Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1037
September 2005
12 USC 24(7)

August 9, 2005

Re: Authority to Hedge Investment Advisory Fees with Cash-settled Derivatives Linked to the Performance of the Standard and Poor's 500 Index ("S&P 500")

Dear **[ ]**:

This responds to your letter of May 16, 2005 requesting confirmation that **[ ]** ("Trust Company") may use cash-settled derivatives linked to the performance of the S&P 500 to hedge the market risk associated with the fees it receives from its investment advisory activities. For the reasons discussed below and subject to the limitations and conditions set forth herein, we believe that the proposed activity is permissible for the Trust Company, provided that the Trust Company has established, to the satisfaction of its Supervisory Office, an appropriate risk measurement and management and compliance process to conduct its proposed hedging activity.

I. Background

The Trust Company acts as an investment advisor to a family of mutual funds. The Trust Company believes its investment advisory activities expose a significant portion of the Trust Company's revenues to market risk. More than 85 percent of the Trust Company's revenues are in the form of advisory fees for managing the mutual funds. These advisory fees are generally a percentage of the advised funds' value. The Trust Company contends that a decline in the value of the securities held by the funds would reduce its advisory fee revenues. In the event of a severe market disruption, the Trust Company believes its earnings and capital could be placed at risk. Accordingly, the Trust Company has determined it is necessary to hedge against that risk.

The Trust Company has determined the price movement of one of the most important and volatile funds[1] it advises is sufficiently correlated to the S&P 500 that a derivative based on the S&P 500 would be an effective hedge of advisory fees from the fund advised by the Trust Company. Accordingly, the Trust Company has proposed to enter into put spread contracts linked to the S&P 500 Index to hedge market risk associated with its advisory fees. The put spread contracts will provide a hedge benefit only for declines in the value of the S&P 500 within certain pre-arranged parameters. The Trust Company would not receive payment for declines above or below those parameters. In this manner, the Trust Company will limit the amount of protection it purchases against market declines to the amount that it believes is necessary or cost effective. This amount will not exceed the forecasted investment advisory fee income earned for advisory services to its equity fund.

The Proposal

To protect against downward movements in the value of the S&P 500, the Trust Company has proposed to enter into three one-year put spread contracts, for a notional amount of $2,000,000 each.[2] Each contract would expire at the end of each successive year. The Trust Company would pay the counterparty an up-front premium, which would increase in amount in each successive contract. In return, the counterparty would make a payment to the Trust Company at the end of each annual contract if the S&P 500 loses a certain amount of value, as measured against the annual average close of the S&P 500 for each year. The payoff amount would be based on the "put spreads" agreed to in the contracts.

These put spreads would be created by buying a put option on the S&P 500 at a particular strike price (Upper Strike Price) and simultaneously selling a put option on the S&P 500 with a lower strike price (Lower Strike Price) within the same contract period.[3] The Upper and Lower Strike Prices would each be a percentage of the value of the S&P 500 at the inception of the contract.[4]

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[1] The fund (the "Fund"), which accounts for 59.6% of the assets under management and 60.3% of the Trust Company's revenues, is the largest account under management and is invested in equity securities.

[2] The notional amount is the amount used to calculate payments made on derivative product. *See* http://www.investordictionary.com. In case of a put spread, the notional amount is the amount of coverage purchased.

[3] A put spread is created by buying a put option(s) at a particular strike price on a particular stock or stock index and simultaneously selling a put option on the same underlying stock or index with a lower strike price within the same contract period. A put spread is typically executed as a package in one single transaction, but could also be created with separate buy and sell transactions. The put spread allows the bank to limit the amount of protection it purchases against market declines to the amount that it believes is necessary or cost effective. *See* http://www.riskglossary.com/articles/options_spread.htm.

[4] The Upper and Lower Strike Prices for each of the three successive contracts would be based on the closing value of the Index on the date prior to the date of the first contract. Thus, when the Trust Company enters into the second and third put spread contracts in years two and three, the Upper Strike Prices and the Lower Strike Prices will be set as a percentage of the closing price of the Index on the date prior to the date the Trust Company enters into the first contract in year one.

The Trust Company would receive payment from the counterparty if the S&P 500 declines to a level below the Upper Strike Price. The payment would be equal to the notional amount ($2,000,000) times the amount by which the percentage decline of the S&P 500 exceeds the Upper Strike Price. For example, if the S&P 500 declines by 12% and the Upper Strike Price is set at 10% below the value of the S&P 500 at the inception of the contract, the payment obligation would equal $40,000 (2% x $2,000,000). If the S&P 500 falls below the Lower Strike Price, then the maximum payment would equal the percentage difference between the Upper Strike Price and the Lower Strike Price multiplied by the notional amount of the contract. For example, if the Upper Strike Price is 10% and the Lower Strike Price is 25%, and if the S&P 500 falls 30% over the contract period, the maximum payment would be $30,000 (15% x $2,000,000).

The following illustrates how the put spread would work, based on the assumptions below:

- Trust Company enters into three one-year put spread contracts beginning in 2006.
- Closing Price of the S&P 500 on December 31, 2005 of $1000.
- S&P 500 Index average daily prices of 1100 in 2006, 800 in 2007 and 700 in 2008.
- Upper and lower strike prices in 2006 equal to 90-85% of the value of the S&P 500 on 12/31/05, 90-80% 2007 and 90-75% in 2008.
- Based on the upper and lower strike prices, the put spread contracts would cover losses in the value of the S&P 500 from 10 to 15% in 2006, 10-20% in 2007 and 10-25% in 2008.
- Premium would rise from 1% of the notional amount of the contract in 2006, to 2% in 2007 and 4% in 2008.

Based on those assumptions, there would be no payoff in 2006, because the average price of the S&P 500 in 2006 is above the closing price of the S&P 500 at the end of 2005. In 2007, there is a 20 percent decline in the S&P 500, but the first 10% decline would not create a payoff obligation, because it is not covered by the put spread. The payoff obligations would only be for the second 10% or loss or $200,000. In 2008, there is a 30 percent decline in the S&P 500. The payoff would only cover 15% of the losses, however, because the first 10 percent and the last 5 percent of loss would not be covered by the put spread. Therefore, the Trust Company would receive a payoff of $300,000. The table below further illustrates the example.

Year	S&P 500 12/31/05 Close	S&P 500 Annual Average	Put Spread: Upper & Lower Strike	Notional Amount	Payoff	Premium Paid
2006	1000	1100	90-85%	$2,000,000	--	$20,000
2007	1000	800	90-80%	$2,000,000	$200,000	$40,000
2008	1000	700	90-75%	$2,000,000	$300,000	$80,000

As the example shows, the put spread contracts will provide a hedge benefit only for declines in the value of the S&P 500 that fall between the Upper and Lower Strike Prices

– the put spread. The Trust Company would not receive payment for declines above or below the Upper and Lower Strike Prices. In this manner, the Trust Company will limit the amount of protection it purchases against market declines to the amount that it believes is necessary or cost effective.

The Trust Company has committed that it will enter into the proposed put spread contracts solely to hedge market risk associated with its investment advisory fees and will not engage in speculation. In addition, the hedging strategy may only be used when there is at least a 95% correlation in price movement between the S&P 500 Index and its Fund. In the event the Trust Company determines that the correlation is such that the hedge is no longer effective, the Trust Company will exit the hedge by selling the contract either to the contract counterparty or to a buyer identified by the contract counterparty.

The Trust Company intends initially to enter into put spread contracts for only 32.3% of the existing exposure to be hedged. The Board of Directors of the Trust Company may increase this percentage depending upon the fund's capital, the forecasted earnings, profits, and the overall hedging strategy as well as any desired increase in the notional amount. The Trust Company has committed that it will not hedge more than the forecasted investment advisory fee income earned for providing investment advisory services to its equity fund.

The Board of Directors and the Audit Committee of the Trust Company have approved written policies and operating procedures for general risk monitoring, identification and control, risk management systems, audit coverage, and an effective risk control function to oversee and assure the appropriateness of the risk management process. The Trust Company will ensure that it has effective senior management supervision and oversight by the Board of Directors to guarantee the proposed activities are conducted in a safe and sound manner and consistent with its commitments.

II. Discussion

The Trust Company has determined that the fees associated with its investment advisory activities are subject to market risk that could reduce the Trust Company's revenues and place its earnings and capital at risk. The Trust Company has proposed to use put spread contracts linked to the performance of the S&P 500 Index to hedge that risk. National banks may use derivative contracts to manage or hedge the risks from permissible activities under certain conditions. Thus, in our opinion, the Trust Company may enter into put spread contracts as a means to hedge its market risk from the fee income it receives from investment advisory activities, subject to the limitations and conditions set forth herein and provided that 1) the proposed put spread contracts are entered to for the purpose of hedging the market risk associated with its investment advisory fee, and not for speculation, and 2) the Trust Company establishes an appropriate risk measurement and management and compliance process to conduct such hedging activities. This process is necessary for the Trust Company to achieve its risk management objectives in a safe and sound manner and, thus, must be established before the OCC can determine that the proposed activities are permissible as part of the Trust Company's investment advisory business.

A. Providing investment advice for a fee and hedging risks associated with those fees with put spread contracts is permissible.

A national bank may engage in activities pursuant to 12 U.S.C. § 24(Seventh) if the activities are part of or incidental to the business of banking.[5] The OCC has long held that a national bank may provide investment advice for a fee as part of the business of banking under 12 U.S.C. § 24(Seventh) and pursuant to its fiduciary powers under 12 U.S.C. § 92a.[6] Hedging risk arising from investment advisory activities is integral to those permissible activities.

The Trust Company has determined that its investment advisory fees are subject to market risk exposure. The Trust Company's management of that risk is therefore integral to its bank permissible business of providing investment advice for a fee. The Trust Company has proposed to use put spread contracts linked to the performance of the S&P 500 Index to hedge that risk. The put spread contracts will provide a hedge benefit only for declines in the value of the S&P 500 within certain pre-arranged parameters. The Trust Company would not receive payment for declines above or below those parameters.

The OCC has long permitted national banks to enter into derivative contracts to manage or hedge risks arising from permissible banking activities.[7] The OCC has recognized the permissibility of such activities both for the purpose of providing bank customers with

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[5] Section 24(Seventh) expressly provides that national banks shall have the power: To exercise . . .all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes. The Supreme Court held that this authority is a broad grant of power to engage in the business of banking, including, but not limited to, the five powers expressly granted in 12 U.S.C. § 24(Seventh) and in the business of banking as a whole. *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("*VALIC*").

[6] *See e.g.*, Interpretive Letter No. 940 (May 24, 2002); Interpretive Letter No. 897 (October 23, 2000) *reprinted in* [2000-2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-416; Interpretive Letter No. 871 (October 14, 1999) *reprinted in* [1999-2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,365; Conditional Approval Letter No. 164 (December 9, 1994); Interpretive Letter No. 648 (May 4, 1994) *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,557; Interpretive Letter No. 647 (April 15, 1994) *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,558; Interpretive Letter No. 403 (December 9, 1987) *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,627.

[7] *See e.g.*, OCC Interpretive Letter No. 896 (August 21, 2000) (*Agricultural Loan Hedge Letter*) *reprinted in* [2000-2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-415 (national bank may purchase cash-settled options on futures on agricultural commodities to hedge bank permissible lending activities).

the ability to hedge their own risks and as a means for banks to directly hedge the risks that arise from permissible banking activities.[8]

For example, in *MII Deposit*, the OCC authorized a national bank to purchase equity index futures to hedge interest rate risk exposures on deposit accounts that had interest rates tied to S&P 500 Index.[9] In confirming the permissibility of the hedging activity, the OCC noted that national banks are permitted, and indeed encouraged, to manage prudently the exposure arising out of bank activities and they must be allowed the flexibility to use the most suitable risk management tool.[10]

Similarly, in *DPC Shares*, the OCC permitted a national bank to buy and sell options to manage market risks associated with changes in the value of shares of a company the

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[8] *See* OCC Interpretive Letter No. 356 (January 7, 1986) *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,526 (bank registered as a futures commission merchant could execute customer orders for agricultural and metals futures in connection with its loans to the customers); *Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A. to Offer the Chase Market Index Investment Deposit Account* (August 8, 1988) ("*MII Deposit*"), 1988 OCC Ltr. LEXIS 266 (national bank may buy and sell futures on the S&P Index to hedge deposits with interest rates tied to the S&P 500 Index); OCC Interpretive Letter No. 937 (May 14, 2002) (*Electricity Derivatives Letter*) *reprinted in* [2001-2002 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,462 (bank could hedge risks arising from financial intermediation transactions based on electricity prices); OCC Interpretive Letter No. 892 (September 13, 2000) *reprinted in* [2000-2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-411 (*Equity Hedge Letter*) (national bank may hedge the risk of derivatives activities by purchasing equity securities); OCC No Objection Letter No. 87-5 (July 20, 1987) *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 (bank could act as principal in commodity price index swaps with its customers); OCC No Objection Letter 90-1 (February 16, 1990) *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095 (bank could act as principal in unmatched commodity price index swaps with its customers and hedge its price risk exposure using exchange-traded commodity futures); OCC Letter from Horace Sneed, Senior Attorney, Legal Advisory Services Division (March 2, 1992) (unpublished) (bank could manage its commodity index swaps on a portfolio basis and hedge the swaps with swaps, exchange traded futures or over-the-counter (OTC) options; OCC Interpretive Letter No. 642 (September 13, 1994) *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600 (bank could engage in equity and equity derivative swaps and hedge risk using futures contracts, options and similar OTC instruments).

[9] *MII Deposit*, *supra*. The threshold issue the OCC confronted was whether the bank had the authority to offer a deposit product with interest based in part on a stock index. The OCC concluded that the offering of the deposit was permissible under the express authority in 12 U.S.C. § 24(Seventh) for national banks to receive deposits. The OCC also specifically rejected the argument that purchasing S&P 500 Index futures contracts was impermissible under the Glass Steagall Act due to restrictions on bank purchases of the underlying securities. *See also Investment Company Institute v. Ludwig*, 884 F. Supp. 4 (D.D.C. 1995) (controlling effect given to *MII Deposit* in denying plaintiff's motion for summary judgment in suit claiming the MII program violated the Glass-Steagall Act). *See also*, OCC Letter from Ellen Broadman, Director, Securities and Corporate Practices Division, OCC to Barbara Moheit, Regional Counsel, FDIC (October 20, 1998) (unpublished) (national bank may hedge interest rate risk on deposits that pay interest based on a particular equity index or unit investment trust ("UIT") by purchasing options on the same equity index or UIT).

[10] *MII Deposit, supra*.

bank had acquired as debt previously contracted in a workout.[11] The OCC concluded that the hedging strategy could facilitate and improve the bank's ability to reduce credit exposures to its borrowers by protecting the value of the shares.

In the *Electricity Derivatives Letter*, the OCC permitted a national bank to hedge bank permissible electricity derivative transactions with electricity futures, and swaps and options and other OTC instruments, provided the activity would be conducted in a safe and sound manner.[12] The OCC concluded that using cash-settled electricity derivatives to hedge against the risks associated with the bank's customer-driven, cash-settled electricity derivatives business was an integral part of those permissible banking activities.

In each of those decisions, the hedging transactions were used to manage risks arising from otherwise bank permissible activities and were not entered into for speculative purposes. In much the same manner, the Trust Company would hedge the market risk associated with the fees it collects from its authorized investment advisory activities by entering into cash-settled put spread contracts linked to the S&P 500 Index. It would not enter into the contracts for speculative purposes.

The major difference between the Trust Company's proposal and the hedging activities approved in the OCC letters cited above is the different contexts in which the banks were seeking to manage risks. In the *MII Deposit*, the bank was managing interest rate risks arising from its deposit *liabilities*, while in *DPC Shares*, the bank was hedging market risks arising from changes in the value of its DPC *assets*. In the *Electricity Derivatives Letter*, the banks used electricity futures, swaps and options to hedge the *off-balance sheet* risk of their bank permissible cash-settled electricity derivatives activities. In this case, the Trust Company seeks to hedge market risks associated with its investment advisory fee *income*. Regardless of whether the bank is hedging risks from its assets and liabilities, from off-balance sheet activities or from its income statement, the fundamental principle is the same -- managing the risks arising from permissible banking activities is part of and is integral to the business of banking. This principle is equally valid whether the activity is deposit-taking, lending, entering into derivatives transactions or providing investment advice for a fee. A bank must manage the risks from its bank permissible activities to operate profitability and may engage in hedging activities to do so.[13] Thus, hedging the Trust Company's advisory fee income by entering into put spreads is permissible under 12 U.S.C. 24(Seventh), provided, as discussed below, the Trust

[11] *See* OCC Interpretive Letter No. 961 (Mar. 17, 2003) ("*DPC Shares*"), *OCC Interpretations and Actions, April 2003* (national bank may buy and sell options on the shares of stock of a company when the bank has acquired shares of the company in satisfaction of debts previously contracts).

[12] OCC Interpretive Letter No. 937 (June 27, 2002) ("*Electricity Derivatives Letter*"), *reprinted in* [2001-2002 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,462 (national bank may hedge bank permissible electricity derivative transactions with electricity futures, and swaps and options and OTC derivative instruments).

[13] *Equity Hedge Letter, supra*.

Company demonstrates to the satisfaction of the OCC, that it has the capacity to conduct the activity in a safe and sound manner.[14]

B. The hedging activity must be conducted in a safe and sound manner.

For the Trust Company to permissibly engage in the proposed activity, the Trust Company's risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner. Consequently, in order for the OCC to conclude that this activity is permissible for the Trust Company because it is part of the business of banking or convenient and useful to conducting authorized banking activities, the Trust Company must demonstrate to the satisfaction of the Supervisory Office that the Bank has established an appropriate risk measurement and management process for its proposed activity. As detailed further in the OCC handbook *Risk Management of Financial Derivatives*[15], Banking Circular 277,[16] and the Statement of Financial Accounting Standards No. 133 ("FAS 133")[17] an effective risk measurement and management process includes board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function that oversees and ensures the appropriateness of the risk management process.

The Trust Company's risk control processes should include the Trust Company's compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income, and generally accepted accounting principles.

In addition to a risk management program, the Trust Company's process must include an independent compliance-monitoring program to ensure ongoing compliance with the specific commitments made by the Trust Company described above.[18] The Trust

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[14] The Trust Company has identified a stock index that is highly correlated (95%) to the risk factors that could affect the Trust Company's income flows. Thus, the derivatives of that stock index provide a highly correlated hedge that justifies the hedging activity.

[15] January 1997.

[16] October 27, 1993.

[17] Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133).

[18] The OCC has long incorporated safety and soundness considerations when determining whether an activity is part of, or incidental to the business of banking. *See e.g., Equity Hedge Letter, supra* (national bank may engage in equity hedging activities only if it has an appropriate risk management process in place); Interpretive Letter No. 684 (August 4, 1985) (commodity hedging is a permissible banking activity provided the activity is conducted in accordance with safe and sound banking practices); *MII Deposit, supra* (national banks have the authority to establish and determine the amount of the payments to be made and received under their deposit and loan contracts by reference to any index or standard as long as the bank is in compliance with safe and sound banking principles); Interpretive Letter No. 376 (Oct. 22, 1986) *reprinted in* [1985-1986 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,600 (indemnification from losses resulting from participation in the bank's fiduciary securities lending program is a permissible

Company must have an adequate and effective compliance monitoring program that includes policies, training, independent surveillance and well-defined exception approval and reporting procedures.

In addition, prior to conducting the proposed activity, the Board of Directors of the Trust Company must execute an operating agreement ("Operating Agreement") with the OCC on terms and provisions acceptable to the OCC. The safeguards in the Operating Agreement will ensure that the Trust Company continues to operate in a safe and sound manner after it commences the proposed hedging activity. This requirement is a condition imposed in writing by the agency in connection with the granting of an application or other request within the meaning of 12 U.S.C. § 1818. As such, the condition is enforceable under 12 U.S.C. § 1818.

The Trust Company may not commence the proposed activity unless and until its Supervisory Office has concluded that the foregoing standards are met.

III. Conclusion

The Trust Company may engage in the proposed activity subject to the limitations and conditions set forth herein and provided the Trust Company acts in accord with the commitments reflected in this letter and has established, to the satisfaction of its Supervisory Office, appropriate risk measurement and management and compliance processes.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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incidental activity provided the indemnification is consistent with OCC guidance and safety and soundness).