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Interpretive Letters

921—December 13, 2001

12 USC 21–23
12 USC 51B
12 USC 51A

Re: [ ] (In Organization), [ ], California ("bank")

Dear [ ]:

This is in response to your letter of November 29, 2000, asking whether the bank may adopt articles of association that permit its board of directors to issue blank check preferred stock. For the reasons discussed below, including your representations, we have concluded the bank may adopt such articles.

I. Background

The bank has elected in its bylaws to be governed by the California Corporations Code, and it would like to adopt articles of association ("articles") containing a provision authorizing the bank's board of directors ("board") to issue preferred stock using a blank check procedure ("blank check preferred stock"). Under current OCC procedures, shareholders typically approve an amendment to the articles for each separate issuance of preferred stock. The amendment sets forth the specific terms of the preferred stock.[1] Under the bank's proposal, shareholders will instead approve an amendment to the articles setting an overall authorized amount of preferred stock and delegating to the board the ability to issue and determine the terms of one or more series of preferred stock.[2] From time to time, the board will pass resolutions approving and defining the terms of series of preferred stock. You state that the bank will amend its articles to provide that such resolutions will be incorporated by reference into the articles of association. No further separate shareholder action to amend the articles will be required to issue or determine the terms of preferred stock that may be issued within the authorized amount.

II. Discussion

A. Interpretive Ruling 7.2000(b)

Under Interpretive Ruling 7.2000(b), a national bank may designate in its bylaws and elect to follow the corporate governance procedures of the state in which it is located, to the extent not inconsistent with applicable federal banking statutes or regulations and bank safety and soundness. The bank has designated California corporate governance procedures in its bylaws. Therefore the bank may issue preferred stock through the proposed blank check procedure if consistent with California law, and if not inconsistent with federal banking statutes or regulations and bank safety and soundness.

B. California Law Permits Blank Check Preferred Stock

You represent that California law permits corporations to issue blank check preferred stock. The bank is proposing to use an article derived from Section 202(e) of the California Corporations Code to issue blank check preferred stock.[3]

C. The Bank's Proposed Issuances of Preferred Stock through the Blank Check Procedure Are Consistent with Federal Banking Statutes and Regulations

The principal issue is whether blank check preferred stock is consistent with 12 USC 51a and 51b. We have concluded that the blank check procedure satisfies the shareholder approval and other requirements of these statutes. Neither the plain language nor legislative history of 12 USC 51a or 51b precludes a national bank from using the blank check procedure. Shareholders' adoption or approval[4] of a blank check preferred stock article constitutes the shareholder action required by 12 USC 51a

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[1] Under 12 CFR 5.46(k), a national bank shall obtain the necessary shareholder approval required by statute for any change in its permanent capital. Since 1989 the OCC has not permitted the use of a blank check procedure by national banks to issue preferred stock, as discussed below. Prior to 1989, the OCC had expressly permitted national banks to use the blank check procedure.

[2] The term "series" is defined in the California Corporations Code as "those shares within a class which have the same rights, preferences, privileges and restrictions but which differ in one or more rights, preferences, privileges or restrictions from other shares within the same class." Cal. Corp. Code § 183 (West 1990).

[3] Section 202(e) of the California Corporations Code authorizes the filing of articles with blank check preferred stock features. Sections 401 and 156 of that code require the board to execute and file certificates of determination that include resolutions setting forth the number of shares of series and terms of classes or series of stock. State banks in California may use the blank check procedure to issue preferred stock. *Cf.* Cal. Fin. Code §§ 600.8 & 112 (West 1990) (filing of certificate of determination with secretary of state and commissioner of financial Institutions).

[4] This shareholder action must be consistent with the requirements of 12 USC 21 or 21a. These statutes govern the adoption of, and amendments to, national banks' articles of association.

and 51b to issue and establish the terms of preferred stock. Thus, the bank may incorporate into its articles, board resolutions setting forth the terms of the preferred stock, in the manner specified in the articles.[5]

(1) 12 USC 51a and 51b

Two pertinent federal statutes governing the issuance and terms of preferred stock by national banks are 12 USC 51a and 51b. These two statutes generally require shareholder approval and appropriate article amendments for issuance of preferred stock, and that the terms of preferred stock be set forth in the articles. Twelve USC 51a states:

> Notwithstanding any other provision of law, any national banking association may, with the approval of the Comptroller of the Currency and *by vote of shareholders owning a majority of the stock of such association*, upon not less than five days' notice, given by registered mail or by certified mail pursuant to action taken by its board of directors, issue preferred stock of one or more classes, in such amount and with such par value as shall be approved by said Comptroller, and make such amendments to its articles of association as may be necessary for this purpose; but in the case of any newly organized national banking association which has not yet issued common stock, the requirement of notice to and vote of shareholders shall not apply. No issue of preferred stock shall be valid until the par value of all stock so issued shall be paid in and notice thereof, duly acknowledged before a notary public by the president, vice president, or cashier of said association, has been transmitted to the Comptroller of the Currency and his certificate obtained specifying the amount of such issue of preferred stock and his approval thereof and that the amount has been duly paid in as a part of the capital of such association; which certificate shall be deemed to be conclusive evidence that such preferred stock has been duly and validly issued (emphasis added).

The relevant language in 12 USC 51b provides

> (a) Notwithstanding any other provision of law, whether relating to restriction upon the payment of dividends upon capital stock or otherwise, the holders of such preferred stock shall be entitled to receive such cumulative dividends and shall have such voting and conversion rights and such control of management, and such stock shall be subject to retirement in such manner and upon such conditions, as may be provided in the articles of association, with the approval of the Comptroller of the Currency.

(2) The Blank Check Procedure Is Consistent with the Literal Requirements of 12 USC 51a and 51b

Under current procedures permitted by OCC, the board of directors of a bank approves the terms of each proposed issuance of preferred stock, and submits each proposal to the Comptroller and to shareholders for approval. Before the stock is certified, the board and shareholders each approve an article amendment to reflect the increased level of issued and outstanding stock and the terms of the stock. The plain language of the statutes may be read to be consistent with this procedure. However, other procedures, including the blank check procedure, also are consistent with a plain reading of the statutes.[6] The statutes do not specify precisely when in the process shareholder or Comptroller approval must be obtained or when the articles must be amended. Section 51a does not say that shareholders must separately approve each separate issuance.

Shareholders' adoption or approval of an article or article amendment establishing a blank check procedure for preferred stock constitutes the shareholder action required to issue and establish the terms of preferred stock.[7] In addition, the other statutory requirements are met through the blank check procedure. The board of directors approves a proposed blank check article and its submission to a shareholder vote. Shareholders receive the required notice of the vote (unless no vote is

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[5] The language of 12 USC 51a may also be interpreted to require a shareholders' vote and approval for each issuance of preferred stock. However, the statute does not explicitly require this outcome and the interpretation herein is consistent with the language of the statute and OCC's policy on corporate governance generally, as described below.

[6] Prior to 1989, the OCC had permitted national banks to have articles containing provisions for blank check preferred stock. *See, e.g.*, letter from Sharon Miyasato, dated April 16, 1985 (unpublished); letter from Elizabeth Malone, dated April 15, 1988 (unpublished). However, in 1989 the OCC limited the scope of those provisions to articles that delegate to directors only the authority to determine exact interest rates and define maturity dates of preferred stock. Interpretive Letter No. 488, March 23, 1989. The OCC stated that as a matter of policy, national bank directors should not have unfettered discretion to change the capital structure of a bank without shareholder approval. In 1996, however, the Office adopted Interpretive Ruling 7.2000, reflecting a general policy to authorize state law governance of corporate practice issues. Therefore, OCC policy has evolved since 1989 in a manner that supports this proposal.

[7] All U.S. jurisdictions today allow the blank check procedure. MODEL BUSINESS CORP. ACT. ANN. § 6.02, Statutory Comparison (1999). Under 12 USC 21, 21a and 51a, national banks generally may incorporate any lawful corporate procedures for adopting or amending articles to issue preferred stock.

required due to the exception clause).[8] The Comptroller approves the amounts and par values of each issuance of the preferred stock (or classes of preferred stock) at the appropriate time, and in the appropriate manner, in the process. The bank makes other amendments to the articles of association *(e.g.,* to reflect the issued and outstanding preferred stock and its terms after it is issued) in the manner specified in the blank check article.[9] Finally, the bank and the Comptroller comply with the appropriate procedures for certification. These actions satisfy all of the requirements of the statutes.[10]

D. Blank Check Preferred Stock Is Consistent with Bank Safety and Soundness

Permitting national banks to issue blank check preferred stock is consistent with bank safety and soundness. Preferred stock offers banks an attractive way to raise needed capital.[11] If banks must hold a shareholder meeting to authorize each separate issuance of preferred stock, they may be unable to raise needed capital expeditiously or compete for funds in a changing market. Blank check preferred stock enables banks to respond quickly to market conditions and sell preferred stock to meet their capital needs.

Issuance of blank check preferred stock affects the interests of existing shareholders. However, a bank board's fiduciary duties to shareholders provide protection against inappropriate use of blank check preferred stock. In addition, banks are required to submit the terms of the sale of the preferred stock to the OCC for its review before issuing any of the preferred shares. *See* 12 CFR 5.46(g). This OCC review provides a safeguard against issuances of preferred stock that are detrimental to a bank's safety and soundness.

[8] The exception clause in the statute provides that "in the case of any newly organized national banking association which has not yet issued common stock, the requirement of notice to and vote of shareholders shall not apply."

[9] Under 12 USC 21a, a national bank's articles may be amended in the manner specified in the articles, unless otherwise specifically provided by law. Thus the bank may incorporate into the articles, resolutions setting forth the terms of the preferred stock, as approved by the Comptroller, in the manner specified in the articles.

[10] We also have examined the legislative history of 12 USC 51a and 51b. Nothing in the legislative history of those statutes specifically precludes national banks from issuing blank check preferred stock in the proposed manner. The statutes were passed under emergency conditions during the banking crisis of 1933 with no hearings and little debate. None of the debate concerned the degree of shareholder approval for the issuance or terms of preferred stock.

[11] The original provisions authorizing national banks to issue preferred stock were added to enable shareholders, the Reconstruction Finance Corporation or others to strengthen the capital sources and add resources to national banks by purchasing preferred stock. 79 CONG. REC. 55, 79 (1933) (remarks of Mr. Barkley, remarks of Mr. Steagall).

III. Conclusion

In conclusion, the bank may amend its articles of association to authorize it to issue preferred stock through the blank check procedure, as discussed above. If so, the articles should require resolutions issuing and defining the terms of series of preferred stock to be incorporated by reference into the articles. If you have any further questions, please feel free to contact me at (202) 874-5210.

Michael C. Dugas
Senior Attorney
Securities and Corporate Practices Division

922—December 13, 2001

12 CFR 16

Re: [ ] ("bank") Proposal to Offer FDIC-Insured Deposit Notes

Dear [ ]:

This responds to your letter of May 8, 2001, requesting an interpretive opinion[1] that certain deposit notes of the bank to be offered and sold through the bank's affiliated retail securities broker–dealer network, would not constitute the sale of "securities" as defined in OCC securities offering regulations at 12 CFR Part 16. Based on your representations and the facts that you provided, it is our opinion that the bank's deposit notes are not securities and, therefore, not subject to registration under Part 16.

A. Background

The bank proposes to issue and market certain FDIC-insured deposit notes through the retail distribution network of [ ] (" ").[2] [ ] is a wholly owned indirect subsidiary of [ ] Corporation, a bank holding company that in turn owns 100 percent of the bank. [ ] is a broker–dealer registered with the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 ("Exchange Act").

[1] We limit our opinion to the applicability of Part 16 to the offering of deposit notes. We offer no views as to any other legal issues the introduction of this product may raise.

[2] The bank in future may sell the deposit notes through unaffiliated broker-dealers or through its other affiliated broker-dealer, [ ], under the same general terms and conditions.

Deposit notes represent transferable individual time deposits of the bank held in book entry form. The bank will offer deposit notes in denominations of $5,000 or $10,000 for terms ranging to 20 years, with fixed or floating rates of interest. The bank, through [ ], will provide purchasers a disclosure statement ("disclosure statement") describing all material terms of the deposit notes, such as restrictions on early withdrawal by customers and information required by Regulation DD[3] of the Board of Governors of the Federal Reserve System ("Federal Reserve Board") to implement the Truth in Savings Act.[4] The deposit notes will be the bank's direct deposit liabilities and FDIC-insured. The bank will include its liabilities for deposit notes in its report of deposits to the local Federal Reserve Bank and maintain reserves in compliance with Regulation D of the Federal Reserve Board.[5]

The bank will market deposit notes through [ ]'s broker–dealer network. [ ] customers will deliver their funds for deposit to [ ]. [ ] will act as the customers' agent in accepting and transferring the money to the bank for deposit. The bank will compensate [ ] on a transaction-related basis for the services it provides. [ ] will not charge depositors any fees on deposit note purchases. Purchasers will receive the same rate of interest regardless of whether they purchase the deposit notes directly from the bank or [ ]. Although the deposit notes are transferable, the bank will disclose that [ ] has sole discretion to maintain a secondary market for deposit notes. Depositors will not receive any liquidity guarantees or assurances with respect to deposit notes.

B. Law

1. The Securities Act and OCC Regulation

The OCC's securities offering disclosure regulations provide that, absent an available exemption, no person may offer and sell a security issued by a national bank without meeting the registration and prospectus delivery requirements of Part 16.[6] Part 16 attempts to achieve the purposes underlying the registration requirements of the Securities Act of 1933 ("Securities Act"), *i.e.,* to provide the investing public full disclosure of the material facts and circumstances regarding the offer and sale of securities by national banks.[7]

Part 16 generally incorporates by reference the definitions, registration and prospectus delivery requirements of the Securities Act and SEC implementing rules, including the Securities Act definition of "security."[8] The Securities Act, however, exempts "any security issued or guaranteed by any bank."[9] Part 16 does not incorporate this exemption; it applies to securities issued by banks. Accordingly, the registration and prospectus delivery requirements of Part 16 would apply to the offer and sale of deposit notes if those bank-issued instruments meet the definition of security in the Securities Act. Although this definition does not specifically include "deposit notes," the definition is broad and courts have construed it broadly.

2. Case Law

The Supreme Court in *SEC* v. *W.J. Howey*, held that an instrument is an "investment contract" and thus a security for purposes of the Securities Act if it evidences: (1) an investment (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others.[10] Applying that test, the Supreme Court held that bank-issued insured certificates of deposits ("CDs") were not securities for purposes of the antifraud provisions of the federal securities laws, given the extensive protections that the federal bank regulatory scheme affords depositors.[11]

In *Marine Bank* v. *Weaver,* the Supreme Court recognized an important difference between a bank-issued certificate of deposit[12] and other long-term debt obligations that are securities, since the CD issuer, a federally regulated

[3] 12 CFR Part 230.

[4] 12 USC 4301 *et seq.*

[5] 12 CFR Part 204.

[6] 12 CFR 16.3(a)(1) and (2).

[7] Office of the Comptroller of the Currency, 12 CFR Parts 5 and 16, 59 *Fed. Reg.* 54,790, 54,798 (Nov. 2, 1994).

[8] 12 CFR 16.2. The Securities Act defines a security as " . . . any note, stock, treasury stock, . . . bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . or, in general, any interest or instrument commonly known as a 'security' . . . . " 15 USC 77b(1). In 1994, the OCC revised Part 16 to provide that its registration requirements applied to bank-issued senior and subordinated debt. At the same time, however, the OCC made clear that it did not intend the definition of security in Part 16 to cover insured or uninsured bank deposits or traditional bank products. The preamble to Part 16 stated that "[t]he definition of 'security' in the final rule does not specifically exclude traditional bank products. Nevertheless, the OCC does not intend that the definition cover insured or uninsured deposits or other traditional bank products, including letters of credit, banker's acceptances, or repurchase agreements." 59 *Fed. Reg.* at 54,798.

[9] 12 CFR 16.5.

[10] *SEC* v. *W.J. Howey*, 328 U.S. 293 (1946) ("*Howey*").

[11] *Marine Bank* v. *Weaver,* 455 U.S. 551 (1982) ("*Marine Bank*"). The Court considered the Exchange Act, rather than the Securities Act definition of security, but noted both definitions are "essentially the same." *Id.* at 555 n.3.

[12] Although the Exchange Act definition of security includes a "certificate of deposit, for a security," that term refers to instruments issued by protective committees in corporate reorganizations, rather than bank-issued CDs. *Id.*, 455 U.S. at 557 n. 5. Accordingly, to qualify as a security, a CD must be either a note or an investment contract.

bank, is subject to a comprehensive set of regulations governing the banking industry. For example, insured deposits in federally regulated banks are protected by reserve, reporting, and inspection requirements. The Court distinguished CDs from ordinary long-term debt securities that carry a risk of the borrowers' insolvency and found it unnecessary to provide additional protection under federal securities law. However, a CD does not invariably fall outside of the federal securities law definition of security. Each transaction must be analyzed "on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole."[13]

The Court of Appeals for the Second Circuit, in *Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., et al.,* relied on this opening, holding that the insured CDs marketed and sold by a broker–dealer were securities under the federal securities laws.[14] A broker created a program to market bank-issued CDs to its customers. The broker purchased from issuing banks CDs with interest rates below those that the same banks sold directly to customers. The broker resold the CDs at the same, lower rates to its customers. The issuing banks paid the broker as compensation this differential in interest rates between the two types of CDs. The broker also created and maintained a secondary market in those CDs.

The Second Circuit distinguished the CDs in *Gary Plastics* from those in *Marine Bank* based on the activities of the broker. The *Gary Plastics* broker was investigating issuers, marketing CDs, and establishing a secondary market in those instruments, thus creating a "common enterprise" within the meaning of *Howey*. The instrument offered purchasers the possibility of price appreciation due to interest rate movements and an ability to capitalize on those movements in a secondary market. The court found that the broker also contributed expertise to the project by maintaining a pool of willing CD issuers.[15]

Given the differences between the conventional CDs in *Marine Bank* and the investments in *Gary Plastics*, the court found that, "absent the securities laws, plaintiff has no federal protection against fraud and misrepresentation by the defendants in the marketplace."[16] However, the Second Circuit reaffirmed the *Marine Bank* holding that federal banking laws protected CD purchasers from possible abuses by the issuers. Additional federal securities law protection was necessary to protect only against abuses by the *broker* in administering the program.[17]

C. Analysis

Application of both the *Howey* and *Reves* tests confirms that the deposit notes are not investment contracts or notes, and thus not securities for purposes of Part 16. Deposit notes are not investment contracts, but deposit liabilities subject to the same regulatory scheme that applied to the CDs in *Marine Bank.* The bank will include its liabilities for deposit notes in its report of deposits to the local Federal Reserve Bank and maintain reserves pursuant to Regulation D of the Federal Reserve Board. Depositors are assured of the return of their principal and interest, subject to applicable FDIC insurance limits. The bank must meet the requirements of the Truth in Savings Act and Regulation DD in marketing the deposit notes. Since the bank and its deposit note program are subject to an extensive regulatory scheme, it is unnecessary to impose additional federal securities law requirements or corresponding Part 16.

[ ]'s participation in the sale of deposit notes does not change this analysis. [ ]'s activities do not resemble those of the broker-dealer in *Gary Plastics,* which actively designed and administered a deposit-gathering program. [ ] is limiting its role to a sales agent for retail customers, accepting customer funds for deposit with the bank. [ ] is not creating certificates or monitoring the creditworthiness of bank issuers. [ ] does not contribute expertise by maintaining a pool of CD issuers. The bank is the only issuer of deposits in this program.

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[13] *Id.,* 445 U.S. at 558, 560 n. 11.

[14] *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., et al.*, 756 F.2d 230 (2d Cir. 1985) ("*Gary Plastics*").

[15] *Id.*, 756 F.2d at 240.

[16] *Id.*

[17] The Supreme Court in *Reves* v. *Ernst & Young*, 494 U.S. 56 (1990) ("*Reves*") later found that application of the *Howey* test for investment contracts may be meaningless in considering whether a different type of instrument, such as notes, is a security. It developed a separate analysis for determining whether a note is a security under the federal securities laws. The Court began by presuming that every "note" is a security, then recognized that some notes "obviously" are not securities. It identified four criteria for determining whether a note has the "family resemblance" necessary for inclusion in a list of notes that courts previously held are not securities. If a note is not sufficiently similar to others on that list, the reviewing court may apply these criteria to determine whether to add another category. These criteria involve the motivations of both parties to the underlying transaction, the plan of distribution for the note, and the reasonable expectations of the investing public. A court then considers whether another factor, *e.g.,* the existence of another regulatory scheme, reduces the risk of the instrument. For example, if the seller intends to finance a general business enterprise and the buyer is motivated by a profit, the note is likely to be a security. But, if the seller has a commercial or consumer purpose, or the buyer has another purpose, *e.g.,* the right to purchase housing, the note is less likely to be a security. If there is "common trading for speculation or investment," the note is more likely a security. A court is likely to affirm the views of the investing public if it reasonably views a note as a security. If there already is a comprehensive regulatory scheme, a court does not also apply the securities laws to the instrument.

In *Gary Plastics*, the defendant's creation and maintenance of a secondary market was crucial in its marketing efforts and permitted holders to profit from interest rate movements. [ ], in contrast, is making no assurances to depositors concerning the existence of a secondary market. Although the deposit notes are transferable, the bank will disclose that [ ] has sole discretion to maintain a secondary market in the deposit notes. Depositors will not receive any liquidity assurances with respect to deposit notes. Because there is no assurance that deposit notes will be more liquid than CDs or other deposits generally, the bank does not offer purchasers an enhanced possibility of price appreciation due to interest rate movements.

The compensation structure in this case is unlike that in *Gary Plastics.* [ ] will receive compensation from the bank on a transaction basis for the services it provides. [ ]will not charge depositors any fees for deposit notes purchases. Purchasers will receive the same rate of interest regardless of whether they purchase deposit notes directly from the bank or [ ].

Given the limited role of [ ] in the program, additional protections afforded by the federal securities laws are unnecessary to protect deposit note purchasers from fraud or other possible abuse. There is no need to treat deposit notes as investment contracts and, thus, securities.[18]

D. Conclusion

For the reasons discussed above, based on your representations and the facts you have provided, it is our opinion that the bank's deposit notes are not securities and, therefore, not subject to registration under Part 16.

If you have any questions, please contact me at (202) 874-5210.

Nancy Worth
Counsel
Securities and Corporate Practices Division

923—December 19, 2001

12 USC 25a

Dear [ ]:

This is in response to your letter of November 20, 2001, in which you alleged that a number of banks in the [ ] area are violating 12 USC 25a by advertising lotteries. You included copies of several advertisements and promotional mailings for the OCC's evaluation. I have reviewed all of the items. In addition, I have contacted the legal departments of, *[A]*, and *[B]*, to obtain further information concerning certain of the advertisements and events. Based on this information and review, it is my conclusion that none of the items violate 12 USC 25a. My reasoning is explained in more detail below.

Discussion

Twelve USC 25a prohibits national banks from participating in certain lottery-related activities. Among other things, national banks may not "announce, advertise, or publicize the existence of any lottery." 12 U.S. 25a(a)(3). You believe that the banks have violated this prohibition.

The statute defines "lottery" as follows:

> The term "lottery" includes any arrangement whereby three or more persons (the "participants") advance money or credit to another in exchange for the possibility or expectation that one or more but not all of the participants ("the winners") will receive by reason of their advances more than the amounts they have advanced, the identity of the winners being determined by any means which includes —
>
> (A) a random selection;
> (B) a game, race, or contest; or
> (C) any record or tabulation of the result of one or more events in which any participant has no interest except for its bearing upon the possibility that he may become a winner.

12 USC 25a(c)(2).

[18] Application of the *Reves* factors confirms that deposit notes are not securities. Deposit notes do not resemble the instruments that courts previously determined are not securities, but applying the *Reves* factors warrants adding deposit notes to the list of instruments that are not securities. Although a seller's use of funds gathered through a program for its general business can indicate a security, this reasoning is not sensible in a *banking* context. Banks raise virtually all their deposits for their general banking business and deposits are virtually never securities. The purchaser's motivation will be to obtain an interest-bearing deposit and the bank's motivation is to market a deposit. The investing public cannot reasonably view deposit notes as securities. They will be denominated as deposits, carry FDIC insurance, and will be subject to the same reserve and reporting requirements applicable to deposits generally. The bank will disclose to customers that there are no assurances of a secondary market for deposit notes. Instead, deposit notes will be subject to the redemption restrictions that normally apply to deposits. Finally, deposit notes are subject to precisely the same regulatory scheme that applied to the CDs in *Marine Bank.* Federal banking laws and FDIC insurance obviate the need for additional protections under the federal securities laws.

With this background in mind, I will now discuss the individual items.

[A] "Focus on Fashion"

The first item is a newspaper advertisement that reads in part as follows:

> *[Co.]*'s
> 13th Annual Charity
> Fashion Show & Luncheon
>
> "Focus on Fashion"
> . . .
> Tickets $35
> Grand Raffle and
> Elegant Basket Raffle
> . . .
> Sponsored by: [*[A]* logo]
> . . .

You asked if this isn't involvement in the sponsoring of the advertisement, citing OCC Interpretive Letter No. 900, June 19, 2000. In that letter, I concluded that a national bank could donate an item for a civic fundraising raffle and be identified in advertisements as the donor of the item, as long as the bank had no involvement with the sponsoring or display of the advertisements.

I contacted *[A],* to obtain information about this advertisement. The bank informed me that the *[Co.]* paid for this ad, not the bank. *[A]* is listed as a sponsor because it donated money for the event. Therefore, the fact situation here is very similar to that in Interpretive Letter No. 900, *i.e.,* the bank is identified as a supporter of the event in an advertisement paid for by someone else. As I concluded in that letter, this type of situation does not violate 12 USC 25a because there has been no action by the bank to publicize the lottery.

[A] "Win the Lottery"

The second item is a newspaper advertisement promoting *[A]* home equity loans. The top of the ad displays the following statement:

> How can the 89,545,673 people who didn't *win the lottery* this weekend make those much-needed home improvements? Introducing our great rates on a home equity line of credit.

(Emphasis added.) In your view, this is announcing the existence of a lottery.

As a statute with criminal penalties, (see 18 USC 1306), 12 USC 25a should be narrowly construed. *See Federal Communications Commission* v. *American Broadcasting Company*, 347 U.S. 284, 296 (1954) (construing 18 USC 1304, also involving lotteries). For that reason, the prohibition against publicizing a lottery should be interpreted to mean an actual, identifiable lottery, not one that is only hypothetical. *See United States* v. *Halseth*, 342 U.S. 277 (1952) (interpreting 18 USC 1302, another lottery statute). The phrase "win the lottery" is simply a figure of speech and does not meet this standard.

[A] Platinum Visa Card

The third item appears to be a promotional mailing for a *[A]* credit card. The mailing includes "terms and conditions for the *[A]* platinum Visa card." Among these terms and conditions is a transaction fee for the purchase of "betting or casino chips or similar items." You believe that this violates the prohibition on publicizing lotteries.

As with the last item, this does not publicize an actual, identifiable lottery. Therefore, in my opinion, it does not violate 12 USC 25a.

[B] [ ] Shuffle

The next item is a newspaper advertisement for the *[B]* [ ] Shuffle 8K race. Although this is not mentioned in the ad, you noted that there was a $30 entry fee to participate in the race, and prizes of $1500, $1000, and $750. You believe this violates 12 USC 25a because it is publicizing a game, race, or contest which, in turn, is a lottery.

I contacted *[B],* which confirmed that it does sponsor this event (and other races) as charity fundraisers every year, and that the bank did pay for this ad.

Referring back to the statutory definition of "lottery," it is an "arrangement" in which the winner is determined by the outcome of, among other things, a "game, race, or contest." It can be seen that the lottery and the race are two separate things: the lottery is the "arrangement," while the race is the means of determining the winner of the lottery. Looking at it another way, under federal case law, one of the essential elements of a lottery is that the winners are selected by chance. *Federal Communications Commission* v. *American Broadcasting Company, supra*. As between the participants in a race, the winner is determined by skill, not chance. Therefore, the race, itself, is not a lottery. Rather, a betting pool among nonparticipants on the outcome of the race would be a lottery.

Accordingly, this advertisement does not violate 12 USC 25a.

[ ] Bowling Party
[ ] Pro Cup

These are newspaper advertisements in which *[B]* is listed as a sponsor of the events. You noted that these are fundraising events in which entry fees are charged and there are prizes for the winners.

It seems likely that these events are not lotteries, for the reasons discussed above. In any event, the bank informed me that it did not pay for either of these ads. Rather, it donated money to the events and was listed as a sponsor in advertisements paid for by the promoters of the events. This brings these ads within the rule of Interpretive Letter No. 900 as discussed above, so there is no violation of 12 USC 25a.

[C] Cancun Raffle

The next item is a newspaper advertisement for a charity raffle offering as a prize a trip to Cancun, Mexico. *[C]* and other companies are listed as sponsors. As *[C]* is not a national bank and is not regulated by the OCC, I will not comment on this item.

[D] Credit Card

The final item is a photocopy of a mailing promoting a credit card offered by *[D]*. This is similar to the *[A]* credit card mailing discussed above. It lists transaction fees for the purchase of "bets, lottery tickets, and casino gaming chips." The discussion of the *[A]* credit card mailing applies equally to this item.

Conclusion

I have carefully reviewed the advertisements and other items that you submitted, and contacted the banks involved to obtain further information where necessary. For the reasons discussed above, I conclude that none of the items violates 12 USC 25a. Either the banks did not pay for the advertisements, or the items do not publicize a lottery within the meaning of the statute.

I hope that this has been responsive to your concerns, and I thank you for bringing this matter to our attention.

Christopher C. Manthey
Counsel
Bank Activities and Structure Division

924—January 2, 2002

12 USC 24(7)

Re: Applying Five Percent Limit on Holding Equity Securities for Hedging Purposes

Dear [ ]:

This is in response to your inquiry regarding the holding of equity securities by [ ] (the "bank") and its direct Edge corporation subsidiary, [ ] (the "Edge corporation"). Specifically, you inquired whether the OCC's five percent limit on a national bank's holdings of equity securities for hedging purposes includes securities held by the Edge Corporation. For the reasons set forth below, we do not apply our policy regarding the five percent limit to securities held by the Edge corporation.

We have previously determined that it is legally permissible for a national bank to purchase and hold equity securities to hedge customer-driven, bank permissible equity derivative transactions, subject to certain conditions.[1] In connection with this determination, the OCC also decided, as a policy matter, that a national bank should not acquire equity securities that constitute more than five percent of a class of stock of any issuer.

The OCC's conclusion that such holdings were permissible for a national bank was based on the National Bank Act, 12 USC 24(Seventh), which broadly authorizes a national bank to engage in activities that are part of or incidental to, the business of banking. We have concluded that equity derivative transactions are authorized as part of the business of banking under Section 24(Seventh). Further, we determined that national banks may purchase equity securities to hedge customer-driven equity derivative transactions as an activity that is incidental to the business of banking.[2] Edge corporations are not authorized under the National Bank Act, but rather under the Federal Reserve Act.[3] Under the Federal Reserve Act, Edge corporations may engage in a broad range of international banking and financial activities.[4] Because the authority for an Edge corporation to invest in companies is distinct and separate from the authority of a national bank to acquire equity securities under its incidental powers

[1] *See* Interpretive Letter No. 892 (September 13, 2000), reprinted in [2000–2001 Transfer Binder] Fed. Banking Law Rep. (CCH) ¶ 81–411.

[2] *See* Interpretive Letter No. 892, *supra*.

[3] 12 USC 611.

[4] 12 USC 615.

under the National Bank Act, we do not apply our policy imposing a five percent limit on holding equity securities for the bank's hedging purposes to securities that are held by an Edge corporation pursuant to a separate authority under the Federal Reserve Act.

If you have any questions, please do not hesitate to contact Donald N. Lamson, assistant director, or Paul Vogel, counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

925—April 12, 2001

12 USC 84

12 CFR 32

Dear [ ]:

I am writing in response to your letter dated March 6, 2001, and supplementary information dated March 9, 2001, requesting our legal opinion. You have asked if loans made by [ ] ("bank") to local [ ] ("local churches") must be combined for purposes of determining the bank's legal lending limit under 12 USC 84. For the reasons set forth below, we believe that the loans to the local churches in question must be combined.

According to the facts set forth in your letter, the bank has four outstanding loans to four separate local churches, which if combined, would not exceed the bank's lending limit. The bank is proposing to lend $500,000 to a fifth area church, [ ] ("5th") to be used for construction of its new church building, and this proposed loan, if combined with the bank's existing loans to local churches, may cause the bank to exceed its lending limit. Each local church is required to enter into a trust agreement with the international office of the parent church, [ ] ("parent church"), under which the local church is a trustee for all real and personal property, and the parent church is the beneficiary of each trust. The legal title to all property rests in the trustee (local church) until such time as the beneficiary (parent church) directs that it be transferred to itself. The trust agreement states that the trust will be revoked when any member (local church) decides to withdraw from the parent church or takes "action contrary to the polity of the [parent church]," at which time "ownership of all property, both real and personal, remains with the [parent church]."[1]

The general rules for combining loans to separate borrowers are found at 12 CFR 32.5(a)(1). The regulation states that loans or extensions of credit will be attributed to another borrower when one of two conditions is satisfied:

(1) When proceeds of a loan or extensions of credit are to be used for the direct benefit of the other person, to the extent of the proceeds so used; or
(2) When a common enterprise is deemed to exist between the persons.

12 CFR 32.5(a)(1). A trust is considered to be a "person" for purposes of the rules. *See* 12 CFR 32.2(k).

Direct Benefit Test

Under the direct benefit test, the proceeds of a loan or extension of credit will be deemed to be used for the direct benefit of another person when those proceeds are transferred to that other person, unless the proceeds are used to acquire property, goods, or services in an arm's-length transaction. 12 CFR 32.5(b). In applying the test to the facts given, it appears that the direct benefit test clearly requires combination of the loans to the local churches.

As noted above, the local church trusts all have an identical beneficiary: the parent church. The trust agreement clearly states that all property is held in trust "for the exclusive use and benefit" of the parent church.[2] Further, the trust agreements are revocable at the direction of the beneficiary (parent church) for several reasons, including when the local church "shall act contrary to [ ] polity."[3] Upon revocation, the local church "shall convey the said real estate upon demand to the State Board of Trustees of [the parent church] in said state, which said state board shall be authorized to use said real estate and personal property, or the proceeds derived from the sale of same . . . for the use and benefit of the [parent church] in that state generally; or the founding of another [ ] *(City, State)* in the same state, or for the promotion of one already existing."[4]

In my opinion, the loans to each local church should be attributed to the parent church and combined under the direct benefit test. Those loans should also be combined

[1] *See* trust agreement*:* S44. CHURCH PROPERTY: IV. All Property Owned in Trust for [ ] *(City, State)*.

[2] *See* trust agreement*:* S44. CHURCH PROPERTY: V. Standard Deeds Recognizing Trust Ownership.

[3] *Id.*

[4] *Id.*

with any loans which may be extended by the bank to the parent church (we understand that there are currently no loans by the bank to the parent church). Because the proceeds of loans made to the local churches are used for transactions which are controlled by trusts having an identical beneficiary (the parent church), and this beneficiary is entitled to the ultimate benefit of those transactions, the loans should be combined and attributed to the beneficiary.

Common Enterprise Test

Under the common enterprise test, found at 12 CFR 32.5(c), a common enterprise will be presumed to exist and loans to separate borrowers will be aggregated when any of the following conditions are met:

(1) When the expected source of repayment for each loan is the same and neither borrower has another source of income from which the loan may be fully repaid;

(2) When the borrowers are related through common control and there exists substantial financial interdependence between those borrowers;

(3) When separate borrowers borrow to acquire a business enterprise where those borrowers will control more than 50 percent of the voting securities of the business enterprise; or

(4) The OCC determines that a common enterprise exists based on an evaluation of the facts and circumstances of particular transactions.

For the purposes of this combination rule, control is deemed to exist when a person directly or indirectly, or acting through or together with one or more persons—

(1) Owns, controls, or has the power to vote 25 percent or more of any class of voting securities of another person;
(2) Controls, in any manner, the election of a majority of the directors, trustees, or other persons exercising similar functions of another person; or
(3) Has the power to exercise a controlling influence over the management or policies of another person.

12 CFR 32.2(g).

Under the first test, a common enterprise will be deemed to exist when the source of repayment for each loan is the same. 12 CFR 32.5(c)(1). In this situation, there appears to be no common enterprise because each loan to each local church has a separate source of repayment—the donations and other revenue generated by each respective church.

Under the second test, a common enterprise will be deemed to exist when the borrowers are related through common control and there exists substantial financial interdependence between them. Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Gross receipts and expenditures include gross revenues, expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments. 12 CFR 32.5(c)(2)(ii). In this case, the trust agreement explicitly states that the parent church controls the local church trusts, thus satisfying the common control element definition in which one person has the power to exercise a controlling influence over the management or policies of another person.[5] However, there does not appear to be substantial financial interdependence, because only five percent of each local church's receipts are sent to the parent church, and the parent church does not routinely fund the expenses of the local churches. Thus, the second common enterprise test is not satisfied.

The third common enterprise test applies when separate borrowers borrow to acquire a single business enterprise. 12 CFR 32.5(c)(3). This test does not apply in this case, because the loans in question are for purposes other than acquiring a business enterprise.

Even if the above-mentioned *per se* tests for combining loans are not met, the OCC will still require the combination of loans to two or more borrowers when it determines that a common enterprise exists based on the facts and circumstances. 12 CFR 32.5(c)(4). On its face, subsection (c)(4) appears to grant to the OCC broad, if not unlimited, discretion in combining loans for lending limit purposes even if the three *per se* rules are not met. However, past OCC rulings and interpretations reveal that a very strong evidentiary record based upon a number of factors must exist before a common enterprise will be found to exist solely on the basis of the facts and circumstances. OCC Interpretive Letter No. 563,

[5] *See* trust agreement: S44. CHURCH PROPERTY: II. Authority of the General Assembly: 1. The General Assembly governs the operation (including ownership of all real and personal property) of the [ ] (*City, State*) at all structural levels: international, national, state/territorial, district, and local.

September 6, 1991, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) & ¶83,314, at ¶71,439. Indeed, the OCC has stated that instances where the facts and circumstances test will apply to the exclusion of the *per se* rules will be rare. *Id.; see also* 54 Fed. Reg. 43,402 (1989).

In various interpretive letters, the OCC has considered the following facts and circumstances to be relevant to a common enterprise determination: engaging in supporting lines of business; interchange of goods and services; common ownership of assets; common management; use of common facilities; commingling of assets and liabilities; closely related business activities; similarity in structure, financing and holding; use of same business address; centralized cash management program; likelihood that a financially troubled member of the group would receive financial aid from other members of the group; family relationships among the borrowers; and pledging of assets to support another's loans. Kenneth C. Rojc, *National Bank Lending Limits—A New Framework*, 40 Bus. Law. 903, 923-24 (1985) (citing various OCC interpretive letters). In my opinion, it may be persuasively argued that many of the above facts and circumstances apply in this case, demonstrating that a common enterprise does exist between the local church borrowers. The local churches engage in supporting lines of business and in closely related business activities, the local churches are commonly controlled by the parent church and have similar, if not identical, structures, and the trust agreement provides for a local church to receive financial assistance from either the parent church or other local churches if necessary.[6] However, since I believe that the loans in question must be combined under the direct benefit test, it is not necessary to rely on the facts and circumstances test for determining whether a common enterprise exists.

This analysis is based upon the facts presented and representations made to this office; different circumstances may affect the legal analysis. Our view of the questions presented by your letter reflects current law and may be subject to revision as future developments warrant. If you have any further questions, please contact me at (312) 360-8805.

We trust this is responsive to your inquiry.

Giovanna Cavallo
Senior Attorney
Central District Office

[6] *See* trust agreement*:* S43. FINANCIAL SYSTEM: III. Church Reports; B. Accumulated Delinquent Funds.

926—September 7, 2001

12 USC 24(7)

Subject: Variable Life Insurance

Dear [ ]:

This is in response to your recent letter sent by e-mail requesting confirmation that it is permissible for national banks to purchase variable life insurance in connection with employee compensation or benefit plans. Such insurance is permissible, provided that certain OCC requirements are met.

The OCC's current guidance on purchases of life insurance by national banks is contained in Bulletin 2000–23, July 20, 2000. You appear to be familiar with this issuance. As you recognized, the OCC does not permit national banks to purchase life insurance purely as an investment. Rather, as stated in the bulletin, the purchase must be for a purpose that is incidental to banking. One of the purposes that we have found to meet that standard is insurance purchased in connection with employee compensation or benefit plans. That is, national banks may purchase life insurance in order to fund or recover the cost of compensation or benefits for their employees, officers, or directors. Thus, the quick answer to your question is that it is permissible for national banks to purchase variable life insurance for this purpose, and it does not matter whether the insurance is single premium or annual premium.

However, if the separate account associated with variable life insurance is to contain equity securities, there is a further limitation. This limitation is that the equities in the account must serve to hedge the bank's liability under the compensation or benefit plan that the insurance is intended to fund. As explained on page 13 of Bulletin 2000-23, "an economic hedge exists when changes in the value of the liability or other risk exposure hedged are offset by counterbalancing changes in the value of the hedging instrument." The bulletin goes on to say:

> An example of such a relationship would be where the amount of the bank's deferred compensation obligation is measured by the value of a stock market index, and the separate account contains a stock mutual fund that mirrors the performance of that index. *If the insurance cannot be characterized as an effective hedging transaction, the presence of equity securities in a separate account is impermissible.*

OCC Bulletin 2000-23, page 13 (emphasis added). Thus, equity investments can be used in connection with variable life insurance, but only if this hedging requirement is met.

In my opinion, a defined contribution plan could meet this standard, while a defined benefit plan could not. This is because in a defined contribution plan, the amount of the bank's liability depends upon the performance of the plan benchmark—typically, an equity security or an equity market index—making it possible for the bank to purchase a security that will track that benchmark and offset the liability. In contrast, a defined benefit plan obligates the bank to pay a certain amount regardless of the performance of the bank's investments. It is therefore impossible to effectively hedge the bank's exposure.

As you are aware, the bulletin sets forth a number of due diligence steps that national banks should take in connection with any purchases of life insurance. Please note that for the purchase of variable life containing equity securities, additional due diligence measures are set forth on page 13 of the bulletin.

It is my understanding that separate accounts can be designed to contain only bank-permissible investments, *i.e.*, Treasury and investment grade fixed income securities. See OCC Interpretive Letter 826, March 17, 1998.[1] In my opinion, that type of separate account product would be permissible in connection with a defined benefit plan because there is no hedging requirement for fixed income investments in a separate account.

To summarize, national banks may purchase variable life insurance for the purpose of funding or recovering the cost of employee compensation or benefit plans. It does not matter whether it is structured as a single premium or annual premium product. If such insurance is to contain investments in equity securities, there is an additional requirement that the securities must be related to the bank's compensation or benefit liability in such a way that their values rise and fall together, so that the insurance can be characterized as a hedging transaction. An example of this would be a defined contribution plan linked to an equity benchmark. However, if variable life is to be used in connection with a defined benefit plan, it is my opinion that the separate account must be limited to bank-permissible (fixed income) investments.

[1] Available on the OCC web site at www.occ.treas.gov/interp/may98/intmay98.htm.

I hope that this has answered your question. Please feel free to contact me again if further questions arise.

Christopher C. Manthey
Counsel
Bank Activities and Structure Division

927—October 29, 2001

12 CFR 3

VIA FACSIMILE

Dear [ ]:

This letter is in response to the issues you raised in your October 11 letter to the OCC regarding the appropriate risk-based capital treatment for [ ]'s securitization transactions. The OCC has determined that, for risk-based capital purposes, the bank must: (i) reflect recourse treatment on the securitized assets; and (ii) demonstrate to the satisfaction of the OCC that its policies and practices have been sufficiently modified to warrant application of non-recourse treatment to new securitization transactions. As you were previously instructed by on-site OCC examiners, [ ]'s Report of Condition and Income (Call Report) for the third quarter 2001 should be filed in a manner consistent with this recourse determination for risk-based capital purposes.

The OCC reviewed [ ]'s securitization program in a recent bank examination and determined that certain practices constitute a sale of assets with recourse for risk-based capital purposes. These practices related to the classification of certain delinquent accounts as fraud losses, resulting in repurchase by the bank at par, when the losses were actually attributable to credit quality. Consequently, the assets that were previously treated as sold under generally accepted accounting principles and for risk-based capital purposes will be risk weighted as if they were still on the bank's balance sheet and included in risk-weighted assets for risk-based capital purposes.

The general rule on recourse, contained in the glossary section of the Call Report instructions, describes the appropriate capital treatment for implicit recourse.[1]

[1] *See* the glossary entry "Sales of Assets for Risk-Based Capital Purposes" in the Call Report instructions. These instructions are incorporated by reference in the OCC's risk-based capital regulations. See 12 CFR Part 3, Appendix A, Section 3(b)(1)(iii), footnote 14.

The instructions state, "Regardless of the legal structure of the transaction, if risk of loss is retained by the seller, either contractually or otherwise . . . the seller should treat the transaction as an asset sale with recourse for purposes of risk-based capital and Schedule RC-R even if the sale . . . is stated as being without recourse."

In your letter, you requested clarification of how the securitized assets should be treated prospectively. You state that you have "committed to change [your] accounting policies to eliminate any implication that [your] characterization of certain loan defaults as fraud losses gives rise to a right of recourse against the bank." Despite this commitment, the bank's past practices warrant continued recourse treatment for risk-based capital purposes on a prospective basis for the securitized assets, the securities backed by those assets, and the master trust from which the securities were issued.

The general presumption with securitization transactions is that a bank is not exposed to risk of loss beyond its contractual obligation. It is this presumption that allows banks to treat securitized assets as sold for risk-based capital purposes *(i.e.,* not apply recourse treatment). Once a bank provides support to a securitization beyond the bank's contractual obligation, the presumption of the bank's limited exposure to loss no longer holds. When a bank provides non-contractual credit support to a securitization, the expectation is raised among securitization investors and bank supervisors that the bank will provide similar future support if needed. Allowing a bank to provide support to a securitization and then later allowing that securitization to receive the risk-based capital benefits of sales treatment can create an incentive for banks to repeatedly support a deal and subsequently alter their practices so as not to trigger recourse treatment going forward. Such a situation could result in the bank effectively providing ongoing support to investors, resulting in no risk transference from the bank to third party investors, with the bank holding capital that is not commensurate with its risk exposure. Consequently, long-standing general OCC policy is that once a securitization has been "tainted," the transferred assets are treated as assets sold with recourse for risk-based capital purposes, even if a bank immediately stops its practice of providing support to investors.

The OCC has communicated its policy with respect to implicit recourse in a number of ways over the years. As we have described, the Call Report instructions clearly require recourse treatment for risk-based capital purposes where a bank provides support "contractually or otherwise." The 1994 Bank Accounting Advisory Series (BAAS) included an example of an implicit recourse situation involving the repurchase of performing and delinquent assets from a securitization trust and the subsequent issuance of a new securitization backed by the performing assets. Regulatory sales treatment was disallowed for the subsequent securitization of the repurchased assets. The BAAS noted that all future securitizations by the bank would require close scrutiny to determine whether implicit recourse existed. Recently issued revisions to the BAAS (September, 2001) continue to include an example of implicit recourse in which risk-based capital is required for securitized assets after a bank's prior actions have demonstrated the retention of a risk of loss. The OCC's policy regarding implicit recourse has also been described in the Comptroller's Handbook on Asset Securitization (November 1997) and the preambles to the 2000, 1997, and 1994 proposed rules on recourse.[2]

In your letter, you requested clarification of whether the OCC would permit sales treatment for risk-based capital purposes for new securities that were exchanged for existing securities, where the new securities would be identical to the existing securities. The OCC would continue to require recourse treatment for the assets underlying these new securities. Recourse treatment is linked not only to the securities issued out of the existing master trust, but also to the receivables that back those securities. Issuing new securities that are identical to existing securities would not eliminate the recourse associated with the trust or the outstanding receivable balances that back those securities.

In order to avoid recourse treatment on any new securitization transactions involving new assets in a new master trust, the bank must demonstrate to the OCC's satisfaction that it has changed the practices that have resulted in recourse treatment and that it will not provide support to future securitizations. Factors that might be considered include an improved ability by the bank to distinguish between fraud losses and credit losses, trust documents that more clearly define how losses are to be shared between the bank and the trust, and demonstration over time that the bank's practices do not result in support to investors beyond the bank's contractual obligation.

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[2] *See* "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes; Proposed Rule," *Federal Register,* March 8, 2000 (Volume 65, Number 46); "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes; Proposed Rule," *Federal Register,* November 5, 1997 (Volume 62, Number 214); and "Risk-Based Capital Requirements-Recourse and Direct Credit Substitutes," *Federal Register,* May 25, 1994 (Volume 59, Number 100).

We hope that this letter allows you to better understand our position with respect to your institution's risk-based capital treatment for securitization transactions. Please feel free to contact Tommy Snow at (202) 874-5070 if you have any questions.

Kevin J. Bailey
Senior Advisor
Bank Supervision Policy

928—December 24, 2001

12 USC 24(7)

Dear [ ]:

This responds to your letter of August 3, 2001, seeking, on behalf of the [ ] (the "bank") an interpretive letter from the Office of the Comptroller of the Currency ("OCC") on the authority of national banks to offer certain electronic commerce and security-related services to their wholesale and non-profit organization customers. For the reasons set forth below, we find that the proposed activities are permissible for national banks.

Background

The bank proposes to engage in several activities in association with its electronic payments services. For merchants, government agencies, and non-profit service organizations that are bank customers (the "customers") with previously established Web sites, the bank will design and host[1] a Web site and provide software[2] enabling: 1) the customers to process various forms of payments electronically from their end clients; 2) customers' end clients to electronically schedule and pay for events offered by a customer organization; and 3) the customer to acquire and compile information[3] from their end clients ("client information") in connection with the above described transactions to be used for authentication purposes and to facilitate future interactions between the customer and its end client. Also, in connection with these Internet-related Web-services, the bank will consult with and advise its customers on how the Web site should be designed and operated so the Web site hosted by the bank and the related information is secure from unauthorized access while on the bank's premises, while in transit to and from the bank, and while in the customer's possession. Finally, the bank will also offer electronic bill presentment and payment services for its merchant, government agency, and non-profit service organization customers.

In addition, while the proposed activity will focus on the bank's customers, the bank will also market the Group's Internet-related services to non-customers—who may or may not have an existing Web site—but who wish to have a payment related portion added to a new Web site that can accommodate the services described above. Any person who wishes to have a payment portion of a Web site designed must have a bank account for settlement purposes—thereby becoming a bank customer.

Customers that sign up for the services offered by the bank will be charged various fees, including a licensing or start-up fee when they initially sign up for the services offered by the bank, monthly maintenance and hosting fees, and/or transaction fees in connection with processing payment transactions.

When the bank builds and hosts the customer's Web site, the bank will do so in a manner that is consistent with the appropriate levels of security and confidentiality risk control measures that are consistent with the standards OCC adopted under 15 USC 6801(b) and codified in 12 CFR Part 30, Appendix B (the Interagency Guidelines Establishing Standards for Safeguarding Customer Information).

Bank is aware that the proposed activities will impose added risks to the bank, including transaction risk, legal risk, and reputation risk. Through a series of internal and external audits of the bank's technology, procedures and controls, the bank has identified and reduced operational risks that were identified by making the adjustments recommended in the audits. The bank plans to have regular internal and external audits of the activities. The staff that would conduct the activities have worked closely with the bank's internal auditors on the bank's recently implemented Information Security Program, required under 12 CFR Part 30, so that the program incorporates

[1] The bank will require that it host the portion of the page it develops.

[2] The software will either be developed by the bank or obtained from a third party.

[3] The client information described in above, will consist of information such as the end client's name, mailing address, shipping address, e-mail address, telephone number, preferred credit card numbers for billing purposes, and other billing account information. The client information will primarily be used for authentication and security purposes by the bank on behalf of its customer. However, from the end client's perspective, the client information will enable the customer to provide a more convenient shopping service since the end client will not have to re-key their information when they visit the customer's site again. The client information will also the enable customer to communicate more effectively with its end clients by sending out newsletters or communication to the end client's e-mail address acquired during the setup process.

the current and proposed activities discussed in this letter. OCC has recently completed an information technology review of the bank that included the proposed Web-hosting activities and systems.

Discussion

The OCC has found that, as part of the business of banking and in association with electronic payments services, national banks may provide merchant customers with services that will enable the merchant to operate a commercially enabled Web site.[4] The processing of payments resulting from orders received through a merchant's Web site is also clearly part of the business of banking.[5] Merchant credit and debit card processing services generally involve verifying credit card authorizations at the time of purchase, processing card transactions, settlement of card transactions, and depositing funds into merchants' accounts. The fact that the credit and debit card and other electronic payment transactions would involve purchases of goods or services over the Internet does not change the nature of the service that would be provided.[6] Thus, the bank's proposed payment processing and associated commercial Web site hosting activities are permissible.

OCC has found that the finder authority to host, develop, and support commercially enabled Web sites extends not only to merchants, but also to non-profit service entities such as government agencies that provide goods and services to the public. OCC Conditional Approval No. 361 (March 3, 2000) (national bank may host Web sites for government agencies that offer goods and services to the public). We believe this rationale applies equally to private non-profit organizations that provide goods and services to the public.[7]

Moreover, OCC has found that incidental to a payments processing service and associated commercial Web site hosting, a national bank may provide Web design and development services. The ability to build the Web sites for the participating merchants as part of a commercial Internet services package is critical to the successful marketing of the package.[8] To enhance marketability and reduce costs to merchants, the firms that will compete with the bank in providing Internet commerce products and services are now offering complete packages to merchants, which include the building of the Web sites. *See e.g.*, Bloom, *supra*; Steven Marjanovic, "First Data to Buy Stake in iMall, a Software Firm," *American Banker,* Nov. 9, 1998, at 17; Tami Luhby, "Wells Fargo Opens Door to Web for Small Business," *American Banker,* Sept. 15, 1998.[9]

OCC has long held that, under their incidental powers, national banks may sell non-banking products and services when reasonably necessary to provide banking

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[4] In association with their electronic payments services, national banks may provide a "package" of Internet-based services to retail merchants including: hosting Web sites on the bank's own server; registering merchants with search engines and obtaining Universal Resource Locators; providing an electronic communication pathway for product ordering and payment; maintaining merchants' data associated with the Web sites on its server *(e.g.,* price information, product descriptions, and images); providing merchants with software to create Web sites; providing reports on transactions, Web site "hits," and sales data; and processing credit card transactions. OCC Interpretive Letter No. 856 *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–313 (March 5, 1999) (providing or maintaining an Internet Web site for merchants is one device that national banks may use as finders to provide information to the merchants' customers).

[5] OCC Corporate Decision No. 99–50 (Dec. 23, 1999) and OCC Corporate Decision No. 2000–08 (June 1, 2000) (national bank may process for its merchant customers purchases made over the Internet); OCC Interpretive Letter No. 856, *supra. See also* OCC Conditional Approval Letter No. 289 (Oct. 2, 1998) (national banks may acquire a minority interest in a firm that, among other things, provides accounts receivable processing and accounts payable processing); OCC Conditional Approval Letter No. 282 (July 7, 1998) (national bank may acquire an interest in a firm that would, among other things, engage in payments processing for the health care firms); OCC Conditional Approval Letter No. 248 (June 27, 1998) (national bank operating subsidiary may acquire a minority interest in an entity that provides merchant credit and debit card processing services); and OCC Interpretive Letter No. 731 *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,048 (July 1, 1996) (national banks as part of the banking business may collect and process accounts relating to an electronic toll collection system).

[6] Likewise, the fact that some of the bank's Web sites will enable end clients to purchase rights to attend events, rather than goods or conventional services, does not change the permissibility of the activity. OCC has found that national banks can process orders and payments for event and attraction tickets. *See* OCC Interpretive Letter No. 718 *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–033 (March 14, 1996). There is no reason why the bank's electronic finder authority should not include bringing together buyers and sellers of events, which really are a form of services.

[7] As we noted in a prior letter: "In the finder analysis, no distinction should be drawn between bringing together with a government agency those who wish to *purchase* goods or services from that agency and those who wish to *consume* goods or services from that agency. The latter, most likely individuals seeking forms, benefits, or other information from the agency, are not "buyers" in the traditional sense; however, as taxpayers, they are essentially buying information or other goods or services for which their taxes have paid. As such, they qualify as legitimate subjects for finder activities by national banks. *See* Corporate Decision No. 98–13 (Feb. 9, 1998) (national bank operating subsidiary, acting as finder, could bring together individuals who wished to enroll in government-sponsored health insurance program with appropriate government agency)." *Id.* at p. 7.

[8] *See* J. Bloom, "Vendor Groups Woo Banks into Net Services," *American Banker,* May 27, 1999, at 14 (reporting that vice president of the National Retail Federation says merchants of all sizes prefer to outsource the building of virtual stores).

[9] Experts say that without these packages, most smaller companies lack the budget and manpower to do a thorough job of creating and maintaining a commerce-enabled Web site. Bloom, *supra*.

products on a competitive basis by creating a package of related services needed to satisfy consumer demand, meet market competition, and enable the bank to successfully market its banking services. Thus, for example, in OCC Interpretive Letter No. 742, OCC found offering of Internet access service was needed to successfully provide and market the bank's Internet banking service. We found limiting the bank's Internet access services, to block non-banking use, would not meet customer needs or the competing products in the marketplace. See also, OCC Interpretive Letter No. 611, *supra,* (bank selling home banking service can also provide customer access to non-banking services "to increase the customer base and the usage of the program"); OCC Interpretive Letter No. 653, reprinted in [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (December 22, 1994) (national banks may offer non-banking products as part of larger product or service when necessary, convenient and useful to bank permissible activities). *Cf., National Courier Ass'n* v. *Board of Governors,* 516 F. 2d 1229, 1240 (D.C. Cir. 1975) (incidental powers of holding companies to provide specialized courier services when service necessary to obtain full benefit of data processing services).

For this reason, the proposed building of Web sites by the bank for those merchants desiring that service is incidental to the business of banking. Corporate Decision No. 2000–08, *supra* and OCC Interpretive Letter No. 875 *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–369 (October 31, 1999). *See also* OCC Interpretive Letter No. 856, *supra* (national bank engaged in permissible Web site hosting activity may provide merchants with software that will enable them to design and modify their Web sites).

As noted above, one of the features the bank proposes to provide for merchants in the designed and hosted Web sites would enable the merchant customer to acquire and compile information from their end clients that would be used primarily for authentication and security purposes and to facilitate additional transactions when the end client returns to the Web site to conduct additional business. This "one-click" shopping information concept is becoming increasingly prevalent in electronic commerce. Major firms such as AOL Time Warner, Inc. and Microsoft are currently developing systems that will allow people to store personal information (such as names, addresses, and credit card numbers) online to simplify their purchasing transactions on the Internet. A. Klein and A. Cha, "AOL May Launch an Internet ID Service," *Washington Post,* July 27, 2001, p. E-1. Similarly, a number of significant electronic merchants and payment processors have developed and are refining an "electronic wallet" which performs much the same function by enabling customers to store identifying, shipping, and payment-related information so that the customer does not need to re-key the information the next time they submit an order. *See* M. Barnett, "It's the Year of the E-Wallet," *The Industry Standard,* June 30, 1999, viewed July 27, 2001, at http://www.cnn.com/tech/computing/9907/01/ewallet.idg/; M. Zane, "NextCard to Offer E-wallet," *ZDNN*, October 18, 1999, viewed July 27, 2001, at http://www.zdnet.com/filters/printerfriendly/0,6061,2374202-2,00.html; Bloom and J. Kutler, "Web Wallet Marketers Struggle for Definition and Acceptance," *The American Banker,* November 4, 1999; and J. Capachin, "Digital Wallets: Their Potential Exceeds Their Performance," *American Banker,* August 17, 2001.

The bank may permissibly offer this "one-click" shopping information service to customers of its commercial Web site services for two reasons. First, the service is incidental to the electronic payments processing service provided by the bank in that it enhances the convenience of the service for both the merchants and their end clients. OCC has held, in Interpretive Letter No. 868 *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81263 (August 16, 1999), that a national bank can hold a minority interest in a company that designs and distributes software that performs the same "one-click" shopping function. That letter concludes that the "one-click" shopping software was permissible because it "will facilitate the electronic transfer of funds from consumers to businesses and financial institutions" and thus performed "activities commonly undertaken by banks directly for themselves, other financial institutions, or as part of servicing customers."

Second, processing of the retail based information relating to identity, shipping information, and payment information with respect to end clients and their transactions for merchant customers is permissible because it involves the processing of banking, financial, and economic data. Case authority supports this conclusion. In *Ass'n of Data Processing* v. *Board of Governors*, 745 F.2d 677 (D.C. Cir. 1984), the D.C. Circuit Court of Appeals upheld a Federal Reserve Board finding that data processing and database services were closely related to banking (and thus a proper activity for bank holding companies) if the "data to be

processed . . . are financial, banking or economic. . . . "[10] Further, the court indicated that "economic data" would include: "agricultural matters, *retail sales matters,* housing matters, corporate profits matters, and anything of value in banking and financial decisions." 745 F.2d at 691 (emphasis added).[11]

Likewise, the proposed processing of the retail-based client information is supported by OCC precedent. OCC has long held that as part of the business of banking, national banks may collect, transcribe, process, analyze, and store for itself and others banking, financial, or economic data.[12] OCC precedent establishes that the information that will be included in the bank's E-wallet and client information service is banking, financial or economic data. OCC Corporate Decision No, 2000-08, *supra* (national bank may, as part of its permissible Web hosting services, provide hosted merchants with information and reports relative to the purchases and transactions on their Web sites); OCC Interpretive Letter No. 677, *supra*. *See also* OCC Interpretive Letter No. 741 *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶81–105 (Aug. 19, 1996) (national bank acting as finder for automobile dealers may also maintain a comprehensive system that allows dealers to track information on customers referred and to generate market statistics such as buying trends and cycles); and OCC Interpretive Letter No. 346, *supra*. *See, e.g.,* OCC Interpretive Letter No. 737, *supra* (national bank may provide transaction and information processing services to support an electronic stored value system); OCC Interpretive Letter No. 653, *supra* (national bank may act as an informational and payments interface between insurance underwriters and general insurance agents).[13] Other agency precedent also supports this conclusion.[14]

The bank proposes to offer electronic bill presentment to its Web enabled customers. OCC has found that electronic bill presentment is part of the business of banking.[15]

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[10] In reaching this conclusion the court said: "The record of this proceeding amply demonstrates, if any demonstration is needed, that banks regularly develop and process for their customers large amounts of banking, financial and economic data, and that they do so (and will presumably continue to do so) through the most advanced technological means." 745 F.2d at 689. Compare *National Retailers Corp*. v. *Valley Nat'l Bank*, 411 F. Supp. 308 (D. Ariz. 1976), *aff'd*, 604 F.2d 32 (9th Cir. 1979) (a national bank does not to have the authority to offer a data processing service to retailers involving the collection and compilation of information relating to their retail sales that had been collected by a special cash register). The district court in *National Retailers* held that no express provision of the National Bank Act authorized national banks to publicly market a retail information service ("RIS") and concluded that, since the RIS was not within the enumerated powers, the determining issue was whether the RIS was within the bank's "incidental powers." 411 F. Supp. at 313. Thus, by implication, the court held that the "business of banking" includes only the enumerated powers. This position has since been repudiated by the Supreme Court's ruling in *NationsBank* v. *Variable Life Annuity Co*., 513 U.S. 251 (1995), that the "business of banking" is not limited to the enumerated powers. The *National Retailers* court failed to consider that non-enumerated informational services can come within the "business of banking" and specifically that the processing of banking, financial and related economic data is part of the business of banking. *Ass'n of Data Processing, supra*. In light of these defects, the holding of *National Retailers* is not entitled to much weight.

[11] Federal Reserve Board has approved as closely related to the business of banking a wide range of data processing services for businesses. Letter to Thomas A. Plant, from Virgil Mattingly (Nov. 25, 1997) (data processing support for the bookkeeping, accounting, and recordkeeping of nonfinancial firms); Compagnie de Paribas, 82 *Fed. Res. Bull.* 82 (1996) (data processing for payroll, accounts receivable, and billing services); The Bank of New York, et al., 80 *Fed Res. Bull.* 1107 (1994) (electronic data capture an electronic data interchange services in which merchants are provided with information relating to inventory and the buying patterns of customers that could be used by the merchants for inventory control, targeted marketing, and other purposes); and Banc One Corp., *et al.,* 79 *Fed. Res. Bull.* 1158 (1993) (same).

[12] An earlier version of 12 CFR 7.1019 stated that "as part of its banking business and incidental thereto, a national bank may collect, transcribe, process, analyze, and store for itself and others, banking, financial, or related economic data." OCC Interpretive Ruling 7.3500, 39 *Fed. Reg.* 14195 (Apr. 22, 1974). Although in its 1984 revision of the ruling, the OCC deleted this statement because it believed that "specific examples [of permissible electronic activities] are inappropriate given the imprecision of terms and rapid pace of change in the data processing industry," the "analytical framework" embodied in the ruling remained the same. 49 *Fed. Reg.* 11157 (Mar. 26, 1984). OCC has consistently expressed this view. *See* OCC Interpretive Letter No. 677 *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83625 (June 28, 1995). *See also* OCC Interpretive Letter No. 737 *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–101 (August 19, 1996) (national bank may provide transaction and information processing services to support an electronic stored value system); OCC Interpretive Letter No. 653 *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (Dec. 22, 1994) (national bank may act as an informational and payments interface between insurance underwriters and general insurance agents); and OCC Interpretive Letter No. 346 *reprinted in* (1985–1987 Transfer Binder) Fed. Banking L. Rep. (CCH) ¶ 85,516 (July 31, 1985) (national banks may maintain records on commodities transactions).

[13] In connection with the client information services it provides to its customers, the bank will have access to personal information regarding its customers' end clients. The OCC expects the bank to limit its use and disclosure of the customer's client information to that which is necessary to perform the services for the bank's customers. The OCC also expects the bank to establish appropriate security measures for safeguarding this information. These issues should be addressed in the bank's agreements with its customers.

[14] Bank of New York, *et al., supra* (electronic data capture and electronic data interchange services in which merchants are provided with information relating to inventory and the buying patterns of customers that can be used by the merchants for inventory control, targeted marketing, and other purposes involve "banking, financial, or economic data") and Banc One Corp., *et al., supra* (same).

[15] *See, e.g.*, OCC Corporate Decision No. 2000-08, *supra*; OCC Conditional Approval No. 304 (March 5, 1999) (electronic bill payment and presentment services over the Internet); OCC Interpretive Letter No. 731, *supra* (operation of electronic toll collection system); OCC Interpretive Letter No. 836, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-290 (March 12, 1996) (data processing and electronic data interchange system to assist in the billing and collection for medical services).

Finally, the bank also desires to consult with and advise its customers on how a Web site should be designed and operated so that the site hosted by the bank and information related to that site concerning payment transactions and end client information is secure from unauthorized access while on the bank's premises, while in transit to and from the bank, and while in the customer's possession.

Some of the bank's proposed security services are clearly encompassed within the hosting, design, and development services discussed above and thus are not a separate product or service. When transaction and client information is within the bank's environment, the bank will be responsible for the security of the information. The bank will be operating the host server and, through its system design, will specify appropriate logical access controls. Also, by hosting the server, the bank will provide physical security. Finally, in designing and developing the commercially enabled Web sites or a portion thereof the bank will design in appropriate security. Adequate security is part of these authorized services and need not be separately analyzed or authorized.

However, it is contemplated that transactional and client information will be made available to customers and placed in environments under their control. The issue is whether the bank can provide customers with advice on security with respect to the information when it is in customers' environments. For the reasons below, we find that, in this context, the security consulting proposed by the bank is a logical outgrowth of its banking business and, thus, permissible.[16]

To date, OCC has authorized national banks to provide security consulting for other financial institutions as a correspondent service. No-Objection Letter 90–3 *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH), ¶ 83207 (May 2, 1990); OCC Interpretive Letter No. 398 *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,622 (September 28, 1987); No-Objection Letter 86–15 *reprinted in* [198X–198X Transfer Binder] Fed. Banking L. Rep. (CCH), ¶ 84,021 (June 6, 1986); and OCC Interpretive Letter No. 137 *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH), ¶ 85218 (Dec. 27, 1979). However, the OCC has permitted national banks to provide consulting and advisory services for non-correspondents in many areas that are financially related or in which banks have developed extensive expertise.

For example, national banks may engage in lease consulting services. OCC Interpretive Letter No. 567 *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶83,337 (October 29, 1991). They may offer financial and consulting services, including market research and analysis, strategic planning, advertising and promotion planning, product development, personnel management, employee relations, affirmative action, and salary and benefit plans to banks and commercial customers. OCC Interpretive Letter No. 137, *supra*. They are permitted to provide consumer financial counseling. *Id.*; OCC Interpretive Letter No. 367 *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) & 85,537 (August 19, 1986). National banks can also offer employee benefit consulting services (including health benefit consulting) to corporations wishing to establish qualified benefit plans and relocation consulting for employees of a bank or its affiliates, or customers of the bank. OCC Corporate Decision No. 98–51 (November 30, 1998). They may engage in financial consulting and advisory services for other financial institutions and the general public, including, among other things, acting as a conduit in conveying loan terms to prospective borrowers or purchasers, supplying financial information regarding a third party, or engaging on behalf of others in research in contemplation of prospective transactions. OCC Interpretive Letter No. 238 *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,402 (February 9, 1982). Finally, OCC has recognized that national banks operating as certification authorities can provide consulting or advisory services to help customers, including other banks, to implement digital signature systems. OCC Conditional Approval No. 267 (January 12, 1998).

Thus, advisory and consulting services are an appropriate way for banks to exercise their core competencies. This has important implications under the logical outgrowth test. As OCC observed in prior precedent:

> Among other things, the "logical outgrowth" test recognizes that the "business of banking" is defined not

[16] The Supreme Court has held that the National Bank Act, in 12 USC 24(Seventh), contains a broad grant of the power to engage in the "business of banking." *See NationsBank of North Carolina, N.A.* v. *Variable Life Annuity Co.*, 513 U.S. 251 (1995) ("*VALIC*"). Specifically, the Court has said that the business of banking "is not limited to the enumerated powers in 24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated." 513 U.S. at 258–59, N. 2. In exercising this discretion, the OCC is guided by several factors reflected in case law and followed by OCC precedent: (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; (3) does the activity involve risks similar in nature to those already assumed by banks; and (4) whether the activity is expressly authorized by law for state-chartered banks.

> only by the services and products that banks provide, but also by the core competencies that banks use to produce them. ***
>
> Clearly, "the business of banking is not static. . . . " *New York State Ass'n of Life Underwriters* v. *New York State Banking Department*, 632 N.E.2d 876, 880 (N.Y. 1994). OCC recognizes that the evolution of "business of banking" is not restricted to lines of business reflecting only products banks have sold or functions banks have served previously. Rather, the "business of banking" must be—and is—sufficiently flexible to enable banks to develop and exploit their unique core competencies and optimize the return on those competencies by marketing products and services reflecting or using those competencies. Today, banks face a rapidly changing market that demands rapidly evolving skills. Thus, it is vital that they be able to plan strategically and adapt and respond appropriately.

OCC Conditional Approval No. 267, *supra*.

In that letter, OCC concluded that as part of the business of banking national banks could act as digital certification authorities because, *inter alia,* the certification authority activity was a logical outgrowth of the core competence that banks had developed in verifying and authenticating customer identities through paper and electronic systems. Here we similarly find that rendering advice is one way that banks can and, with appropriate limitations, should be able to exploit their core competencies. Indeed, some OCC letters authorizing advisory activities reflect the rationale that the particular advisory activities are permissible because they involve the bank in providing advice on an activity that the bank could provide directly to the advisee. For example, in concluding that a national bank can offer financial advisory services on credit funding alternatives to public and private entities, OCC found the activity permissible because it "will involve the bank's own expertise developed internally in considering direct loans to these types of borrowers." Unpublished letter from Thomas Taylor (May 25, 1984).

Thus, we find that where a bank would be permitted as part of the business of banking to provide a service and related expertise to an entity, the bank should also be permitted, as part of the business of banking, to employ that expertise to provide advice to that entity as to how the entity can perform the service for itself. This will enable a bank that has developed extensive expertise on a service to share that expertise and competence with persons to whom the bank could have sold the service. The risk exposures of providing advice on an activity, while somewhat different from providing the actual service, would certainly be no greater and can be properly limited and controlled.[17]

Here the bank proposes to provide advice on maintaining the security of information relating to transactions arising from a commercially enabled Web site the bank designed and hosts for its customer. Clearly, the bank could provide safekeeping and security services directly to its customers on this information.[18] The OCC recently issued a letter concluding that, as part of the business of banking, a national bank can provide electronic safekeeping services for personal information and valuable confidential trade or business information. OCC Conditional Approval No. 479, (July 27, 2001). That letter found national banks have established safekeeping functions that encompass securing valuable business records and papers and that the electronic safekeeping of such records is an electronic expression of this established safekeeping function.

The information for which the bank would provide its customers security consulting services would qualify for direct safekeeping under this precedent. Thus, it would be a logical outgrowth for the bank to provide security consulting with respect to that information. In other words, since the bank as part of the business of banking can and will provide safekeeping services for its customers with respect to this information, it is a logical outgrowth of that business for the bank to advise its customers on maintaining the security of that information when it is in the customers' systems and under their control.

The proposed consulting activities would also respond to customer needs or otherwise benefit the bank or its customers. The customers would clearly benefit because the bank could insure that the security program of the customer integrated with the program and systems of the

[17] The advising bank would potentially be liable if it failed to render competent advice. Accordingly, we would expect advising banks to take suitable steps to control that risk, such as keeping adequate records of the advice rendered, obtaining appropriate insurance coverage, and ensuring that the staff rendering the advice is competent, trustworthy, and has appropriate professional credentials. Moreover, we would expect that generally a bank would only render advice on banking services that it has actual direct experience in performing adequately. This would not generally include, for example, a bank that has relied upon outsourcing for an activity. Additionally, when acting in an advisory or consulting capacity, a bank should not actually engage in a management role or exercise any form of operating control over the advisee. Finally, banks providing advisory services should be careful to define clearly in their engagement letters or agreements the scope of advice rendered and the bank's liability for that advice.

[18] In fact, as noted above, the bank will be responsible for the security of this information during the time that it is in the bank's environment and under its control.

bank that initially would hold and process the information. The bank would benefit because it would be able to allocate additional resources to upgrading its security expertise (and enhance its own security) since it would be able to share the cost of that expertise with its consulting customers.

Finally, the proposed advisory activity would involve risks similar in nature to those already assumed by banks. As noted in OCC Conditional Approval No. 479, *supra*:

> [T]he offering of electronic safekeeping of data will expose banks to risks similar to those that banks are already expert in handling. As noted, national banks have long experience in safekeeping of physical items and documents for their customers. In that capacity, they have developed extensive procedures and regimes to handle the responsibilities and risks that arise from this bailment. *See, generally*, Ann Graham, 1 BANKING LAW, Ch. 10 (Safe Deposit Boxes); James McBain, *Safe Deposit Department*, 72 BANKING L. J. 533 (1955). Moreover, OCC has developed guidance on this activity. *Comptroller's Handbook: Consigned Items and Other Customer Services, supra*. Much of this experience, process, and guidance can and should be applied to electronic safekeeping activities. While the use of electronic media to store and access items raises additional risks, banks already have extensive expertise in dealing with these risks and OCC has provided guidance on addressing these risks. In this regard, as noted above, OCC expects that banks offering this service will comply with the requirements under the new Interagency Guidelines Establishing Standards for Safeguarding Customer Information.

Footnotes omitted.

Thus, banks are expert in dealing with business information security risks and in managing the risks of safekeeping activities regarding that information. Moreover, as noted above, banks have considerable experience in managing the special risks that arise when acting in an advisory capacity.

Conclusion

For the reasons set forth below, the proposed activities described in your letter of August 3, 2001, pertaining to electronic commerce and security-related services to their commercial and quasi-commercial customers' activities are permissible for national banks.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

929—February 11, 2002

12 USC 24(7)

12 CFR 28

Subject: [ ] ("bank") Foreign Branch Membership in the London Clearinghouse ("LCH")

Dear [ ]:

This letter responds to your letter and phone conversations concerning the issue of whether it is legally permissible for the bank, via its London branch, to join the LCH as a SwapClear Member ("SCM") to clear interest derivative contracts. For the reasons discussed below, and based on your representations, we believe that the bank's foreign branch LCH membership would be permissible under national banking law, subject to the concurrence of supervisory staff that the activity can be conducted in a safe and sound manner.[1] Conversely, the branch may become an LCH SCM under the Federal Reserve Board's (FRB's) Regulation K.[2]

A national bank must file notice with the OCC when its foreign branch joins a foreign exchange or clearinghouse, whether under the authority of national banking law or Regulation K. The filing requirements for national bank foreign operations are at 12 CFR Part 28. Section 28.3(c) provides that a national bank shall furnish the OCC with information involving the bank's foreign operations in addition to that specifically identified in the regulation. The OCC requires a national bank that becomes a member of a foreign exchange or clearinghouse, by stock acquisition or otherwise, to notify its EIC within 10 days of the membership. A national bank must certify in the notice that its loss exposure is limited as a legal and accounting matter and the bank does not have open-ended liability for the obligations of the exchange or clearinghouse or its members.

I. Background

The LCH provides clearing services to its members in certain exchange-traded and over-the-counter ("OTC") markets. LCH clears: (1) futures and options contracts traded on the International Petroleum Exchange, the London International Financial Futures and Options Exchange, and the London Metal Exchange, (2)

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[1] *See* 12 USC 24(Seventh) and 12 CFR 7.7010 and 28.3.

[2] *See* 12 USC 604a; 12 CFR Part 211.

equity transactions effected on virt-x, the London Stock Exchange, and the Irish Stock Exchange (via EquityClear), (3) interest derivative contracts (via SwapClear), and (4) repurchase agreements (via RepoClear). LCH members may be members of one or more of these exchanges. LCH has approximately 113 members that include investment banks, brokerage houses, and producers.

SwapClear provides multilateral clearing, settlement, and payment netting services for OTC interest derivative contracts. LCH becomes the central counterparty for all agreements cleared through SwapClear. LCH nets contracts not only for an SCM's interest derivative contracts, but across all of LCH's product lines, including equity and petroleum products. This results in a net single pay or receive amount per currency per day between LCH and each SCM.

As SCMs, branches have a number of financial obligations to the LCH. LCH members must purchase a single share of LCH stock for $420,000, provide margin, and contribute to a single LCH default fund. LCH pools all its members' default fund contributions for all the exchange-traded and OTC products that it clears. So, for example, if a member defaults on a London Stock Exchange equity contract, an SCM's default fund contribution ultimately is available to cover the losses from that default. Each SCM contributes $3 million to the default fund.[3] All SCM contributions total $145 million. The aggregate default fund contributions for all LCH exchange-traded and OTC business totals approximately $565 million.[4]

LCH's Default Rules define acts that constitute member defaults and describe the actions LCH may take once it declares a member in default. The primary act of default is non-payment of any amount due to LCH.[5] Other acts of default include any breach of LCH Regulations, any breach of exchange or regulatory requirements, and the commencement of insolvency arrangements.[6] The LCH can declare a member in default before the member fails to meet an obligation if it appears the member is, or is likely to become, unable to meet contract obligations.[7]

The LCH may take a number of actions against a defaulting member. LCH may close out and settle open contracts of the defaulting member, transfer open positions to another consenting member (with or without margin cover), and enter into new exchange or OTC contracts to hedge the market risk in the defaulting member's open-positions.[8] The LCH may liquidate losses resulting from a member's default, using this priority schedule: (1) the defaulting member's initial margin,[9] (2) the defaulting member's default fund contribution, (3) LCH's year-to-date profits (capped at $14 million), (4) the non-defaulting member's default fund contributions up to $290 million, (5) insurance of $144 million, (6) the remainder of the default fund, and, if necessary, [7] LCH capital.[10]

Upon a default, LCH can request members to make additional contributions to restore the default fund to its original level. LCH's call for additional contributions is voluntary.[11] A non-defaulting member can contribute to the default fund or resign its membership and close out its existing positions.[12] As a result, there is a theoretical cap on a non-defaulting member's contingent liability for the default of other members—the member's original default fund contribution. In addition, since it takes approximately three months for a resigning member to completely withdraw from membership, the member is still responsible during that time for losses on its portfolio and must continue to provide variation margin.

II. Discussion

For the reasons discussed below, we conclude that the bank's foreign branch LCH activities are permissible under national banking law or Regulation K.

A. National Banking Law

National bank foreign branches[13] may engage in general banking activities, which are determined under national

[3] Contributions are re-calculated quarterly and depend on the levels of each member's clearing activity in relation to the market as a whole. LCH, *Market Protection* (March 1999), at 29. The default fund contribution is the higher of $3 million or 10 percent of the initial margin requirement. LCH General Regulations, Default Rules, and Procedures ("LCH Regulations"), *Default Rule 19E* (February 2001), at 190.

[4] LCH, *Report and Financial Statement* (2000), at 6.

[5] LCH Regulations, *Default Rule 5* (February 2001), at 170, 171.

[6] *Id.*

[7] *Id., Default Rule 3* (February 2001), at 169.

[8] *Id., Default Rule 6* (February 2001), at 171–174.

[9] LCH re-calculates initial margin requirements daily and members must at all times meet the current requirements. LCH, *Market Protection* (March 1999), at 20, 24.

[10] LCH Regulations, *Default Rule 16,* at 183, 184.

[11] *Id., Default Rule 32(b)* (February 2001), at 201.

[12] *Id.*, *Default Rules 32–35* (February 2001), at 201–204.

[13] OCC regulations define the term "foreign branch" to mean an office of a national bank (other than a representative office) that is located outside the United States at which banking or financing business is conducted. 12 CFR 28.2(d). Regulation K defines a "foreign branch" as an office of an organization that conducts a banking or financing business outside the country in which the organization is legally established. 12 CFR 211.2(k).

banking law.[14] National banking law permits national banks, their operating subsidiaries, and their branches to engage in execution and clearing activities, subject to safety and soundness limitations, as activities that are part of the business of banking because the activities are functionally equivalent to bank permissible credit and financial intermediation activities.[15] National banks may provide default fund contributions (indemnification) on their own behalf and on behalf of their foreign branches, as an activity "incidental" or "convenient" or "useful" to these bank permissible activities[16] or as an activity permitted by 12 CFR 28.4(c). Section 28.4(c) expressly permits national banks to guarantee the deposits and other liabilities of their Edge corporations, Agreement corporations, and their corporate instrumentalities in foreign countries. National banks also may own stock in a clearinghouse or exchange to conduct these bank permissible activities.[17]

Clearing is a form of extending credit, one of the main functions of banking institutions.[18] A clearing agent substitutes its credit for that of its customers. A clearing agent is liable to a clearinghouse for performance on all submitted contracts, and assumes, with respect to the exchange, clearinghouse, and counterparties, the risk of its customers' defaults.[19] The clearing function is akin to two other traditional bank credit functions, providing bankers' acceptances and letters of credit.[20] The credit function provided by the bank in its clearing capacity is part of the business of banking, because a principal business of a bank is to extend credit, whatever its form.[21]

National bank clearing and execution activities are functionally equivalent to the primary role of banks as financial intermediaries. The role of a bank is to act as an intermediary, facilitating the flow of money and credit among different parts of the economy.[22] The role of a bank intermediary takes many forms: providing payments transmission services, borrowing from savers and lending to users, participating in the capital markets as here, or using and adopting whatever new methods the economy, markets, and technology develop over time. As the recognized intermediaries between other, non-bank participants in the financial markets and the payment systems, banks possess the expertise to effect transactions between parties and to manage their own intermediation position. Hence, the bank's LCH activities are permissible as part of bank authorized financial intermediary activities.[23]

The OCC has permitted national bank operating subsidiaries to engage in clearing and execution activities identical to those of the bank in LCH, both domestically and abroad.[24] The amount of risk a national bank may

[14] *See* 12 USC 604a; 12 CFR 211.4(a).

[15] Courts have affirmed OCC interpretations that an activity is within the scope of the "business of banking" if it: (1) is functionally equivalent to or a logical outgrowth of a traditional banking activity; (2) would respond to customer needs or otherwise benefit the bank or its customers; and (3) involves risks similar to those already assumed by banks. *See, e.g., Merchant Bank* v. *State Bank*, 77 U.S. 604 (1871); *M & M Leasing Corp.* v. *Seattle First Nat'l Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978); *American Insurance Ass'n*. v. *Clarke*, 865 F.2d 278, 282 (2d Cir. 1988). In *IAA* v. *Hawke*, 211 F.3d 638 (D.C. Cir. 2000), the court expressed the position that the "logical outgrowth" rationale needed to be kept within bounds, but endorsed the "functional equivalent" component of the test.

[16] Incidental activities are activities that are permissible for national banks, not because they are part of the powers expressly authorized for bank or the "business of banking," but rather because they are "convenient" or "useful" to those activities. *See NationsBank* v. *Variable Annuity Life Insurance Co.,* 513 U.S. 2251 (1995); *Arnold Tours, Inc.* v. *Camp*, 472 F.2d 427 (1st Cir. 1972); OCC Interpretive Letter No. 742 (August 19, 1996), *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–106; OCC Interpretive Letter No. 737 (August 19, 1996), *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–101; OCC Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

[17] *See, e.g.,* OCC Interpretive Letter No. 421 (March 14, 1988), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (national bank permitted to own stock in the Government Securities Clearing Corporation).

[18] *See* OCC Interpretive Letter No. 494, *supra*.

[19] A clearing member is subject to two types of incidental and contingent liabilities. First, a clearing member is obligated to perform all trades of its customers, whether or not the customer is able to perform the trade. Second, a clearing member is exposed to partial contingent liability for the obligations of all other clearing members to the clearing corporation. It is clear that whether a bank's operating subsidiary or branch is liable as broker to a clearing firm or as clearing broker to a clearing corporation, the ultimate liability and investment risk for all trades lies with the customer, against whom an action for recovery may be maintained. The OCC, therefore, does not consider the clearing member's "guarantee" of its customers' trades to the clearing corporation to violate the "without recourse" provision of Section 24(Seventh). *See* OCC Interpretive Letter No. 380 (December 29, 1986), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604.

[20] *See* OCC Interpretive Letter No. 494, *supra*.

[21] *Id.*

[22] *See, e.g*., OCC No-Objection Letter No. 90-1 (February 16, 1990) *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095; OCC No-Objection Letter No. 87-5 (July 20, 1977), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034.

[23] *See* OCC Interpretive Letter 892 (September 8, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–411.

[24] See, e.g., OCC Interpretive Letter No. 494, supra (national bank and operating subsidiary clearing and exchange members); OCC Interpretive Letter No. 422 (April 11, 1988), reprinted in [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (same); OCC Interpretive Letter No. 384 (May 19, 1987), reprinted in Fed. Banking L. Rep. (CCH) ¶ 85,608 (same); OCC Interpretive Letter No. 380, supra (execution, clearance, and exchange membership); OCC Interpretive Letter No. 372 (November 7, 1986), reprinted in [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,542 (same).

assume from exchange and clearing activities must be limited, however, due to safety and soundness concerns.[25] Thus, for example, the OCC has not permitted national banks to guarantee or become liable for customer trades executed by, or otherwise assume the liabilities of, their subsidiaries.[26]

The National Bank Act is silent on the authority on national banks to provide guarantees.[27] The Supreme Court has not held that guarantees are *per se* impermissible for national banks. [28] Instead, the Court has upheld a national bank's power to make guarantees given the specific facts under consideration.[29] Lower courts have tended to generalize these cases, however, in stating that national banks may not provide guarantees.[30]

National banks may provide guarantees, however, if the guarantee qualifies as "incidental"or "convenient"or "useful" to the business of banking under 12 USC 24(Seventh). This reasoning is supported by OCC Interpretive Ruling 7.1017, which confirms the authority of a national bank to lend its credit, bind itself as surety to indemnify another, or otherwise become a guarantor, if the bank has a substantial interest in the performance of the transaction involved. [31] A "substantial interest" exists if the guarantee provided by the bank is "incidental" to another of its authorized activities.[32] The nexus between the bank permissible transaction and the guarantee provides the "substantial interest" for the bank.[33] For example, the interest of a bank in assuring the financial performance of a co-fiduciary constitutes a sufficient interest to justify the issuance of a guarantee.[34] That relationship is analogous to the interest of a bank in assuring the financial performance of an affiliate, including a subsidiary corporation.

We believe that a national bank's provision of a default fund contribution to cover the potential default of customer transactions and, to a limited extent, the obligations of third party participant defaults as a necessary precondition to engaging in bank permissible clearing activity, qualifies as incidental to that activity. The bank has a substantial interest in providing such funds/guarantees on behalf of its branch, in order to retain the ability to provide customers bank permissible clearing and execution services, qualifying the activity as incidental to banking. The branch, as a clearing member, will not directly or indirectly guarantee the performance of its customers on the transactions it clears. Rather, the ultimate liability and investment risk for all trades lies with the customer, against whom the bank may bring an action for recovery.[35] In addition, a national bank, via its branch, may contribute to a default fund to guarantee its obligations and those of other exchange members consistent with the requirements of OCC Interpretive Ruling 7.7010 discussed above.

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[25] *Id.*

[26] *See, e.g.,* OCC Interpretive Letter No. 683 (July 28, 1995), *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,631 (permitted membership on the London Platinum and Palladium Market provided the bank did not undertake any guarantee or liability for other members trades); OCC Operating Subsidiary Notice Application Control Number: 94-ML-08-0002 (September 21, 1994) (permitted registration as a futures broker with the Monetary Authority of Singapore ("MAS") and clearing membership in the Singapore International Monetary Exchange ("SIMEX") provided that neither MAS nor SIMEX required the bank or its subsidiaries to guarantee or become liable for executed and cleared trades); OCC Interpretive Letter No. 507 (May 5, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,205; OCC Interpretive Letter No. 494, *supra*.

[27] 12 USC 24(Seventh).

[28] *See, e.g., Texas & Pacific Rwy*. v. *Potorff,* 291 U.S. 245 (1934) (national bank has no authority to secure a private deposit); *First N.B. of Aiken* v. *Mott Iron Works,* 258 U.S. 240 (1922) (declining to void a bank's guarantee of contract performance, and holding bank liable since it received the benefit of the guarantee); *Citizens Central N.B*. v. *Appleton,* 216 U.S. 196 (1910) (declining to void one national bank's guarantee to another bank, but deciding based on a theory of implied contract); *Merchants N.B.* v. *Wehrmann,* 202 U.S. 295 (1906) (national bank may not assume unlimited liability as a partner); *Logan City N.B*. v. *Townsend,* 139 U.S. 67 (1891) (declining to accept national bank defense that it had no authority to guarantee a contract and holding bank liable since it benefited from the contract); *Cook County N.B.* v. *U.S.,* 107 U.S. 445 (1883) (not within implied or express powers of national bank to provide the U.S. a priority of payment of claims arising from bank's insolvency).

[29] *See Peoples Bank of Belleville* v. *Manufacturers N.B. of Chicago,* 101 U.S. 181 (1880) (guarantee of notes held within powers of a national bank when the transaction was in substance an "indorsement"); *Cochran* v. *U.S.,* 157 U.S. 286 (1895) (contract of guarantee held within implied powers of a national bank).

[30] *See, e.g., Dunn* v. *McCoy,* 113 F.2d 587 (9th Cir. 1940); *Kimen* v. *Atlas Exchange N.B.*, 92 F.2d 615 (7th Cir. 1937) (invalidating bank sale of bonds to a customer and simultaneous guarantee to repurchase the bonds at any time in the future at par); *Border N.B.* v. *American N. B.*, 282 F. 73 (5th Cir. 1922 (upholding as letter of credit, rather than an impermissible guarantee, an agreement covering the purchase and shipment of 200 tons of sugar); *Bowen* v. *Needles N.B.,* 94 F. 925 (9th Cir. 1899), *cert. denied,* 176 U.S. 682 (1900) (invalidating bank guarantee of payment of customer's checks, in full knowledge that the customer had no funds on deposit with the bank).

[31] 12 CFR 7.1017.

[32] OCC Interpretive Letter No. 376, *supra* (national bank indemnification of lender of securities against loss is incidental to securities lending program and constitutes a "substantial interest" in the activity for purposes of exception to general prohibition against guarantees).

[33] OCC Interpretive Letter No. 218 (September 26, 1981), *reprinted in* [1978–1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,299 (national bank may issue a bill of lading guarantee due to its substantial interest in facilitating liquidation of goods after the previous issuance of a letter or credit). *But see* OCC Interpretive Letter No 79 (July 26, 1979), *reprinted in* [1978–1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,154 (bank does not have a substantial interest in guaranteeing the payment of pension funds held on deposit, which would violate prohibition against pledging private deposits).

[34] *See* 12 CFR 7.1017(a); OCC Interpretive Letter No. 57 (October 5, 1978), *reprinted in* [1978–1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,132.

[35] OCC Interpretive Letter No. 380, *supra*.

Furthermore, Section 28.4(c) expressly permits national banks to guarantee the deposits and other liabilities of its Edge corporations, Agreement corporations, and its corporate instrumentalities in foreign countries.[36] Hence, the bank may legally provide a default fund contribution in connection with its bank permissible clearing and execution activities, subject to the satisfaction of supervisory staff that the activity can be conducted in a safe and sound manner.

In addition, it is legally permissible for the bank to purchase a share of stock in LCH to enable the foreign branch to conduct bank permissible exchange and clearinghouse activities on LCH. OCC precedent recognizes that national banks may acquire stock and make noncontrolling stock investments that are not motivated by speculative purposes, but necessary to conduct a banking business.[37] For example, the OCC has permitted national banks to own shares in The Depository Trust and Clearing Corporation ("DTCC"), and the National Securities Clearing Corporations ("NSCC"). The OCC found the investment permissible under Section 24(Seventh) because the only purpose for the holding was to enable the owners to conduct permissible banking activities, *i.e.,* securities clearing and settlement activities through DTC and NSCC.[38]

B. Regulation K

Regulation K provides a separate source of authority for a national bank to join LCH. Regulation K affords foreign branches of national banks additional powers to those they otherwise enjoy under national banking law.

Under Regulation K, national bank foreign branches may, in addition to their authority under national banking law, exercise such further powers as may be usual in connection with the transaction of the business of banking in the country where the branch transacts business.[39] The FRB limits these powers (*i.e.,* permissible activities and investments) to the eight listed at 12 CFR 211.4(a). A national bank may rely on two of the listed powers—investing in securities of clearinghouses and shares of automated electronic payment networks, and the provision of guarantees—to permit foreign branch membership in foreign exchanges and clearinghouses.[40]

Specifically, Section 211.4(a)(3)(i) and (iii) permit foreign branches of national banks to invest in the securities of clearinghouses, as well as shares of automated electronic payment networks that are necessary to the business of the branch. The total investment of a bank's branches in the investments set forth in Section 211.4(a)(3) are subject to a limit of one percent of the total deposits in the bank's branches in that country on the preceding year-end call report date.[41] You state that the bank can invest in LCH under this authority and adhere to the one percent limit.

In addition, foreign branches may be able to provide a default contribution to LCH under Section 211.4(a)(1). Section 211.4(a)(1) permits branches to guarantee debts, or otherwise agree to make payments on the occurrence of readily ascertainable events if the guarantee or agreement specifies a maximum monetary liability. However, except to the extent that the bank is fully secured, it may not have liabilities outstanding for any person on account of such guarantees or agreement which, when aggregated with other unsecured obligations of the same person, exceed the limit contained in 12 USC 84 for loans and extensions of credit.

III. Conclusion

Accordingly, we conclude that the bank's foreign branch membership in LCH as an SCM is permissible under national banking law, subject to the satisfaction of supervisory staff that the activity can be conducted in a safe and sound manner. Conversely, the bank may rely on Regulation K to become a SCM in LCH. In either event, a national bank foreign branch that becomes a member of a foreign exchange or clearinghouse, by stock acquisition or otherwise, must notify its EIC within 10 days of the membership. The bank must certify in the notice that its loss exposure is limited as a legal and accounting matter and the bank does not have open-ended liability for the obligations of the exchange or clearinghouse or its members.

I trust the foregoing is responsive to your inquiry. If you have additional questions, please do not hesitate to contact Donald N. Lamson, assistant director, or Tena M. Alexander, special counsel, Securities and Corporate Practices Division at (202) 874-5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[36] 12 CFR 28.4(c).

[37] *See* OCC Interpretive Letter No. 892, *supra;* OCC Interpretive Letter No. 878 (December 22, 1999), *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,375; OCC Interpretive Letter No. 848 (November 23, 1998), *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,303.

[38] *See* OCC Interpretive Letter No. 421 (March 14, 1988) *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645.

[39] *See* 12 CFR 211.4.

[40] *See* 12 CFR 211.4(a)(1) and (a)(3)(i) and (iii).

[41] *See* 12 CFR 211.4(a)(3)(ii).