)(acquisition of discount broker Charles Schwab Corp., which would pay interest on idle credit balances to be swept into an unaffiliated money market mutual fund or unaffiliated commercial bank). The U.S. Supreme Court upheld the FRB’s approval of BankAmerica’s acquisition of Charles Schwab without discussion of the permissibility of payment of interest on credit balances. See *Securities Industry Ass’n v. Board of Governors of the Federal Reserve System*, 468 U.S. 207 (1984).

company. The OCC advised that paying interest on customer balances arising from brokerage transactions is incidental to permissible securities brokerage activities and “obviously a banking function” that is “currently performed by commercial banks.” The OCC therefore urged the FRB to determine that paying interest on these credit balances is closely related to banking and a proper incident thereto.<sup>90</sup>

Several months after filing its comment letter urging the FRB’s approval of a bank holding company’s acquisition of a broker-dealer, the OCC approved a national bank’s establishment of an operating subsidiary that would conduct discount securities brokerage activities. The OCC concluded, albeit in a context other than section 19(i), that credit balances arising in connection with securities brokerage transactions are not deposits, and that a national bank’s discount brokerage operating subsidiary that maintains and pays interest on customer credit balances would not be receiving deposits.<sup>91</sup> The OCC distinguished credit balances arising incidentally to brokerage activities on functional and legal grounds from bank deposits, noting that

[b]ank deposits are generally funds placed with a depository institution for the primary purpose of safekeeping, earning a return in the form of interest, or facilitating payments to third parties. They may be withdrawn at the discretion of the depositor under the terms and conditions of the account. The receipt of deposits is a principal function of banks, which publicly solicit deposits to provide funds to be used in the banks’ lending business. Credit balances maintained by brokers, on the other hand, arise in connection with securities transactions of customers and, as such, are not directly solicited from the public. Indeed, the Securities Investor Protection Act, . . . operates to restrict the advertising, promotional and selling practices of brokers regarding interest-bearing free credit balances. . . . Further, there are specific regulatory restrictions regarding the use of credit balances by brokers.

Finally, the OCC noted that the meaning of the term “deposit” may be different, depending upon the statutory or regulatory context.<sup>92</sup>

<sup>90</sup> See OCC comment on BankAmerica Corp.’s Proposed Acquisition of Charles Schwab Corp., 1982 OCC QJ LEXIS 1179 (June 10, 1982). The comment letter did not state whether the brokerage activities were conducted directly in the banks and the resulting credit balances held by the banks, rather than in operating subsidiaries. *Id.*

<sup>91</sup> The OCC concluded that credit balances are not deposits within the meaning of the McFadden Act, and that therefore the offices at which the discount brokerage would offer its services would not constitute “branches” under the McFadden Act because none of the statutory branching functions – receiving deposits, paying checks, or lending money – would be performed. Decision of the OCC on the Application by Security Pacific National Bank to Establish an Operating Subsidiary to Be Known as Security Pacific Discount Brokerage Services, Inc., 1982 OCC QJ LEXIS 1287 (Aug. 26, 1982).

<sup>92</sup> The OCC stated “[e]ven assuming that credit balances are treated as deposits for the narrow monetary control purposes of Regulation D, however, it should be recognized that the meaning of deposit may be different in other regulatory or statutory contexts, such as under the McFadden Act.” Decision of the OCC on the Application by

In the context of the prohibition of payment of interest on commercial demand deposits, both the OCC and FRB have distinguished between free credit balances in a securities brokerage account and deposits in a depository institution. The OCC's comment letter and the FRB's subsequent approval of an application in 1983 thus indicate that the permissibility of payment of interest on customer credit balances by brokerage affiliates of national banks and bank holding companies is well established.

The permissibility of payment of interest on customer credit balances by brokerage affiliates of nonmember, insured banks is also well established. Like section 19(i) of the Federal Reserve Act and Regulation Q,<sup>93</sup> the Federal Deposit Insurance Act and FDIC regulations impose a prohibition on the payment of interest on commercial demand deposits in insured nonmember banks. The Federal Deposit Insurance Act provides that exceptions to the prohibition shall be made the same as exceptions to the prohibition applicable to member banks.<sup>94</sup>

In responding to a bank's proposal to establish a sweep account for certain customers, the FDIC indicated that such an account would not violate the FDIC regulation prohibiting state nonmember banks from paying interest on demand deposits.<sup>95</sup> The FDIC characterized the issue as "whether the investment account, or the sweep account arrangement as a whole, violates the prohibition on the payment of interest on demand deposits." Concluding that neither the investment account nor the sweep arrangement violates the prohibition, the FDIC reasoned, citing 1831(l), that funds in the investment account do not constitute a demand deposit within the meaning of FDIC regulation § 329.1 because "deposit" refers to money or its equivalent "received or held by a bank or a savings association." Since a mutual fund is not a bank, funds in the investment account are not deposits under section 3(l) of the FDIA. In addition, the FDIC concluded that earnings on the funds in the investment account are not "interest" within the meaning of FDIC regulation § 329.1(c) because the earnings are not "payment to or for the account of any depositor as compensation for the use of funds constituting a deposit" and the earnings are not paid by the bank. Thus, the FDIC, like the FRB and OCC, would not apply a statutory prohibition on the payment of interest on demand deposits to the payment of interest

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Security Pacific National Bank to Establish an Operating Subsidiary to Be Known as Security Pacific Discount Brokerage Services, Inc., 1982 OCC QJ LEXIS 1287 (Aug. 26, 1982).

<sup>93</sup> 12 U.S.C. § 371a; 12 C.F.R. Part 217 (2006).

<sup>94</sup> 12 U.S.C. § 1828(g). *See also* 12 C.F.R. § 329.2 (2006)(FDIC implementing regulation).

<sup>95</sup> FDIC Advisory Opinion #00-2 (April 4, 2002), available at <http://www.fdic.gov/regulations/laws/rules/4000-10040.html> (July 28, 2006). The sweep account would be linked with an investment account maintained at a money market mutual fund operated by unaffiliated third parties; the bank would not own or operate the money market fund. The FDIC distinguished its Advisory Opinion #92-27, in which it concluded that a sweep account violated the prohibition of payment of interest on demand deposits: 1) in the earlier opinion the demand deposit account and investment account were both in the bank; 2) the customer could automatically transfer funds between the two accounts; and 3) the bank paid interest on the account that violated the prohibition, whereas in the sweep arrangement at issue in Advisory Opinion #00—2, the Money Market Fund paid the customer earnings from the fund's investments. *Id.* at n.1.

from earnings on customers' free credit balances held in a broker-dealer subsidiary of an insured depository institution.

### **Conclusion**

We conclude that federal savings associations may conduct the clearing activities currently being conducted by LLC, as described in the Background section hereof. Accordingly, after the reorganization, when LLC becomes OpSub-LLC, an operating subsidiary of the Association, OpSub-LLC may continue to conduct such clearing activities subject to supervisory conditions established by the OTS's Southeast Regional Office. Further, we conclude that the payment of interest on customers' free credit balances by OpSub-LLC would not violate the HOLA § 5(B)(1)(b)(i) prohibition against paying interest on demand accounts.

In reaching the foregoing conclusions, we have relied on the factual information and representations contained in the materials you submitted to us and in subsequent discussions with OTS staff. Our conclusions necessarily depend upon the accuracy and completeness of such information and representations. Any material difference in facts or circumstances from those described herein could result in different conclusions.

If you have any questions regarding this matter, please contact Martha Vestal Clarke, Counsel, at (202) 906-6087 or Vicki Hawkins-Jones, Special Counsel, at (202) 906-7034.

Sincerely,

/s/

John E. Bowman  
Chief Counsel

cc: Regional Directors  
Regional Counsel