United States General Accounting Office

GAO

Report to the Honorable
James A. Leach
House of Representatives

August 2001

EQUITY HEDGING

OCC Needs to Establish Policy on Publishing Interpretive Decisions

GAO-01-945

Contents

Abbreviations

EIC	examiner-in-charge
FDIC	Federal Deposit Insurance Corporation
GLBA	Gramm-Leach-Bliley Act
OCC	Office of the Comptroller of the Currency
VALIC	Variable Annuity Life Insurance Company

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

August 16, 2001

The Honorable James A. Leach
House of Representatives

Dear Mr. Leach:

This report responds to your request that we review the Office of the Comptroller of the Currency's (OCC) legal decision and the process OCC used to allow national banks[1] to acquire equities to hedge the risks arising from customer-driven equity derivative transactions.[2] Over the last 10 years, a small number of large national and state banks have become equity derivative dealers. Prior to OCC's decision to allow national banks to hedge their equity derivative transactions within the bank, national banks had been hedging these transactions through nonbank affiliates of holding companies. Rather than hedge in this manner, four national banks sought OCC's opinion on whether it was permissible to hedge their equity derivative transactions by holding equities in the bank. Section 24(Seventh) of the National Bank Act, 12 U.S.C. § 24(Seventh), contains equity-related limitations and restrictions that generally prohibit a national bank from purchasing equities for its own account. These same limitations and restrictions also apply to state banks.[3] OCC considered the permissibility of banks owning equities under the National Bank Act and approved four national banks' requests, concluding that the equity limitations in section 24(Seventh) of the National Bank Act do not prohibit the purchase of equities for the purpose of hedging customer-driven equity derivative transactions.

Because of your view on the equity ownership prohibitions contained in section 24(Seventh), you questioned OCC's decision, stating that allowing banks to own equity in commercial companies is something that is not

[1]National banks are banks that are federally chartered and regulated by OCC.

[2]Equities are stocks (ownership interest possessed by shareholders of a corporation). In a letter to you (OCC interpretive Letter No. 892 at 1 (Sept. 8, 2000)), the Comptroller of the Currency described "customer driven" transactions as "originated by customers for their valid and independent business purposes." The Comptroller also stated that the term "equity derivative transactions" means "transactions in which a portion of the return (including interest, principal or payment streams) is linked to the price of a particular equity security or to an index of such securities."

[3]See footnotes 19 and 20.

sanctioned by law. You also questioned the way in which OCC made its decision, noting that OCC appeared to have granted its approval to the national banks in "virtual secrecy," or without notice or opportunity for public comment.

Our objectives in this review were to (1) provide you with information on the process OCC used to make its decision to allow banks to acquire equities and discuss whether the decision was consistent with the way in which OCC generally makes and communicates its decisions and (2) provide a legal opinion as to whether national banks are authorized to purchase equity securities to hedge their equity derivative transactions under existing law.

Results in Brief

OCC has discretion to determine how it will convey its decisions, but the criteria it uses to determine when and whether to publish its decisions are unclear. For the equity hedging decision, OCC first determined that banks holding equities to hedge equity derivative transactions was a permissible activity under the National Bank Act. OCC then decided that the requesting banks would not be allowed to engage in the activity of equity hedging without first obtaining supervisory staff approval of their activities and risk management systems, enabling OCC to ensure that each bank had the necessary risk management systems in place to monitor risks and prevent speculation. OCC did not publish its interpretation until after it received a congressional inquiry in September 2000 questioning its decision. In making certain other decisions interpreting the National Bank Act, OCC has published written interpretive letters. By approving the equity hedge decision the way it did, OCC has been criticized for using supervisory approval as a way to avoid public scrutiny of its decision and has left itself open to questions not only about the process used in this case, but also about the criteria OCC uses to decide when to publish its interpretive decisions. Helping the Congress and other banking regulators affected by OCC's decisions understand the criteria OCC uses to determine when and whether to publish interpretive decisions could help mitigate concerns that arise when OCC interprets federal banking laws that not only affect other banking regulators but are also considered controversial.

We agree with OCC's conclusion that the four national banks have authority under the National Bank Act to own equities to hedge their equity derivative transactions. To support this conclusion, OCC first determined that certain equity derivative transactions and managing the risks of those transactions are a permissible banking activity authorized by

section 24(Seventh) of the National Bank Act. OCC next found that owning equities to conduct these hedging activities is not prohibited by the stock-related limitations contained in the section. We concur with OCC's conclusion that those limitations do not prohibit the four banks from maintaining the stock hedges as an incidental activity.

We recommend that the Comptroller of the Currency establish a policy that articulates the criteria OCC uses in deciding when and whether to publish its interpretive decisions. We also recommend that the Comptroller of the Currency publish legal interpretations that pertain to section 24(Seventh) of the National Bank Act in order to keep other federal bank regulators and financial institutions informed of its interpretation.

We provided a draft of this report to the Comptroller of the Currency. OCC agreed with our recommendations.

Background

The rapid rise in equity prices over the last 10 years has been accompanied by new strategies for hedging equity positions. In the mid-1990s, some national banks began engaging in customer-driven equity derivative transactions. Since then, equity derivatives have become an increasing part of banks' businesses, as bank customers, both institutions and private clients, increasingly use equity derivative products to hedge their equity positions. Equity derivative products include instruments such as equity options, equity collars, equity and equity-indexed swaps, and other products.[4] Although the notional amount of equity derivatives is still small compared with the volumes of other types of derivatives that bank customers use, it has tripled in the last 5 years. According to the Bank for International Settlements, the volume of equity derivative notional amounts has gone from $630 billion in 1995 to almost $1.9 trillion in 2000, while the notional amount for all over-the-counter derivatives has increased from $41 trillion in 1995 to over $95 trillion in 2000. According to OCC officials, the trading revenue from equity derivatives has also increased as a share of bank customer revenues. As the equity derivatives

[4]An equity option is the right to buy (call option) or sell (put option) a specified amount of shares of an underlying instrument (equity) for an agreed upon amount. An equity collar is an option that limits upside and downside risk by selling a call and buying a put. An equity index swap is an arrangement in which two parties (called counterparties) enter into an agreement to exchange periodic appreciation or depreciation on an equity index such as the Standard and Poor's 500 Index.

business has grown, banks have increasingly had to devote more attention and resources to managing the risks related to equity derivatives. Banks hedge in order to offset or manage the risks arising from engaging in equity derivative transactions.

Until recently, national banks hedged their equity derivative transactions through holding company affiliates. The equity derivative was booked at the bank, and the equities used to hedge the equity derivative transactions were booked in a holding company affiliate. The holding company affiliates were usually nonbank entities that were not broker-dealers and were set up for the express purpose of hedging the bank's equity derivative risks. The banks would instruct the affiliates on the structure, nature, and timing of the relevant hedging transactions, and the affiliates would enter into the hedging transactions only when directed. These arrangements allowed the banks to hedge their equity derivative exposures without ever directly owning or selling the stock, in accordance with prevailing guidelines.

The hedging transactions that the affiliates engaged in included "mirror" transactions and going long or short in a particular equity or basket of equities. For example, if a bank sold an equity derivative to its customer, it would purchase an identical equity derivative from its affiliate in order to hedge any risk, "mirroring" the initial transaction. Some of the banks we spoke with said that instead of entering into mirror transactions with their affiliates, they would instruct their affiliates to buy or short (sell) equities on a delta equivalent basis.[5] Banking officials told us that no matter what type of hedge the bank booked through the affiliate, the risks arising from engaging in customer-driven equity derivative transactions always remained in the bank, even when the bank hedged its risks through the affiliate. See appendix I for a more detailed example of an equity derivative hedge.

[5]Delta is a hedge ratio that banks calculate to determine the amount of equity the bank must buy or short, so that for any given change in the price of the equity, the equity hedge position will change by the same amount as the change in the equity derivative position. With delta 1 hedging, a one-to-one correlation exists between the amount of shares the bank instructs the affiliate to purchase or short to hedge the bank's exposure and the amount of shares underlying the equity derivative. Delta hedging, as distinct from delta 1 hedging, usually involves equity options. The objective of delta hedging is to have the change in the value of the client derivative transaction match the change in the value of the equity hedge, but in different directions. Unlike delta 1 hedging, the amount of equity the bank would instruct its affiliate to hold would vary over time as the price of the underlying equity changed.

Beginning in December 1999, certain national banks requested OCC's opinion on whether it would be permissible for them to hedge their customer-driven equity derivative transactions within the bank, eliminating the need to enter into hedging transactions with affiliates. After months of consideration, on July 20, 2000, OCC began verbally approving the banks' requests, relying on its internal written interpretation of section 24(Seventh). As a result of OCC's decision, the banks have begun to directly book equity hedges within the banks. In addition, some state-chartered banks have also asked their primary federal banking regulators about OCC's decision and its implication for their activities.

OCC's Process in Making Its Equity Hedging Decision Is Controversial

Beginning in December 1999, three national banks requested OCC's opinion on whether the banks may hold equities to hedge their customer-driven equity derivative transactions.[6] The banks said that their inability to hedge their equity derivative transactions directly in the bank had caused them to incur additional expenses and potentially increased their risk. OCC approved the banks' requests, but initially did not make its decision public. After deciding that equity hedging in the bank was a permissible activity, the process OCC used to approve the banks' request was one in which OCC required each bank to obtain supervisory staff approval prior to engaging in the activity of equity hedging within the bank. OCC has acknowledged that its initial decision was made in a nonpublic manner. But OCC has insisted that it was necessary to grant the approval on a bank-by-bank basis rather than issuing a blanket approval, in order to ensure that each bank had the necessary risk management systems in place to monitor risks and prevent speculation. In making certain other decisions about equities or hedges, OCC has published written legal interpretations. Because OCC has the discretion to determine how it will convey its decisions, no one process exists for doing so. Consequently, OCC leaves itself open to being questioned when it does not publish a written interpretation on issues that others may consider controversial.

Banks Request OCC's Approval to Equity Hedge Within the Banks

Three banks initially requested OCC's interpretation about whether it would be permissible to hold equities in the bank in order to hedge their equity derivative transactions. Prior to OCC's decision, the banks hedged their equity derivative exposures through contractual arrangements with holding company affiliates, which were set up as separate legal entities for

[6]A fourth bank received OCC's approval after OCC had made its decision.

the sole purpose of hedging the bank's equity derivative transactions. The banks hedged in this manner largely because of the perceived legal constraints preventing banks from direct ownership of equities. In making their requests to OCC, the banks stated that purchasing, holding, or selling equities was a more cost-effective and accurate way to hedge exposures arising from equity derivative transactions. The banks also maintained that they could more practically manage the risks associated with equity derivative transactions by purchasing and booking equity hedges within the bank.

The primary reasons the banks gave for requesting OCC's approval were that booking equity hedges within the bank was likely to reduce their costs and their exposure to operations risks. The cost savings would result from eliminating the need for corporate funding and the expense of maintaining and managing a separate legal entity. The corporate funding expense occurred because a bank's affiliate obtained its funding from the bank's corporate parent at a rate higher than the bank's own funding rate.[7] In addition, the banks maintained the affiliate as a separate legal entity, sometimes incurring the expense of maintaining separate staff and supporting the processing, reconciliation, accounting, and reporting requirements for internal transactions between the bank and its affiliate.[8] The cost of both corporate funding and maintaining a separate legal entity made it expensive for the banks to hedge their equity derivative transactions through affiliates.

The banks also said that they could reduce operations risks by directly hedging their equity derivative transactions within the bank. According to banking officials, hedging through an affiliate created numerous trading, operational, and funding inefficiencies. For example, a bank's affiliate might have to maintain a long equity position in one account and a short position in another because of the limitations on the banks holding

[7]By funding the hedging activity through the bank holding company rather than the bank, the banks were trying to avoid creating a covered transaction. Under the Federal Reserve Act and Federal Reserve Board regulations, certain financial transactions between banks and their affiliates, such as loans, are defined as "covered transactions" subject to requirements intended to limit the bank's exposure to an affiliate's credit or investment risk. 12 U.S.C. §§ 371c, 371c-1 (1994 & Supp. 2000); 12 C.F.R. Part 250 (2001). A bank could have created a covered transaction if the bank directly extended credit to its affiliate to fund the purchases and sales of equities used to hedge the bank's equity derivative transactions.

[8]This expense, which included capital usage, was included in a fee the bank paid to its corporate parent.

equities. Long and short positions in different entities were not effectively netted, or canceled out, in the risk reports a bank produced. Risk management systems would not always recognize all positions taken by a bank and its affiliate, increasing the chance of trading, risk management, and operational inefficiencies. The banks said that the optimal way to hedge would be to net the long and short position in the same entity, increasing the bank's operational efficiency. Banking officials also said that in order to hedge through an affiliate, banks must make multiple trades, resulting in more transactional inputs that can lead to errors and the need for more reconciliation.

Banking officials said two developments spurred their requests: OCC's decision to allow national banks to hedge nonqualified employee deferred compensation plans, and the passage of the Gramm-Leach-Bliley Act (GLBA) of 1999.[9] In December 1999, OCC decided to allow national banks to hold an interest in insurance company products and other products in order to hedge, on a dollar-for-dollar basis, their deferred compensation obligations to employees.[10] Banking officials said that they thought the same analysis would support a bank's ability to hedge its equity derivative transactions within the bank. In addition, with the passage of GLBA, the Federal Reserve Board was instructed to address the question of whether credit exposures arising from derivative transactions between an insured depository institution and its affiliates should be covered by section 23A of the Federal Reserve Act.[11] The Federal Reserve was considering whether transactions between the banks and their hedging affiliates constituted loans or extensions of credit instead of funding for the purchases and sales that banks termed the transactions.[12] Banking officials said that if the Federal Reserve Board did determine that credit exposure arising from derivative transactions was covered by section 23A of the Federal Reserve

[9]Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[10]OCC Interpretive Letter No. 878 (Dec. 22, 1999). Banks proposed to offer their employees a variety of registered investment companies and private investment funds as benchmarks under the employee compensation plan. The benchmark funds were to include funds that invest exclusively in bank-eligible assets, as well as funds that invest in assets traditionally impermissible for investment by national banks. To hedge their obligations under the employee compensation plan, the banks were proposing to acquire the number of units of each benchmark fund selected by the employee.

[11]Pub. L. No. 106-102 § 121(b)(3), 12 U.S.C. § 371c(f)(3) (Supp. 2000).

[12]Federal Reserve officials said that the banks were providing the holding company with funds that ultimately allowed holding company affiliates to purchase or sell the equities used to hedge the banks' equity derivative transactions.

Act, then the Federal Reserve could impose collateral requirements, markedly increasing the cost of hedging their equity derivative transactions through affiliates.[13] Lawyers representing two of the banks said that they could not get a definitive reply from Federal Reserve Board officials on this question. As a result, the banks turned to OCC.

OCC Determines Equity Hedging Is Permissible, Subject to Supervisory Approval

After the decision that equity hedging in the bank was a permissible activity, the process OCC used to allow four national banks to hedge their equity derivative transactions was one in which OCC required each bank to obtain supervisory approval prior to engaging in the activity of equity hedging within the bank. OCC officials said that the legal determination allowing banks to hold equities to hedge equity derivative transactions could not be made without OCC supervisory staff generally determining that there was no safety and soundness risk in allowing banks to hedge their equity derivative transactions within the bank. Once the legal determination was made, OCC decided that in order for equity hedging within a particular bank to be permissible, OCC supervisory staff would have to first review and approve the types of equity derivative transactions, processes governing proposed hedges, and internal risk management systems of the requesting banks. OCC considered its approval to be a supervisory matter relating to each institution rather than one that is generally applicable to all national banks. As a result, OCC decided not to publish its interpretation, even though OCC has previously published interpretations on the National Bank Act, including decisions relating to hedging and equities.

Supervisory Concerns Dominated OCC's Decisionmaking Process

In December 1999, outside counsel for two national banks called OCC to ask if OCC was receptive to allowing banks to hedge their equity derivative transactions by holding equities within the bank. The Chief Counsel's Office agreed to explore the legal issue. In January 2000, OCC requested that the outside counsel for one of the banks submit a written letter to the Chief Counsel's Office in order to facilitate OCC's consideration of a possible framework for banks themselves to engage in equity derivative hedges. The outside counsel complied and sent requests on behalf of these banks to OCC for its interpretation on whether the National Bank Act provides the authority for banks to minimize the risks associated with customer-related equity derivative transactions through

[13]See 12 U.S.C. § 371c(c), (f) (1994 & Supp. 2000).

hedging transactions, including hedging transactions involving long and short positions in physical equity securities.

In considering whether banks should be allowed to hold equities for hedging purposes, OCC decided that its supervisory office would need to determine if this activity posed a safety and soundness risk. OCC officials said that in making any decision, they always consult with the examiner-in-charge (EIC) or the deputy comptroller for large bank supervision of the institution requesting an opinion on possible issues that need to be taken into consideration before an interpretation is issued. However, in this case OCC said that the supervisory judgment was to be a major factor in determining whether this activity would be permitted. OCC's Chief Counsel told us that the agency was looking not so much for examiner approval as for assurances that OCC supervisory staff would have no objections to OCC determining that holding equities within the bank to hedge equity derivative transactions is a permissible activity. Thus, if OCC supervisory staff had determined that equity hedging within a national bank posed safety and soundness risks, OCC could not have permitted the activity. OCC supervisory staff said they did not see a reason to oppose the permissibility of equity hedging on a safety and soundness basis. Based on the supervisory staff's findings, OCC moved ahead with its deliberations.

After being informed that OCC would consider the legal aspects, the banks sent in proposals for their equity hedging programs. Our review of OCC documents and discussions with OCC officials showed that OCC supervisory staff sought to understand the specific nature of the banks' hedging proposals, the benefits of allowing banks to engage in this activity, and OCC's examiners' ability to supervise the activity effectively. In May 2000, OCC formed a working group separate from field staff, which immediately decided that the requesting banks should brief OCC on the methods they would use to control the risks arising from the transactions.

In considering the equity hedging proposals, OCC evaluated the types of products that would be involved, as well as the risk management systems the banks would need to have in place to effectively equity hedge within the banks.[14] OCC supervisory staff said they focused on the models and methodologies the banks would use to measure risk, such as the risk limits

[14]The type of equity products the banks were engaging in included equity options, equity forwards, equity swaps, and variable forwards.

that would be imposed to manage the risks.[15] OCC was particularly concerned about whether the risks at the bank level, especially market risk, would change because of this proposal. Other supervisory concerns related to the types of controls that would need to be in place to prevent speculation and the taking of anticipatory or residual positions in stocks.

In order to ensure that banks effectively monitored their equity derivative transactions and hedges, OCC decided that while it would determine that it was legal for banks to hold equities to hedge equity derivative transactions, it would not be permissible for banks to engage in this activity without obtaining EIC approval of their activities and risk management systems. Furthermore, when the four banks submitted their equity hedging proposals to OCC, the banks made certain representations as to how they would conduct hedging within the bank. OCC determined that the banks would be allowed to engage in equity hedges within the bank only if the equity hedges were done the way the banks represented to OCC in their requests. The banks represented that they would

- use equities solely for hedging and not speculative purposes and
- not take anticipatory or maintain residual positions in equities except as necessary to the orderly establishment or unwinding of a hedging position.

OCC officials said that if in practice the bank's equity hedging programs did not meet those representations, the banks would not be engaging in a permissible activity, and OCC could take enforcement actions against them if necessary.

OCC Did Not Initially Make Its Approval Public

OCC Chief Counsel's Office prepared an "Equity Hedge Memorandum" on July 13, 2000, that was for internal use only and not for public distribution. The memorandum, which laid out the rationale for OCC's legal decision allowing banks to hold equities in order to hedge equity derivative transactions, was sent solely to the Deputy Comptrollers for Large Bank Supervision.

[15]Specific types of equity derivative transactions, such as options and collars, pose specific risks. In order to manage price or market risk, banks first have to quantify them. Several measures exist to quantify risk, including delta, gamma, and vega. As previously stated, delta measures the sensitivity of an option's value to small changes in the price of the underlying asset. Gamma measures the amount delta would change in response to a change in the price of the underlying asset (in this case equity). Vega measures the sensitivity of an option's price to changes in the volatility of the price of the underlying asset (equity). In managing an options portfolio, managers try to limit the bank's exposures to these risks.

At the time the Equity Hedge Memorandum was finalized, OCC had not decided how to publicly communicate its decision. The Chief Counsel's Office and the Deputy Comptrollers for Large Bank Supervision met to determine how to let all national banks know about the OCC decision without making it public. After much deliberation, OCC decided that the Securities and Corporate Practices Division attorneys would prepare a communication strategy for the Deputy Comptrollers for Large Bank Supervision to give to EICs. The EICs would not promote the proposal or provide copies of the Equity Hedge Memorandum to banks. Instead, they would encourage banks interested in equity hedging to contact OCC's Securities and Corporate Practices Division in order to determine whether their proposals for equity hedging were permissible under OCC's legal determination. The EICs would also be responsible for determining whether the banks had the appropriate risk management systems in place prior to engaging in the activity of equity hedging in order to prevent equity hedging in the bank from being used for speculation.

On July 25, 2000, a cover distribution memorandum was finalized and sent from the Chief Counsel's Office to the Deputy Comptrollers for Large Bank Supervision and large bank EICs, District Deputy Comptrollers, and Assistant Deputy Comptrollers for mid-sized banks stating that OCC supervisory staff may discuss OCC's position with national banks other than the requesting banks. The memorandum stated that because the Equity Hedge Memorandum was an internal document, it was not to be distributed outside of OCC. The memorandum also stated that each bank was to be directed to obtain its EIC's approval prior to hedging equity derivative transactions with equities and that EICs were to make sure that banks had adequate procedures in place to ensure that the bank's equity holdings were not for speculative purposes.

The EICs of the three requesting banks had already notified their banks of OCC's approval prior to the distribution of the Equity Hedge Memorandum to all the EICs of large banks.[16] The EICs of the three requesting banks spoke to their banks' legal departments to say that OCC had determined that hedging equity derivative transactions is a permissible activity, subject to supervisory approval of the banks' risk management systems. The banks were told that the legal determination was effective immediately and were encouraged to contact the Securities and Corporate Practices Division to determine whether their equity derivative activity was, in fact,

[16]The fourth bank also received EIC notification on July 26, 2000.

permissible under OCC's legal determination. Finally, the EICs informed their banks that equities would be held for hedging purposes only and not for speculation, as represented by the banks. The EICs said that an additional meeting would need to be set up with the banks' risk management staff to discuss expectations regarding the safety and soundness practices and policies that would have to be implemented. The banks were to formalize their policies and procedures and risk management systems so that the EICs could review them either during targeted examinations, the current supervisory cycle, or as the bank implemented policies and procedures.[17]

We interviewed the EICs of the four banks that OCC had given approval to equity hedge within the bank to get a better understanding of the process used to approve the banks' policies and procedures. The EICs told us that they asked the banks to put together individual risk management programs that would monitor the risks arising from equity derivative transactions, in-house equity hedges, and any speculation resulting from hedging within the bank. In some cases, the EICs made recommendations that banks implemented before undertaking equity hedges. The EICs said that they also discussed with banking officials the types of reporting requirements that would be put in place to mitigate speculation.

OCC Decision Not to Initially Publish Its Interpretation Is Questioned

The way in which OCC approved this activity caused you and certain regulatory officials to question OCC's process for determining whether to publish a decision and to ask whether OCC circumvented its "normal" process in communicating this decision. Because OCC has discretion in determining how it conveys its decisions to national banks, it does not have one set process for doing so. Thus, it is unclear what criteria OCC uses to determine when and whether to publish its decisions. OCC officials said, however, that there are several ways to convey decisions to national banks. For example, OCC can publish an interpretive letter when a bank requests its interpretation of the law. By using this method, OCC is letting all national banks know its interpretation of the law or the permissibility of an activity. Also, examiners for large banks reside in the

[17]According to OCC examination manuals, in large banks most examination-related work is conducted during the 12-month supervisory cycle through various ongoing supervisory activities or targeted examinations. Targeted examinations are often conducted as integrated risk reviews by business or product line. Since a product may have implications for several risk categories, the targeted reviews evaluate risk controls and processes for each applicable risk category.

banks and frequently talk informally with bank staff. In some cases, an examiner will attempt to obtain the views of OCC's legal staff about a specific activity and will ask for an oral or written opinion. Additionally, legal staff from the banks often communicate informally with OCC's legal staff and may seek informal counsel on various issues. Furthermore, OCC can issue no-objection letters when national banks ask if the agency objects to a particular activity; however, such letters are usually not legal decisions. Finally, OCC said that it provides oral comments to banks whenever necessary.

OCC officials said that the form of their response is dictated by the way the question is posed. In other words, if a bank requests a written opinion, OCC will respond with a written opinion. With the equity hedge decision, OCC did not initially issue either an interpretive letter or an opinion letter. OCC and national banking officials told us that the agency chose initially to provide a verbal opinion on the permissibility of equity hedging to the requesting banks because the banks requested an oral response.

We asked OCC officials whether OCC's initial decision not to publish its interpretation was based on concern about a reaction from members of Congress or officials from other federal banking agencies. The Chief Counsel told us that OCC did not publish its interpretation because it was focused and narrow in terms of notifying the banks that had requested the approval. OCC also did not want to encourage other national banks that it believed should not be engaged in equity derivatives to pursue this activity because of the decision. The Chief Counsel also said that the circumstances in this decision were limited to a small number of national banks that were likely to present to OCC the issue of wanting to hedge their equity derivative transactions within the bank. Thus, OCC believed that only a handful of institutions would be affected by its legal determination.

In light of the nonpublic way in which OCC initially conveyed its equity hedge decision, questions arose about OCC's overall process for determining whether to publish its decisions and the legal basis on which a decision was made. OCC has previously published numerous decisions regarding equities and hedging. For example, OCC has published decisions allowing banks to invest in warrants,[18] to maintain ownership of equity in

[18]A warrant is a financial instrument that usually entitles the holder to buy a proportionate amount of common stock at a specified price, usually higher than the market price at the time of issuance, for a period of years or to perpetuity.

insurance companies, and to own otherwise impermissible investments to hedge employee compensation plans. Furthermore, OCC's 1994 decision authorizing national banks to engage in equity derivative transactions was a published decision.

OCC's Chief Counsel said that OCC tries to publish its decisions, such as interpretive letters, on a regular basis and has an informal process whereby a law department committee reviews decisions and decides which to publish. However, the committee does not comment on and publish every decision. The equity hedge decision was not submitted to the committee initially because at the time OCC did not intend the decision to apply to all national banks. OCC officials told us that from the time they made their legal determination, they were considering how best to publicly treat their decision. However, congressional concern about the decision prompted them to issue Comptroller Hawke's response to your inquiry as an interpretive letter in September 2000.

Other federal banking regulators also have an interest in OCC publishing its decisions, especially when OCC interprets the equity-related provisions contained in section 24(Seventh). The Federal Reserve Act provides that state member banks are subject to the same limitations and conditions with respect to investment securities and stock as those contained in section 24(Seventh).[19] The Federal Deposit Insurance Act prohibits insured state banks from engaging in any activity that is not permissible for a national bank unless the Federal Deposit Insurance Corporation (FDIC) determines that the activity would pose no significant risks to the deposit insurance fund and the bank complies with applicable federal capital standards.[20] Federal Reserve officials told us that the Federal Reserve independently determines whether a particular equity-related activity is permissible under section 24(Seventh). FDIC told us that in deciding on the permissibility of a bank's securities activity, the agency typically relies on OCC's determination. By failing to inform other federal banking regulators of their analysis, OCC potentially affects how those regulators interpret the National Bank Act on behalf of the institutions they oversee.

[19]12 U.S.C.§ 335 (1994).

[20]12 U.S.C. § 1831a(a)(1) (Supp. 2000).

We Concur With OCC's Legal Decision

We agree with OCC's conclusion that the purchase of equity securities by a national bank for the purpose of hedging its customer-driven equity derivative transactions is a permissible incidental banking activity. To support its conclusion, OCC first determined that customer-driven equity derivative transactions and managing the risks of those transactions are permissible banking activities authorized by section 24(Seventh) of the National Bank Act. OCC next found that owning equities to conduct the hedging activity is not prohibited by the stock-related limitations contained in the section. We believe that OCC's analysis is based on a reasonable construction of section 24(Seventh).

The Bank Powers Provision Defines and Limits Banking Activities

National bank powers, as well as limitations on those powers, are contained in the National Bank Act. Specifically, the first sentence of Section 24(Seventh) (referred to as the "powers clause") provides that a national bank may engage in the business of banking, which includes but is not limited to the five types of activity enumerated in the sentence, and any activity incidental to the business of banking.[21] The stock- and securities-related restrictions, which immediately follow the powers clause are in table 1.

[21]*NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) (*VALIC*). The first sentence of section 24(Seventh) lists the following five activities as within the business of banking "discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt . . . receiving deposits . . . buying and selling exchange, coin, and bullion . . . loaning money on personal security and . . . obtaining, issuing and circulating notes according to the provisions of title 62 of the Revised Statutes." In VALIC, the Supreme Court held that the business of banking is not limited to the five types of activity enumerated in the first sentence, and said that OCC has discretion "within reasonable bounds" to determine whether an activity constitutes the business of banking.

Table 1: Relevant Provisions of Section 24(Seventh)

Components of section 24(Seventh)	Provision
Powers clause (First sentence)	To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other 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.
Dealing and Underwriting Prohibition (Second sentence)	The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account and the association shall not underwrite any issue of securities or stock.
Stock Ownership Limitation (Fifth sentence)	Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation.

Source: 12 U.S.C.§ 24(Seventh).

In approving the equity hedging activity, OCC maintained its long-standing position, which dates back to the 1960s, that national banks may hold stock in certain instances based on the incidental activities authority contained in the powers clause.[22] In a letter to you dated September 8, 2000 (Equity Hedge Letter), the Comptroller relied upon a provision in GLBA referring to equity derivative transactions as transactions that are part of the banking business.[23] OCC also referred to an earlier interpretive letter, which concluded that one type of equity derivative transaction–equity derivative swaps—is a permissible banking activity under the powers clause and stated that hedging risks is an integral part of such transactions as well as other permissible banking activities.[24] Relying again on the powers clause, OCC next concluded that the banks' purchase of equity securities to hedge equity derivative transactions is permissible because the activity is incidental to the business of banking. Specifically, OCC determined that equity hedging benefits the banks by enabling them to efficiently manage risks arising from permissible derivative activities and thus are convenient and useful to those activities. In this regard, we note that each approval was conditioned upon OCC examiners determination

[22]Acquisition of Controlling Stock Interest in Subsidiary Operations Corporations, 31 *Fed. Reg.* 11459 (1966).

[23]Equity Hedge Letter at 5-6.

[24]Equity Hedge Letter at 5-8.

that a particular bank's risk management system is adequate. Finally, OCC concluded that the equity hedging activity does not violate the stock ownership limitations contained in section 24(Seventh). (See app. II.) We believe OCC had reasonable bases for reaching these conclusions.

Hedging With Equities Does Not Violate the Dealing or Underwriting Prohibitions of the National Bank Act

In determining that the limitations on securities and stock ownership contained in section 24(Seventh) do not prohibit hedging with equities, OCC first concluded that this activity does not constitute dealing or underwriting under the statute. Specifically, the statute limits a national bank's ability to engage in the ". . . business of dealing in securities and stock . . . to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account." Furthermore, the sentence prohibits a national bank from underwriting any issue of securities or stock.

The National Bank Act does not define any of the key terms in the second sentence. Accordingly, OCC has defined the term "the business of dealing" as the purchase and sale of securities as part of a regular business. OCC has defined a dealer as one that maintains an inventory of securities and holds itself out to the public as willing to purchase, sell, and continuously quote prices for these securities.[25] In essence, OCC has interpreted this "dealing in" limitation on banks as prohibiting only those securities activities that constitute the business of dealing, not all purchases and sales of securities by banks as principal if such holdings qualify as being incidental to a permissible business function.

Although the banks, in connection with the hedging activity, will purchase and sell equity securities on a regular basis, OCC concluded that securities hedges do not constitute dealing in securities, which is prohibited by the second sentence. According to OCC, the banks will not hold the securities as inventory in order to engage in the business of regularly buying and selling them in the secondary market. They will not act as market makers in the securities by continuously quoting prices on both sides of the market.[26] They will purchase and sell the securities solely to hedge their own risks and not for the speculative purpose of profiting from price movements. As OCC further points out in the Equity Hedge Letter, unlike the business of dealing, securities hedges are intended to manage and

[25]Equity Hedge Letter at 10-11.

[26]*Id.*

reduce a bank's own risks arising from bank-permissible activities. Based on these reasons and subject to the outlined conditions, we concur with OCC's conclusion that the equity hedging in question does not constitute dealing in securities as prohibited by section 24(Seventh).

OCC also has defined underwriting in the second sentence as encompassing the purchase of securities from an issuer for distribution and sale to investors through a public offering. In connection with the equity hedging activity, the banks will not engage in underwriting securities. We concur with OCC's conclusion that the equity hedging activity does not violate the underwriting prohibition because the banks, in connection with the equity hedges, will not participate in a public offering of securities to investors.[27] Furthermore, we believe that OCC's interpretation of the second sentence and its determination that equity hedging does not constitute dealing and underwriting in securities are reasonable.

Hedging With Equities Is Not Prohibited by the Stock Ownership Limitation Contained in the National Bank Act

OCC interprets the fifth sentence of section 24(Seventh), which limits a bank's ability to purchase stock for its own account, as clarifying that the immediately preceding provision permitting banks to own certain debt securities does not authorize national banks to purchase stock. The fifth sentence provides "[e]xcept as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation." This sentence, rather than affirmatively proscribing stock ownership, provides that "nothing herein contained" authorizes a national bank to purchase stock for its own account, subject to two exceptions. In our view, although the sentence has a generally prohibitive effect on a national bank's ability to own stock, it does not contain an absolute bar on stock ownership. We concur with OCC's view that the fifth sentence is not a blanket prohibition on all equity holdings by national banks and that national banks have the power to acquire and hold corporate stock in those specific circumstances that qualify as incidental to the business of banking.

A key point to OCC's analysis of the fifth sentence is its interpretation of the phrase "nothing herein contained." If the phrase pertains to section 24(Seventh) in its entirety, it means that nothing in the section, including

[27] *Id.*

the powers granted to national banks by the powers clause, authorizes a national bank to purchase stock for its own account unless the activity is permitted in subsequent provisions of the section or "otherwise permitted by law." Because neither the subsequent provisions of the section nor any statutory provision outside of section 24(Seventh) authorizes stock ownership except in specific circumstances not pertinent here, under this interpretation the sentence would bar banks from owning stock for hedging purposes. On the other hand, if the phrase "nothing herein contained" does not refer to the authority contained in the powers clause, stock ownership is "otherwise permitted by law" to the extent authorized in the first sentence and therefore is not prohibited by the fifth sentence.

OCC interprets the phrase "nothing herein contained" as referring only to a specific provision in section 24(Seventh) that does not apply to stock ownership. The Congress added the fifth sentence in a 1933 amendment to section 24(Seventh) that also permitted national banks to purchase certain types of debt securities, which the section describes as "investment securities." OCC has concluded that the Congress added the fifth sentence to clarify that nothing contained in the investment securities ownership authority permits national banks to purchase corporate stock. Consequently, banks may purchase stock if the activity is "otherwise permitted by law," which law includes the powers clause. OCC thus interprets the powers clause to permit stock ownership as an activity incidental to the business of banking.

We believe that the fifth sentence was intended to do more than clarify the investment securities ownership authority. We interpret the sentence as generally prohibiting national banks from owning stock for their own accounts. Therefore, we do not completely agree with OCC's analysis of the fifth sentence. However, we find that it is reasonable for OCC to conclude that this sentence, like the second sentence, does not preclude a national bank from owning securities if such ownership is authorized by the powers clause as an activity incidental to the business of banking.[28]

The powers clause, which was enacted in 1864, initially was interpreted to restrict the securities activities of national banks by, among other things, prohibiting these banks from dealing and investing in stocks. Early

[28]Failure to interpret these sentences this way would appear to result in a bank's inability to hold securities as collateral on a failed loan. All of the federal banking agencies have recognized banks' ability to hold securities for this purpose.

Supreme Court decisions interpreted the clause to prohibit bank dealing and investment in stocks and securities but held that a national bank's incidental power to engage in activities necessary for it to carry on the business of banking includes stock ownership. In two cases, the Supreme Court permitted stock ownership because it was incidental to one of the enumerated banking powers. Thus, the Supreme Court held that a bank was not prohibited from owning stock when the stock was acquired to compromise a preexisting debt[29] or when it was taken as personal security incidental to the power to loan money.[30]

The second and fifth sentences were passed in 1933 as part of the Glass-Steagall Act, which was enacted to prohibit commercial banks from engaging directly in investment banking. Neither section 16 of Glass-Steagall nor the act's legislative history indicate that the Congress intended to reverse or modify these decisions or the underlying principle that a national bank's incidental power includes owning stock when necessary to carry on the business of banking. The exception in the fifth sentence allowing for banks to own stock as "otherwise permitted by law" can reasonably be interpreted as referring to the incidental powers provision, as construed by the Supreme Court before passage of section 16, that permits national banks to own stock for incidental purposes. Accordingly, OCC had a reasonable basis for concluding that hedging with equities, which it determined to be incidental to the business of banking, is not prohibited by the second or fifth sentences of section 24(Seventh).

Conclusions

Although we concluded that OCC had a reasonable basis for making its equity hedging decision, the process it used to communicate the decision to national banks, regulatory officials, and other interested parties raised concerns, especially given the nature of the legal interpretation to be communicated—banks owning equities. OCC's stated goal was to communicate its decision on the law as a supervisory matter rather than as a generally applicable legal interpretation for all national banks. By verbally conveying its approval to the requesting banks and requiring that those banks and other interested national banks receive EIC approval prior to booking equity hedges within the bank, OCC ensured that its decision would not be generally applicable to all national banks.

[29]*First National Bank of Charlotte v. National Exchange Bank of Baltimore*, 92 US 122, 128 (1875).

[30]*California National Bank v. Kennedy*, 167 U.S. 362, 366-67 (1897).

OCC has continually emphasized that the reason it conveyed its approval in this way was because safety and soundness concerns led it to conclude that banks needed to obtain supervisory approval prior to engaging in equity hedging within the bank. However, it is hard to understand how this interpretation differs substantially from previous decisions OCC has made in which supervisory approval was a precondition for banks to engage in an activity deemed permissible. In addition, by communicating its decision the way it did, OCC eventually drew external attention that focused on the basis for the nonpublic nature of that communication. Because the basis for determining whether to publish its interpretations was unclear, some were left to assume that OCC does not publish an interpretive decision when it does not want to draw attention to a decision. Much of the concern about the basis for OCC's decision could have been avoided if OCC had had a well-defined policy that clearly articulated the criteria used to decide when and whether to publish interpretive decisions and had acted in accordance with those criteria.

OCC determines permissible bank equity-related activities under section 24(Seventh) of the National Bank Act, and its conclusions are relevant in determining whether such activities are permissible for state-chartered banks that are members of the Federal Reserve System or insured by FDIC. Thus, in this situation when OCC interpreted section 24(Seventh) to permit an equity-related activity for the first time, informing the other federal bank regulators and the banks they regulate of the decision would have contributed to regulatory transparency and efficiency in a number of ways. For example, furnishing the information to the federally regulated state-chartered banks would have enabled them to determine whether such an activity was suitable for their purposes and to seek regulatory guidance from their respective regulators. Furthermore, providing its decision and analysis to the Federal Reserve and FDIC would have given each agency an opportunity to decide whether OCC's interpretation should serve as guidance for all the institutions they supervise and, if not, to set forth clear standards for those institutions to follow.

The issue of banks owning equities has been the subject of debate for decades. The recent OCC interpretation focuses on the activity of holding equities in the bank as incidental to its equity derivatives banking business. One of the criteria expressed in the interpretation states that banks are not to hold equities for speculative purposes. However, it can be difficult in practice to draw too fine a line between speculation and hedging. As such, continued OCC oversight will be required to monitor that line. More controversial issues could be raised if OCC were to take an even broader interpretation of the business of banking or its incidental

powers so that owning equities outright would become a permissible banking activity for national banks. Whether such controversies should be settled by regulatory interpretation or by legislation would be a fundamental question.

Recommendations for Executive Action

Because of larger questions that the process of reaching and announcing this equity hedge decision raises about OCC's interpretive decisionmaking process, we recommend that the Comptroller of the Currency establish a policy that articulates the criteria OCC uses in deciding when to publish its interpretive decisions. Furthermore, because interpretations relating to section 24(Seventh) of the National Bank Act have implications for other banking regulators, we recommend that the Comptroller publish all legal decisions that pertain to section 24(Seventh) in order to keep other bank regulators and financial institutions informed of OCC's analysis.

Agency Comments

We received written comments on a draft of this report from OCC that are reprinted in appendix III. OCC agreed with our recommendations and said that they are currently in the process of establishing a policy that is responsive to our recommendations. OCC also provided technical comments on the draft that we incorporated as appropriate.

Scope and Methodology

To report on the process by which OCC approved this activity, we spoke to OCC legal officials about the process used, the way in which their approval was communicated to banks, and other ways in which OCC could have communicated its decision. We reviewed OCC's internal documentation (including e-mails, notes, and rough drafts of memorandums) on its internal decisionmaking process and concerns that OCC had about granting this approval. Included in the files we reviewed was information on the role of OCC supervisory staff in OCC's approval, as well as information on the types of equity hedges banks would be engaging in and the risks involved. To further understand the supervisory role in the approval process and the equity hedge activities, we interviewed the EICs of the four banks that had requested OCC's approval and other risk management and supervisory officials at OCC. We also talked with legal and risk management officials from the Federal Reserve Board and FDIC about how their banks were hedging their equity derivatives exposure through affiliates and what they believed the risks were in allowing banks to book equity hedges within the bank. Finally, we spoke to officials from banks that were equity derivative dealers to get a better understanding of equity hedging and to get their views on OCC's approval. The five banks

we interviewed included two national banks that are engaging in equity hedges within the bank, one national bank that has not sought OCC's approval to hedge within the bank, and two state member banks of the Federal Reserve that are large equity derivatives dealers. The interviews with banking regulators and the banks included detailed discussions on OCC's decision as well as on the process OCC used in granting its approval.

In order to determine whether OCC's decision was in accordance with section 24(Seventh) of the National Bank Act, we examined OCC's letter outlining its legal opinion and related OCC documents, the applicable and related statutory provisions, legislative history, prior OCC decisions under section 24(Seventh), and relevant case law and secondary sources. In addition, we spoke with attorneys at OCC regarding its opinion in this case and prior decisions. We also spoke with lawyers at the Federal Reserve Board and the FDIC to get their views on OCC's legal opinion and the related statutory provisions applicable to the state banks they regulate. Finally, we spoke with a number of banks, including their counsel, that are equity derivative dealers to get their views of the OCC approval.

We performed our work between February and June 2001 in accordance with generally accepted government auditing standards. We visited regulatory agencies and banks in Washington, D.C.; New York, N.Y.; and Chicago, Ill.

As agreed with you, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will provide copies to the Chairman and Ranking Minority Member, House Committee on Financial Services, and the Chairman and Ranking Minority Member, Senate Committee on Banking, Housing and Urban Affairs. We are also sending copies to the Comptroller of the Currency and the Chairmen of the Federal Reserve Board and the FDIC. Copies will be made available to others on request.

This report was prepared under the direction of Barbara I. Keller, Assistant Director, Financial Markets and Community Investment, and Rosemary Healy, Assistant General Counsel, Office of the General

Counsel. If you have any questions about this report, please contact me at (202) 512-8678 or Susan Poling at (202) 512-7648. Key contributors to this report were Tamara Cross, Paul Thompson, John Treanor, and Emily Chalmers.

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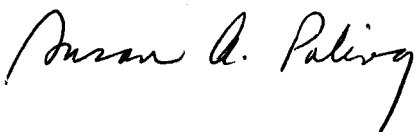

Susan A. Poling
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Appendix I: Equity Derivative Hedging

The Office of the Comptroller of the Currency (OCC) and banking officials said that banks have clients that may have concentrated equity holdings representing significant risks to the bank's customer. Although customers may engage in a put option with a bank to protect against the risk that their equity price might fall, the most common product bank customers have purchased to protect against the downside risk of their equity position is a zero-cost collar. The collar is created when the customer purchases a put option from the bank at a strike price below the current market price of the stock and sells a call option to the bank at a price above the current market price of the stock. With a collar, the bank provides the customer with a minimum and maximum value around the customer's equity position until the expiration of the option. The collar is referred to as a zero-cost collar because the premium the customer receives from the bank for selling the call option to the bank exactly offsets the premium or purchase price the customer pays to the bank in purchasing the put option.

An Example of an Equity Collar

A customer owns 100,000 shares of XYZ stock with a current market price of $50. In entering the collar, the customer buys a 3-year, European-style, cash-settled[1] XYZ put option from the bank, with a strike price of $35 and sells a 3-year, European-style, cash-settled XYZ call option to the bank, with a strike price of $90. The collar minimum is $35 dollars and the maximum is $90. The customer is thus protected if the price of XYZ falls below $35 but is "exposed" to the price difference between the put strike price and current market price until the price falls below $35. The customer participates in the appreciation of XYZ's price up to $90 but does not participate in any upside appreciation of XYZ's price above $90. If the price of XYZ stock is below $35 upon expiration of the collar, the bank pays the customer the difference between the strike price of $35 and the current market price below $35. If the price of XYZ is above $90 upon expiration of the collar, the customer pays the bank the difference between the strike price of $90 and current market price above $90. If, however, the price of XYZ is between $35 and $90 at the time of expiration of the collar, the options expire worthless.

[1]If the customer wanted to physically settle its option at the time of expiration, the customer would sell its shares to the bank with the put option and the investor would pledge its shares to the bank to secure its obligations to the bank under the call option.

Hedging Through an Affiliate

Prior to OCC's decision, banks hedged their equity derivative transactions by entering into offsetting mirror transactions with their affiliates. The bank entered into a collar with its affiliate that exactly matched the collar entered into with a customer. For example, the XYZ collar entered into with the customer consisted of the bank buying an XYZ call option from the customer and selling an XYZ put option to the customer. The mirror transaction with the affiliate consisted of the bank purchasing an XYZ put option from its affiliate with the exact terms and conditions of the XYZ put the bank sold to the customer and selling an XYZ call option to the affiliate with the exact terms and conditions of the XYZ call that the bank bought from the customer. As a result of this mirror transaction with the affiliate, the bank has perfectly hedged its market risk. The hedging affiliate would then hedge its collar with the bank by taking a position in XYZ stock—that is, by shorting XYZ stock.

Hedging Within the Bank

Once OCC made its decision that banks were allowed to hedge their equity derivative transactions by booking equity hedges within the bank, the requesting banks were no longer obligated to enter into mirror transactions with an affiliate in order to hedge their collars. Banks could therefore hedge changes in their equity derivative transactions through delta hedging. As previously stated, delta is a hedge ratio that banks calculate to determine the amount of equity the bank must buy or short, so that for small changes in the price of the equity, the bank's equity hedge position and its contract with the client will change by equal, and offsetting, amounts.

With the XYZ collar example, as the price of XYZ goes up, the value of the XYZ collar increases because the bank's call option increases in value and the put option decreases in value. Without entering into a perfect mirror collar with its affiliate, the bank needs an equity hedge position that changes in value as the value of the collar changes, but in a different direction than the change in the value of the collar. Thus, the bank needs an equity hedge position that declines in value when the price of XYZ rises and increases in value when the price of XYZ falls. The bank would therefore short XYZ on a delta basis because a short position in XYZ would produce losses when the price of XYZ rises. For example, the bank would determine an initial delta of say 0.7, so that for every $100 represented by the collar, the bank needs to be short $70 in XYZ stock. Then for every $1.00 increase in price of XYZ, the collar value to the bank increases by $0.70, an amount which is offset by losses in the short position the bank has in XYZ shares. Alternatively, for every $1.00 decrease in the price of XYZ, the collar value to the bank decreases by $0.70, which again is offset

by a gain the short position in XYZ shares. Over the life of the collar, the bank rebalances its hedge, buying and selling XYZ shares as the collar's delta changes. At maturity, the collar's delta is either 0 percent or 100 percent—100 percent if the price of XYZ is below the put strike price or above the call price and 0 percent if the price of XYZ is between the strike prices.

Banks contend that being able to book equity positions within the bank enables the bank to net its positions more effectively on a portfolio basis. For example, when a bank customer sells an XYZ put option to the bank, the bank's hedge is to go long or buy the XYZ stock on a delta basis. If the bank has sold collars on XYZ stock to other customers, then the bank's hedge for those positions would be to short XYZ stock. At the end of the day, the short and long positions of XYZ stock are to cancel each other out, and the bank then hedges any residual position that is left over. Banks also contend that hedging within the bank decreases the operational risk of booking back-to-back transactions and reduces costs.

Appendix II: Legal Analysis of OCC Equity Hedging Decision

During 2000, the Office of the Comptroller of the Currency (OCC) approved the requests of four national banks to purchase equities to hedge their equity derivative transactions. In approving these requests, OCC concluded that a provision of the National Bank Act, 12 U.S.C. § 24(Seventh), which generally prohibits national banks from purchasing stock for their own account, does not prohibit these banks from purchasing equities to hedge their customer-driven equity derivative transactions.[1] That provision sets forth the primary authority for national banks to engage in the business of banking by limiting their activities to those that are either part of the banking business or incidental to carrying on that business (an incidental power). OCC concluded that the four banks have authority, by virtue of their incidental powers, to own stock as a hedge against equity derivatives risks, provided that their hedging programs satisfy supervisory requirements.

Representative James A. Leach, a member of the House Committee on Financial Services, asked us to assess the process OCC followed in issuing its approval and to determine whether national banks have authority under the National Bank Act to own corporate stock to hedge their equity derivative transactions. Our work relating to the approval process is discussed in the accompanying report. Our analysis of whether national banks have authority to hedge equity derivative transactions by owning equities is discussed in this appendix.

After a review of applicable laws, judicial decisions, and related materials, we agree with OCC's conclusion that the four national banks have authority under the National Bank Act to own corporate stock to hedge their equity derivative transactions. OCC's approvals are consistent with a

[1]In a letter to Representative Leach dated September 8, 2000, the Comptroller described the term "equity derivative transactions" to mean "transactions in which a portion of the return (including interest, principal or payment streams) is linked to the price of a particular equity security or to an index of such securities. Equity derivative transactions include equity and equity index swaps, equity index deposits, equity-linked loans and debt issues, and other bank permissible equity derivative products." The Comptroller described "customer driven" transactions as "originated by customers for their valid and independent business purposes." OCC Interpretive Letter No. 892 at 1 (Sept. 8, 2000) (Equity Hedge Letter).

reasonable interpretation of section 24(Seventh).[2] OCC first determined that the business of banking includes equity derivative transactions and managing the risks of those transactions. OCC further determined that the four banks have authority under their incidental powers to own stock in order to carry on that business, subject to approval of their risk management systems. OCC construes section 24(Seventh) so that notwithstanding a general prohibition against stock ownership, a national bank may own stock only as necessary to carry on the business of banking. We believe that interpreting section 24(Seventh) to permit equity hedging as an incidental power is reasonable.

Background

National banks derive their general banking powers from section 24(Seventh) of the National Bank Act. The first sentence of the section, known as the "powers clause," authorizes national banks to conduct "the business of banking" and to exercise "all such incidental powers as shall be necessary to carry on" that business.[3] The second sentence limits a national bank's business of dealing in securities and stocks to brokerage and specifically prohibits owning securities and stocks as part of the bank's business of dealing in securities. The second sentence also prohibits national banks from underwriting any issue of securities and stocks.[4] The fifth sentence states that a national bank is not authorized to

[2]Under *Chevron U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 842-843 (1984), and, more recently, *United States v. Mead Corp.*, 121 S. Ct. 2164 (2001), OCC's approvals likely would be accorded deference by the courts. In *Mead*, the Supreme Court recognized that it gave considerable weight to an OCC opinion of whether an activity constitutes the business of banking or an incidental activity under section 24 (Seventh) despite the lack of a notice-and-comment procedure or other administrative formality. *Mead*, 121 S. Ct. at 2173 (citing *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 256-57, 263 (1995)).

[3]The powers clause provides that a national bank shall have the following power:

To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other 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.

[4]The second sentence states, in pertinent part, as follows:

purchase corporate stock for its own account, except as specifically provided in subsequent parts of the section or otherwise permitted by law.[5]

Four national banks sought OCC's approval to purchase equities to hedge their customer-driven equity derivative transactions. OCC determined that equity derivative transactions and hedging the related risks are part of the business of banking. OCC approved the four banks' ownership of stocks to hedge equity derivatives by interpreting the stock-related limitations and restrictions in section 24(Seventh) to mean that national banks generally are prohibited from owning stock but are authorized to do so if owning stock constitutes a permissible incidental activity. An incidental activity is one that is necessary to carry on the business of banking.[6] OCC concluded that the purchase of equity securities as a hedging device is an incidental activity not prohibited by the stock-related limitations contained in section 24(Seventh).

OCC based its approvals on an interpretation of section 24(Seventh) it has relied on since the 1960s.[7] OCC reiterated this position in 1996 in its revised final rules governing national bank ownership of subsidiaries. Specifically addressing the fifth sentence, OCC stated:

"This language, which was added to 12 U.S.C. 24(Seventh) by section 16 of the 1933 Act has, for decades, been consistently interpreted by the OCC as preventing national banks

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The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: . . . *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.

The term "investment securities" is defined elsewhere in the section to mean certain marketable debt securities.

[5]The fifth sentence states as follows: "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation."

[6]In an interview, OCC officials told us that an activity cannot be incidental to conducting an authorized banking activity unless the incidental activity is conducted in a safe and sound manner. OCC defines an activity as "incidental" to the business of banking when the activity is "convenient" or "useful" to conducting statutorily enumerated banking activities or other activities that are permissible because they are part of "the business of banking." Equity Hedge Letter at 9; *See infra* note 34.

[7]Equity Hedge Letter at 14; *Acquisition of Controlling Stock Interest In Subsidiary Operations Corporation*, 31 Fed. Reg. 11459 (1966).

from undertaking the types of speculative stock purchases that were the object of the 1933 Act, not as a bar to the ability of national banks to have subsidiaries or to own stock, where such ownership is otherwise authorized. This interpretation is entirely consistent with the language of 12 U.S.C. 24(Seventh) cited above — that the new provisions added in 1933 do not authorize national banks to purchase corporate stock, but to the extent other authority exists to do so, that authority remains intact (citation omitted)."[8]

This interpretation of national bank powers is the legal foundation of OCC's decision to permit equity hedging.

The following discussion sets forth our analysis of OCC's authority to determine which activities constitute the business of banking and our reasons for concluding that OCC acted within its authority by considering equity derivative transactions and associated risk management programs to be part of the business of banking. We then analyze the laws and principles applicable to OCC's conclusion that section 24(Seventh) does not prohibit equity hedging and discuss the reasons why we believe OCC's interpretation of the section is reasonable.

Discussion

OCC's approvals of equity hedging by the four banks touches upon several aspects of the nature of dealing in equity derivatives as a banking business and the legality of the banks' owning stock to hedge the risks arising from the business. In contrast with earlier opinion letters concluding that derivatives transactions are permissible because they are a financial intermediary activity incidental to the business of banking, OCC now considers such transactions to be a part of the business of banking.[9] In addition, the approvals broke new ground by specifically authorizing the ownership of stock as an activity incidental to that function.

[8]61 Fed. Reg. 60,342, 60,351 (1996).

[9]In the Equity Hedge Letter, the Comptroller acknowledged that OCC once considered financial intermediation, which includes equity derivative transactions, to be an incidental activity but has re-examined this position and now considers financial intermediation to be a function in its own right as within the business of banking. Equity Hedge Letter at 7 n. 19.

Equity Derivatives Transactions and Hedging the Associated Risks Are Part of the Business of Banking

In a letter to Representative Leach dated September 8, 2000 (Equity Hedge Letter), the Comptroller of the Currency (Comptroller) stated that equity derivative transactions are authorized under express authorities in the National Bank Act and as part of the business of banking. He pointed out, moreover, that where bank-permissible activities involve risks, "…banks must manage [the risks] as part of the business of banking . . . and may engage in hedging activities to do so."

OCC has discretion, "within reasonable bounds," to determine whether an activity, including derivatives transactions, is part of the business of banking. In *NationsBank of North Carolina, N.A. v. Variable Annuity Life Insurance Co.* (VALIC), the Supreme Court addressed the question of what constitutes the business of banking under section 24(Seventh) by holding that "'the business of banking' is not limited to the enumerated powers in [the first sentence of] §24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated."[10] The Supreme Court further observed that "[t]he exercise of the Comptroller's discretion, however, must be kept within reasonable bounds" and that "[v]entures distant from dealing in financial investment instruments . . . may exceed those bounds."[11] In this case, OCC exercised its discretion in concluding that equity derivative transactions are part of the business of banking.

In reaching this conclusion, the Comptroller relied upon a definition in the Gramm-Leach-Bliley Act (GLBA) describing certain instruments in which banks may conduct business.[12] GLBA specifies that banks conducting transactions in "identified banking products" are not within the definitions of "broker" and "dealer" contained in the Securities Exchange Act of 1934

[10]513 U.S. 251, 258 n. 2 (1995). Prior to VALIC, a debate existed as to whether the business of banking authorized in the powers clause was limited to the five activities enumerated in the clause, which are as follows: "discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt . . . receiving deposits . . . buying and selling exchange, coin, and bullion . . . loaning money on personal security . . . and obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes." In VALIC, the Supreme Court accepted OCC's determination that the business of banking includes the brokerage of financial instruments as part of national banks' traditional function as financial intermediaries. 513 U.S. at 257, 258- 259. The Supreme Court upheld the agency's determination that brokerage of annuities is "incidental" to that function. 513 U.S. at 264.

[11]VALIC, 513 U.S. at 258 n. 2.

[12]Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

(Exchange Act).[13] GLBA defines "identified banking products" to include "swap agreements," which are defined as:

"any individually negotiated contract, agreement, warrant, note or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other identified banking product."[14]

Thus, the Comptroller concluded that because equity derivative transactions are swap agreements as defined by GLBA, they are part of the business of banking.

The Comptroller's reliance on GLBA's definition of "identified banking products" is reasonable. GLBA defines both brokers and dealers as persons engaged in the securities business.[15] The Congress excluded banks that engage in swap transactions from these definitions because it recognized that banks, by conducting such activities, might otherwise be subject to the Exchange Act. It is reasonable to infer that the Congress, by acknowledging bank equity derivative transactions as a business activity, considers them to be part of the business of banking. Even if the Comptroller's reliance on GLBA's provision is misplaced, OCC appears to have appropriately concluded that equity derivative transactions are part

[13]15 U.S.C. § 78c(a)(4)(B)(xi) (Supp. 2000); 15 U.S.C. § 78c(a)(5)(iv) (Supp. 2000).

[14]15 U.S.C. §78c(a)(6) (Supp. 2000). *Compare* Equity Hedge Letter at 1 n.1.

[15]Section 201 of GLBA amended the term broker as defined in the Exchange Act, to mean "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4)(A) (Supp. 2000). Section 202 amended the term dealer, as defined in the Exchange Act, to mean "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." *See* 15 U.S.C. § 78c(a)(5)(A) (Supp. 2000).

of the business of banking based on the application of tests generally used to determine whether an activity constitutes the business of banking.[16]

In addition to determining that customer-driven equity derivative transactions are part of the business of banking, OCC concluded that hedging the risks arising from those transactions is part of the business of banking because risk management is "integral" to equity derivative transactions as well as other bank activities incurring risk. When a national bank's business involves derivatives, OCC always has required the bank to take appropriate risk management measures.[17] When OCC determined that equity swap business was authorized as an incidental power, it required adequate risk management not as an activity "incidental to the incidental" derivatives business, but as a part of that business governed by supervisory principles.[18] In conjunction with its present position that financial intermediation (and therefore derivatives dealing) constitutes the business of banking, OCC continues to consider risk management to be part of that function, as it considers risk management to be part of any banking activity involving risk.[19] Finally, it is clear from our interviews with officials from several large banking institutions that risk management is an inherent part of the banks' equity derivative activities. According to these officials, even when equity derivative transactions were hedged through arrangements with affiliates with the

[16]OCC applied tests used by courts for determining whether an activity is part of the business of banking. Equity Hedge Letter at 4-6 (*citing 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 Assn. V. Clarke*, 865 F.2d 278, 282 (2d Cir. 1988). The tests consider whether the activity (1) is functionally equivalent to or a logical outgrowth of a recognized banking function, (2) benefits bank customers and/or strengthens the bank, and (3) presents risks of a type similar to those already assumed by banks. Equity Hedge Letter at 4 n. 8; Julie L. Williams and Mark P. Jacobsen, *The Business of Banking: Looking to the Future*, 50 Bus. Law. 783 (1995). The Equity Hedge Letter discusses how the function of financial intermediation is a logical outgrowth of recognized banking functions, how the activity benefits customers and strengthens the bank, and how equity hedging presents risks of a type similar to those already assumed by banks. As discussed previously, OCC acknowledges that it no longer considers the function to constitute an incidental activity. This recharacterization of the activity does not appear to be arbitrary or to have a prejudicial effect–consequences that have occasionally undermined agency changes of position. *Smiley v. Citibank*, 517 U.S. 735, 742 (1996).

[17]OCC approved the stock hedging in question here subject to each bank's compliance with supervisory risk management standards.

[18]OCC Interpretive Letter No. 652 (Sept. 13, 1994).

[19]See Equity Hedge Letter at 7.

affiliates holding the stock for hedging purposes (mirror transactions), the risks (profit and loss) of owning the stock as a hedge were attributed to the banks. In this regard, we note that each of the approvals in the matter under discussion was conditioned on OCC's determining that the particular bank's risk management controls are adequate.[20]

Based on the previous analysis, in our view, OCC reasonably concluded that the business of banking includes equity derivative transactions and managing the risks of those transactions. OCC's conclusion is based on a reasonable interpretation of GLBA and the application of tests typically used by courts to determine whether an activity is part of the business of banking.[21]

Section 24(Seventh) Does Not Prohibit Banks From Owning Stocks for Incidental Purposes

Section 24(Seventh) contains limitations and restrictions upon a national bank's authority to do business in securities. The section allows banks to own certain debt securities (defined in the section as "investment securities") and to deal in, underwrite, and purchase for their own account government obligations specified in the section, but it imposes limitations specific to stocks and other bank-ineligible securities.[22] The second sentence prohibits banks from dealing in and underwriting bank-ineligible securities, and specifically stocks. The fifth sentence states as follows: "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association [i.e., a national bank] for its own account of any shares of stock of any corporation."

OCC interpreted the second sentence as prohibiting stock ownership only in the contexts of dealing and underwriting.[23] OCC concluded that owning stock for hedging purposes does not constitute either type of activity. Thus, the second sentence does not apply here. OCC interprets the fifth sentence as a statutory explanation that amendments made to section 24(Seventh) in 1933 did not authorize banks to purchase stock for their

[20]Equity Hedge Letter at 1-2.

[21]*See* note 41 *supra*.

[22] For purposes of this opinion, the term "bank-ineligible securities" refers to all types of debt and equity securities that a bank may not own, underwrite, or deal in directly under 12 U.S.C. § 24(Seventh).

[23]Equity Hedge Letter at 10-11.

own account.[24] According to OCC, the sentence does not affect a national bank's authority to own stock.[25]

We believe that OCC's interpretation of section 24(Seventh) is reasonable. We base our conclusion on Supreme Court decisions since the 19th century, which hold that the powers clause permits stock ownership as an incidental power, and on the reasoning that the Congress did not overrule or limit this principle when it inserted the stock ownership prohibitions in 1933. We note, moreover, that interpreting section 24(Seventh) to permit stock hedging as an incidental power is consistent with other indications by the Congress that the section does not impose a complete bar against national bank ownership of corporate stock.

National Bank Incidental Powers Permit Stock Ownership

Since the early days of the National Bank Act, the Supreme Court and OCC have interpreted the powers clause as granting national banks two distinct but related powers–the power to carry on the business of banking and the incidental powers necessary to conduct the business.[26] Certain activities prohibited because they did not constitute the business of banking were nonetheless authorized because they were necessary for banks to carry on their business. This analysis is found in Supreme Court decisions dating to the late 19th century, in which the Court interpreted the powers clause to prohibit national banks from owning stock for dealing, investment, and other purposes, but recognized that banks have authority to own stock as an incidental power.

In *First National Bank of Charlotte v. National Exchange Bank of Baltimore*, the Supreme Court in 1875 determined that national bank dealings in stock were implicitly prohibited because authority to engage in such activities was not granted by the powers clause.[27] However, the Supreme Court held that the plaintiff national bank was authorized to acquire stock, "with a view to their subsequent sale or conversion into money so as to make good or reduce an anticipated loss," in a "fair and *bona fide* compromise of a contested claim . . . growing out of a legitimate

[24]Equity Hedge Letter at 12-14.

[25]As discussed later, OCC maintains that section 24(Seventh) nonetheless prohibits stock ownership except as an incidental activity.

[26]Since it was adopted in 1864, the powers clause has remained virtually unchanged.

[27]*First National Bank of Charlotte v. National Exchange Bank of Baltimore*, 92 U.S. 122, 128 (1875).

banking transaction."[28] In addition, the Supreme Court observed that the bank directors had specific authority to transact the bank's business and that section 24(Seventh) granted all incidental powers necessary to carry out that authority.[29]

The Supreme Court applied the same reasoning with respect to the performance of a commercial banking activity—that is, lending. On this point, in *California National Bank v. Kennedy* the Court made the following observation:

"It is settled that the United States statutes relative to national banks constitute the measure of the authority of such corporations, and that they cannot rightfully exercise any powers except those expressly granted, or which are incidental to carrying on the business for which they are established. . . . No express power to acquire the stock of another corporation is conferred upon a national bank, but it has been held that, as incidental to the power to loan money on personal security, a bank may, in the usual course of doing such business, accept stock of another corporation as collateral, and, by the enforcement of its rights as pledge, it may become the owner of the collateral . . . . So, also, a national bank may be conceded to possess the incidental power of accepting in good faith stock of another corporation as security for a previous indebtedness. It is clear, however, that a national bank does not possess the power to deal in stocks."[30]

It is clear from these and other Supreme Court decisions that before 1933, national banks were prohibited from doing business or investing in corporate stock but that owning stock was permissible when necessary in order for banks to conduct their business affairs or carry on commercial banking activities.[31]

[28] *Id.* at 126-28.

[29] *Id.*

[30] 167 U.S. 362, 366-67 (1897) (citations omitted). In *First National Bank of Ottawa v. Converse*, 200 U.S. 425, (1906), the Supreme Court made clear that business of banking also does not include investing in stock for speculative purposes. In that case, the Court stated that "no authority, express or implied, has ever been conferred by the statutes of the United States upon a national bank to engage in or promote a purely speculative business or adventure. . . . [I]t follows that the bank had no power to engage in such business by taking stock or otherwise." *Id.* at 438-39.

[31] The Supreme Court has applied the same analysis in holding that national banks' incidental powers authorize other types of activity that do not constitute the business of banking. Edward Symons, *The* "Business of Banking" in *Historical Perspective*, 51 Geo. Wash. L. Rev. 676, 683, 702-13 (1983).

Prohibitions on Stock Ownership Do Not Limit National Banks' Incidental Power to Own Stock

The Supreme Court decisions permitting stock ownership as an incidental power were decided before the stock-related limitations and restrictions in section 24(Seventh) became law in 1933.[32] Whether OCC correctly approved stock ownership for hedging purposes depends upon the scope of national banks' incidental power to own stock before 1933 and the effect of the 1933 provisions upon that power. We believe that the authority to own stock as an incidental power was not limited to the facts of the cases decided by the Supreme Court and that the 1933 provisions did not limit the banks' incidental powers to own stock.

The powers clause defines a national bank's incidental powers as those "necessary" for the bank to carry on the business of banking. Nothing in the clause itself suggests that stock ownership qualifies as "necessary" only in relation to particular types of banking activities. Although the Supreme Court decisions permitting stock ownership as an incidental power involved particular sets of circumstances, nothing in those decisions suggests that the incidental powers authority was limited to those circumstances.[33] In approving stock hedging by the four banks, OCC applied the standard generally accepted to show that an activity is "necessary" and, therefore, permissible as an incidental power.[34] OCC's decision that the four banks have incidental authority to own stock as a hedging device is consistent with the express language of the powers clause as well as with Supreme Court interpretations of the clause in place before 1933.

[32]Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified in scattered sections of title 12 of the Unites States Code) (1933 Banking Act). The stock-related limitations and restrictions in section 24(Seventh) were contained in section 16 of the Glass-Steagall Act, which consists of sections 16, 20, 21, and 32 of the 1933 Banking Act.

[33]See *First National Bank of Charlotte*, 92 U.S. at 127 (describing incidental powers to be "such as are required to meet all the legitimate demands of the authorized business, and to enable a bank to conduct its affairs, within the general scope of its charter, safely and prudently").

[34]Equity Hedge Letter at 9-10. To determine whether a particular activity is necessary to carry on the business of banking, OCC applies standards derived from a decision of the First Circuit Court of Appeals in *Arnold Tours, Inc., v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972) and VALIC and standards generally accepted by courts. *See Independent Insurance Agents of America v. Hawke*, 211 F.3d 638, 640 (D.C. Cir. 2000). In *Arnold Tours*, the court held that the term "necessary" in 12 U.S.C. §24(Seventh) should be construed broadly to include activities that are "convenient and useful" to one of the five types of activity enumerated in the first sentence. *Arnold Tours*, 472 F.2d at 432. Applying the holding in VALIC, OCC determines whether an activity is convenient and useful to an activity that constitutes the business of banking regardless of whether the activity is covered by the statutory list.

Nothing in section 16 of the Glass-Steagall Act or the legislative history of the 1933 Banking Act establishes that the Congress limited the scope of incidental powers with respect to stock ownership. The purpose of the Glass-Steagall provisions was to separate commercial banks from engaging directly in investment banking.[35] The Congress adopted section 16 to prohibit banks from risking depositor funds by participating directly or indirectly in bank-ineligible securities and stock markets as dealers, underwriters, or investors.[36] Nothing in the section or its history indicates that the Congress sought to prohibit or limit the ability of national banks to conduct activities recognized as commercial banking.

The second sentence of section 24(Seventh) specifies that a national bank's "business of dealing in securities and stock" is limited to brokerage and does not include purchasing and selling securities and stock for the bank's own account. In addition, the sentence specifically prohibits a national bank from underwriting securities and stock. The terms "dealing" and "underwriting" are not defined in the 1933 Banking Act. OCC interprets the dealing activity referred to in the second sentence to encompass the purchase of securities as principal for resale to others. According to OCC, dealing is buying and selling as part of a regular business. A dealer typically maintains an inventory of securities and holds itself out to the public as willing to purchase, sell, and continuously quote

[35]See *Citicorp*, 73 Fed. Res. Bull. 473, 479 (1987), *aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988). In its decision in that proceeding, the Federal Reserve said that the Glass-Steagall Act provisions "were enacted with one central purpose in mind, to protect bank depositors from the hazards that Congress viewed as attributable to the combination of commercial and investment banking."

[36]During the years before 1933, national banks were involved in investment banking primarily through state-chartered affiliates whose investment banking activities largely involved bonds and other debt securities. After passage of the McFadden Act in 1927, Pub. L. No. 69-639, which amended section 24(Seventh) specifically to permit national banks to purchase and sell certain debt securities (bonds and other forms of indebtedness described as "investment securities"), bank affiliates, often using the banks' resources, also engaged in underwriting operations, stock speculation and maintaining a market for the bank's own stock. Among other things, these activities gave rise to the concern that bank deposits were being placed at risk in the stock market. *Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst.*, 450 U.S. 46, 61, n. 27 & 28 (1981); *see also* Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 6 Banking L. J. 483, 495-505 (1971).

prices.[37] Similarly, OCC interprets the underwriting activity prohibited by the sentence to be "the purchase of securities from an issuer for distribution and sale to investors. . . . [o]ne cannot be an underwriter in the absence of a public offering."[38] Given these definitions, the second sentence only prohibits national banks from owning stock as part of the general prohibition against dealing in and underwriting certain securities and stock. We consider OCC's reliance on these definitions to be reasonable and therefore agree with its conclusion that the second sentence does not prohibit equity hedging.[39]

Unlike the second sentence, the fifth sentence by its terms does not affirmatively proscribe stock ownership. Rather, the fifth sentence utilizes explanatory language. It states that "nothing herein contained" authorizes a national bank to purchase stock for its own account, subject to two exceptions. The first exception allows for any stock ownership authority

[37]Equity Hedge Letter at 10-11; see also *Citicorp*, 73 Fed. Res. Bull. at 481 (according to the Federal Reserve Board, the term "dealer" commonly refers to an entity that holds itself out to the public as being willing to buy and sell securities for its own account (citation omitted)).

[38]Equity Hedge Letter at 11.

[39]*See, e.g.*, *Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 158 n. 11 (1984) (discounting commercial paper is not the "business of dealing" in securities prohibited by the second sentence because the discounting activity is part of the business of banking). By "limiting" banks' "business of dealing" to brokerage, the syntax of the second sentence suggests that the Congress considered securities brokerage to be an activity within banks' business of dealing. Brokerage is not within the definition of dealing applied by OCC. OCC's definition of dealing, therefore, might appear to be underinclusive. In this regard, we note that in the Securities Act of 1933, the Congress defined the term "dealer" to mean "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issues by another person." 15 U.S.C.§ 77b(12) (1994). The legislative history of the Securities Act of 1933 indicates that the Congress used this expansive definition of "dealer" for the purpose of subjecting those within the definition to the same advertising restrictions that apply to dealers in order to prevent brokers and others from "being used as a cloak for the sale of securities." H.R. Rep. No. 85, 73d Cong. 1st Sess. 14 (1933). This action suggests that even in the context of the Securities Act of 1933 the Congress considered dealing to be an activity distinct from brokerage. OCC's interpretation appears to be consistent with the general understanding of the practice of "dealing in" securities that existed before the second sentence was adopted in 1933. As early as 1875, the Supreme Court observed that "a prohibition against trading and dealing [is] nothing more than a prohibition against engaging in the ordinary business of buying and selling for profit, and [does] not include purchases resulting from ordinary banking transactions." *First National Bank of Charlotte*, 92 U.S. at 128 (1875) (citation omitted).

provided in the portion of section 24(Seventh) that follows the sentence.[40] The second exception allows for stock ownership "otherwise permitted by law."

In OCC's view, this sentence does not prohibit stock hedging because it does not affect a national bank's authority to own stock to the extent authorized by the powers clause. OCC considers the fifth sentence to be simply a statement by the Congress clarifying that amendments made to section 24(Seventh) by section 16 of the Glass-Steagall Act did not authorize national banks to purchase stock for their own account. Thus, the sentence has no effect on bank powers that existed before section 16 was passed. A key point in OCC's analysis of the sentence is the meaning of the phrase "nothing herein contained." If the phrase pertains to section 24(Seventh) in its entirety, it means that nothing in the section, including the powers granted to national banks by the powers clause, authorizes a national bank to purchase stock for its own account unless the activity is permitted in subsequent provisions of the section or "otherwise permitted by law." In this sense, the phrase "otherwise permitted by law" refers to laws other than section 24(Seventh). Because neither the subsequent provisions of the section nor any law outside of section 24(Seventh) authorize stock ownership except in specific circumstances not pertinent here, under this interpretation the sentence would bar the ownership of stock as an incidental power. On the other hand, if the phrase "nothing herein contained" does not refer to the authority contained in the powers clause, stock ownership is "otherwise permitted by law" to the extent authorized in the powers clause and therefore is not prohibited by the fifth sentence.

OCC interprets the phrase "nothing herein contained" so that it refers only to a specific provision in section 24(Seventh) that does not apply to stock ownership. Although section 16 of the Glass-Steagall Act limited bank powers with respect to securities and stock, the section authorized national banks to own certain types of securities for their own account. These securities, referred to in the section as "investment securities," are defined generally as "marketable obligations, evidencing indebtedness." OCC maintains that the Congress added the fifth sentence only to clarify that nothing contained in the investment securities ownership authority

[40]Following the fifth sentence, section 24(Seventh) specifically provides that the limitations and restrictions relating to dealing in, underwriting and purchasing investment securities do not apply to several government or government-related obligations and securities and stock issued in connection with government-sanctioned programs.

permits national banks to purchase corporate stock. Consequently, the fifth sentence recognizes that banks may purchase stock if the activity is "otherwise permitted by law," which law includes the incidental powers authority contained in the powers clause.[41]

The fifth sentence, in our view, was intended to do more than clarify that the authority to own debt securities does not authorize national banks to own stock.[42] We believe that the sentence generally prohibits national banks from owning stock.[43] However, we believe that the sentence permits stock ownership as an incidental power because that activity was within the powers granted by the powers clause at the time the Congress enacted section 16 and, therefore, falls within the "otherwise permitted by law"

[41]As noted previously, OCC has maintained this position since at least 1966. The interpretation of section 24(Seventh) on which OCC relied in approving the stock hedging is essentially the same one that the agency first announced in the Federal Register in 1966 and has adhered to since then. OCC Rules, Policies, and Procedures for Corporate Activities, 61 Fed. Reg. 60342, 60351 (Nov. 27, 1996); 12 C.F.R. § 7.10 (published at 31 Fed. Reg. 11459 (Aug. 31, 1966)).

[42] Additional evidence that the Congress intended generally to prohibit stock ownership through the fifth sentence exists in the Banking Act of 1935. Pub. L. No. 74-305, 74 Stat. 684 (1935). In that act, the Congress amended the second and fifth sentences to reflect what was originally intended by section 16 of the 1933 Act. The fifth sentence language in the 1933 Act said, in pertinent part, that "nothing herein contained shall authorize the purchase by the association (bank) of any shares of stock of any corporation." The 1935 Act added the words "for its own account" after the term "association." 74 Stat. 709. The purpose of this provision was to clarify section 24(Seventh) to provide that national banks may not buy and sell stocks for their own account. S. Rep. No. 74-1007, 74th Cong., 2d Sess. 1935 at 17.

[43]OCC itself has expressed the view that section 24(Seventh) generally prohibits national banks from owning stock. For example, in a 1979 interpretive letter OCC stated as follows: "With limited exceptions for investment securities and certain other named securities, 12 U.S.C. §24(Seventh) prohibits a national bank from purchasing stock for its own account." OCC Interpretive Letter No. 96 (May 14, 1979), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,171; See also OCC Interpretive Letter regarding Point of Sale Terminals (Nov. 9, 1992) (national banks are generally prohibited from purchasing or owning corporate stock by virtue of 12 U.S.C. § 24(Seventh); whether a bank may acquire and own stock in another entity will turn on whether such shares are being acquired to facilitate the bank's participation in a legitimate banking activity rather than for investment or speculative purposes). In OCC Interpretive Letter No. 419 at p. 7 (Feb. 16, 1988), *reprinted in* Fed. Banking L. Rep. (CCH) P85,643. OCC stated as follows:

Our concern with national banks purchasing stock in a corporation arises from the language of Section 16 of the Glass-Steagall Act which provides that except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by [a national bank] for its own account of any shares of stock of any corporation (brackets in the original).

exception contained in the sentence. Moreover, such an interpretation is in harmony with the overall purpose of the section and other provisions of the 1933 Banking Act, which contained section 16 of the Glass-Steagall Act.

Interpreting the fifth sentence as a general prohibition that nonetheless permits stock ownership as an incidental power is consistent with both the purpose of section 16 and provisions of the 1933 Banking Act. Incidental powers are, by statutory definition, necessary to the performance of an activity that constitutes the business of banking. Limiting a bank's incidental powers also limits the bank's ability to conduct its business.[44] While section 16 establishes that the Congress considered stock ownership generally not to be part of the business of banking, nothing in the section indicates that the Congress also intended to limit a national bank's ability to carry on the business of banking. This principle underlies fundamental banking activities recognized by both OCC and the Federal Reserve Board.[45] For example, both agencies recognize the authority of the banks they regulate to collateralize for a loan with stock and to take possession of the stock upon default.[46] Both agencies permit the banks they regulate to own stock in subsidiaries based on the incidental powers authority in the powers clause.[47]

[44]This principle underlies the early Supreme Court decisions recognizing a national bank's authority to own stock as an incidental power even though the business of banking did not include stock ownership. As demonstrated in the preceding discussion of those decisions, the Supreme Court observed that banks could not conduct legitimate activities without such authority.

[45]Under the Federal Reserve Act, state member banks are "subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks" under 12 U.S.C. § 24(Seventh). 12 U.S.C. § 335 (1994). In addition, the Federal Deposit Insurance Act prohibits insured state banks from engaging as principal in any type of activity that is not permissible for a national bank unless the FDIC determines that the activity would pose no significant risk to the appropriate deposit insurance fund and the insured state bank complies with applicable capital standards. 12 U.S.C. § 1831a(a)(1) (Supp. 2000).

[46]12 C.F.R. § 1.7 (2001) (national banks may own securities held in satisfaction of debts previously contracted); 12 C.F.R § 225.12 (2001) (state member bank may acquire without Board approval voting securities of a bank or bank holding company in the regular course of securing or collecting a debt previously contracted in good faith).

[47]See 12 C.F.R. § 5.34 (2001) (OCC); 61 Fed. Reg. at 60342 (OCC); 12 C.F.R. § 250.141(c) (2001) (Federal Reserve); 1968 Fed. Res. Bull. 168 (incidental powers authority in 12 U.S.C. § 24(Seventh) authorizes state member banks to own stock in wholly owned subsidiaries engaged in activities the banks themselves may perform).

A review of other provisions of the 1933 Banking Act indicates that the Congress contemplated stock ownership as an activity incidental to the business of banking.[48] Nothing in the Banking Act of 1933 or elsewhere in the National Bank Act specifically authorized national banks to own subsidiaries or interests in affiliates. Owning stock for this purpose was not listed in section 24(Seventh) as a banking activity. However, in the 1933 act, the Congress specifically recognized the power of national banks to own corporate stock despite the fifth sentence. Section 2 of the act defined the term "affiliate" to include "any corporation, business trust, association, or other similar organization . . . of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors."[49] Section 16 preserved a preexisting provision of section 24(Seventh) limiting the amount of stock a national bank could own in a corporation operating a safe deposit business, even though banks had no specific authority to own such stock.[50]

[48]A fundamental principle of statutory construction is that the various provisions of a statute should be construed as a whole and that a particular section of a statute may not be interpreted in isolation without regard to other sections of the statute of which it is a part. *United States v. Morton*, 467 U.S. 822, 828 (1984); *Philbrook v. Glodgett*, 421 U.S. 707, 713 (1975).

[49]Pub. L. No. 73-66 § 2(b), 12 U.S.C. § 221a (1994).

[50]*See* S. Rep. No. 69-473 (69th Cong., 2d Sess. 1926) at 7 (accompanying Pub. L. No. 69-639 § 2 (1927) (McFadden Act)) (safe deposit provision was added to section 24(Seventh) by the McFadden Act in recognition that conducting safe deposit business and investing in corporations organized to conduct the business "is a business which is regularly carried on by national banks"). With regard to this provision, the Supreme Court made the following observation: "The language of the proviso of § 24, just quoted, is the language suitable to impose restrictions on a recognized power, not the language that would be used in creating a new power." *Colorado Nat. Bank of Denver v. Bedford*, 310 U.S. 41, 49 (1940). Because the Congress recognized stock ownership for this purpose as a permissible activity even though owning stock was not within the activities enumerated in the first sentence and was prohibited except as an incidental power, it is reasonable to infer that the Congress considered owning stock in a corporation to have been authorized as an incidental power. This conclusion is consistent with another McFadden Act amendment to section 24(Seventh) recognizing bank activities which had been conducted pursuant to the incidental powers authority. Section 2 of the McFadden Act amended section 24(Seventh) specifically to permit national banks to engage in the nonrecourse buying and selling of "investment (debt) securities." The legislative history states that the Congress made this amendment to recognize as the business of banking an activity that previously had been authorized as incidental to banks' express authority to discount and negotiate promissory notes. S. Rep. No. 69-473 at 5-7.

Considering the specific purposes of section 16 and national banks' express incidental powers authority, which included stock ownership long before section 16 was enacted, it is reasonable to interpret the fifth sentence as recognizing stock ownership to be otherwise permitted by law pursuant to the incidental powers provision. The legislative history of the 1935 Banking Act contains no congressional explanation of the "otherwise permitted by law" exception to the general prohibition against stock ownership. We note, however, that if the Congress had intended to prohibit stock ownership except as provided in the part of section 24(Seventh) following the fifth sentence and in statutory provisions other than section 24(Seventh), the exception for stock ownership as otherwise permitted by law would be redundant. As OCC pointed out in its 1966 interpretation of section 24(Seventh) permitting ownership of subsidiaries, another statute permitting stock ownership would take effect regardless of such an exception.[51]

Conclusion

We agree with OCC's conclusion that national banks, subject to supervisory approval, have authority under the National Bank Act to own corporate stock to hedge their customer-driven equity derivative transactions. OCC determined that equity derivatives dealing and managing the risks of that activity are part of the business of banking based on a reasonable interpretation of GLBA and the application of the test typically used by courts to determine whether an activity is part of the business of banking. Applying the generally accepted judicial test for determining whether an activity is within a national bank's incidental powers authority, OCC also reasonably concluded that equity hedging is incidental to the business of banking. Although 12 U.S.C. § 24(Seventh) generally prohibits national banks from owning stock, the prohibition does not limit a bank's authority to own stock as an incidental power. Since the early days of the National Bank Act of 1864, the powers clause has been interpreted to authorize stock ownership as an incidental power. We concur with OCC that nothing in the stock ownership prohibition restricts or limits this interpretation. The second sentence of section 24(Seventh) prohibits national banks from owning stock in order to engage in the business of dealing in or underwriting securities and stock. The fifth sentence of the section 24(Seventh) generally prohibits national banks

[51]1966 Fed. Reg. 11459 n. 4; *see*, e.g., *United States v. Dalcour*, 203 U.S. 408, 421 (1906) (interpreting phrase "unless otherwise provided by law" contained in another federal statute as "refer[ring] to existing provisions and not to be merely a futile permission to future legislatures to make a change").

from purchasing stock for their own account, but the sentence recognizes that national banks may own stock if the activity is otherwise permitted by law. When the Congress enacted the fifth sentence in 1933, incidental ownership was permitted by the powers clause. Nothing in the 1933 amendments indicates that the Congress intended to limit the meaning of the powers clause. Moreover, interpreting section 24(Seventh) to permit stock ownership as an incidental power is consistent with a reasoned interpretation of the Banking Act of 1933 in its entirety.

Appendix III: Comments From the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

August 9, 2001

Thomas J. McCool
Managing Director
Financial Institutions and Community Investment
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. McCool:

We have reviewed the draft report entitled *Equity Hedging: OCC Needs to Establish Policy on Publishing Interpretive Decisions* prepared by the United States General Accounting Office (GAO). The GAO prepared the draft report in response to Congressman Leach's request that it review the Office of the Comptroller of the Currency's (OCC) legal decision and the process used by the OCC to allow certain national banks to acquire equities to hedge the risks arising from customer-driven, bank permissible equity derivatives transactions.

In the draft report, the GAO agrees with the OCC's legal determination that the equity derivative transactions and managing the risks of those transactions are permissible banking activities authorized by Section 24(Seventh) of the National Bank Act. In addition, you concur with the OCC's conclusion that the stock related limitation contained in Section 24(Seventh) does not prohibit banks from owning equities to conduct the hedging activity. Finally, the GAO concurs with the OCC's conclusion that the stock related limitation does not prevent the banks in question from owning equities to hedge their equity derivative transactions as an incidental activity.

You also recommend that the OCC establish a policy that articulates the criteria the OCC uses in deciding when and whether to publish its interpretive decisions. Further, you recommend that the OCC publish legal interpretations that pertain to Section 24(Seventh) of the National Bank Act.

We appreciate the time and attention your office devoted to understanding and considering the complex transactions and legal issues involved in this matter. We appreciate your concurrence with our legal conclusion that national banks have the authority to own equities to hedge their equity derivative transactions pursuant to their incidental powers under the National Bank Act, and we accept your recommendation that the OCC establish a policy that articulates the criteria we use in deciding when to publish interpretive opinions. We also accept your recommendation that the OCC publish new legal interpretations pertaining to Section 24(Seventh) of the National Bank Act so that other federal bank regulators and financial institutions are informed of our

interpretations. We are drafting an OCC Policy and Procedures Memorandum establishing a policy that is responsive to these recommendations.

Thank you for the opportunity to review and comment on the draft report. We provided some technical comments to your evaluators separately.

Sincerely,

John D. Hawke, Jr.
Comptroller of the Currency

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