June 1996

Derivatives-Related Bank Activities as Authorized by the Office of the Comptroller of the Currency and the Federal Reserve Board

Steven McGinity
INTRODUCTION

Not too long ago, prior to 1975, financial intermediation was easily divided into three major industries: banking, insurance, and securities. Generally, banks took deposits and lent money, insurers offered simple insurance products and invested premiums in government bonds, and securities brokers underwrote, issued, and traded debt and equity securities. Each industry was highly regulated and, to different degrees, protected by anticompetitive business practices. However, in the past two decades, technological developments in electronics, computers, and communication; innovations in financial theory, legislative and regulatory changes; and fundamental economic developments have combined to dissolve the demarcations of the past and unleash competition throughout the financial services industry.

Commercial banks, once the predominant providers of transaction services and lending products to the corporate world, now face strong competition from nonbanking organizations. Major corporate customers increasingly turn to wholesale capital markets and other financing alternatives when they need funds. This has caused a decline in the banks' traditional borrowing and lending activities. To remain competitive, replace lost market share, and better serve their customers, banks have expanded beyond these traditional activities to include involvement in derivatives-related activities.

More importantly, recent decades have endured increased volatility in interest rates, currency exchange rates, commodity prices, and inflation. This phenomenon has caused increased risks within the fi-
nancial markets. As experienced by the savings and loan industry in the 1980s, price volatility in the cost of goods and services can result in severe disruptions in business operations. Accordingly, there has been tremendous growth throughout the corporate world in financial risk management. Derivatives are the financial products designed to manage a firm's exposure to volatility in the financial markets. They have dramatically increased risk management capabilities and give unprecedented flexibility to manipulate a firm's exposure to many different types of risk. Derivative products isolate and repackage a firm's financial risk into new financial products that are attractive to others who are more willing or able to manage the risks inherent within those new products.

Clearly, derivative instruments present the banking industry with great opportunities to hedge their own financial risks. Because the interest in financial risk management is not relegated to the banking industry, however, other opportunities abound. End-users of these financial products include securities and commodities firms, insurance companies, governments, mutual and pension funds, and major corporations around the world. An increasing number of banking institutions are utilizing their expertise in financial instruments and financial markets and are assuming a familiar role as intermediary by offering brokerage and advisory services for derivative products. This has dramatically changed the business of banking. Banks can no longer remain in the business of simply taking deposits and extending credit. Today, the banking business has expanded to include risk management services—and the sharpest tool for managing financial risk is derivatives. As a matter of survival, banks will become increasingly involved in derivatives-related activities, both as end-users for their own risk management needs and as intermediaries for their custom-

3. The savings and loan industry accepted short-term deposits with which it made long-term loans. Traditionally, short-term interest rates had been lower than long-term interest rates and the savings and loans made their income on the spread between the two rates. When short-term interest rates became highly volatile and exceed long-term rates, the industry experienced increased costs and decreased revenues. This caused major disruptions in their business and was one factor for the collapse of the industry. For a historical review, see Alex M. Azar II, Note, 


5. See id. at 24; Andrew Freeman, The Regulators Balk, ECONOMIST, Apr. 10, 1993, at Survey 32-33.


7. See Freeman, supra note 5, at Survey 37-38; Michael A. Hiltzik, Banks Enter New World of High Risk, L.A. TIMES, Oct. 27, 1985, § 5, at 1.
ers, generating income from transaction fees, bid-offer spreads, and advisory services.

Thus, it is necessary for bank officers and their counsel to acquire an understanding of the applicable laws, regulations, guidelines, and industry standards prior to using derivative products. To assist in this endeavor, this Article reviews selected banking statutes, regulations, orders, and interpretive letters to identify the derivatives-related activities in which national banks, bank holding companies, and their subsidiaries are authorized to engage. Initially, this paper identifies several examples of how the banking industry engages in derivatives-related activities. Then, it describes the different enabling statutes pursuant to which the banking regulators authorize derivatives-related activities. Finally, selected derivatives-related activities are examined with respect to their basis for being part of, incidental to, or closely related to the “business of banking,” and regulatory considerations, conditions, and commitments are identified.

I. Uses of Derivative Financial Products by the Banking Industry

The Office of the Comptroller of the Currency (“O.C.C.”) defines derivatives as “financial instruments which derive their value from the performance of assets, interest or currency exchange rates, or indexes.”8 Although the variety and complexity of derivative products are limitless, there are four basic types that form the foundation for all other derivative contracts: futures, forward, option, and swap contacts.9

These contracts are traded worldwide on organized exchanges and through over-the-counter (“OTC”) agreements. Contracts with standardized terms of maturity, size, and delivery are usually found on organized exchanges, while privately negotiated agreements tailored to meet the specific needs of the parties involved are available in the OTC market.

The primary purpose of financial derivative products is to transfer price risks associated with fluctuations in asset values. They provide a low cost and effective method to hedge and manage exposures to interest rates, commodity prices, and currency exchange rates. For

example, banking institutions engage in derivative activities as end-users to reduce financing costs, to reduce risk exposures in investment portfolios, and to reduce hedging exposures associated with undesired mismatches in the bank's asset/liability management.¹⁰

One way financial institutions reduce financing costs is by "quality spreads" that arise due to differences in interest rates available in the credit markets to firms with higher credit ratings as opposed to firms with lower credit ratings. For example, assume that a bank with a triple-A credit rating has access to lower-cost fixed-rate funds than others with lower credit ratings. If the bank has a need for floating rate funding, the bank can "swap" its advantage in the fixed-rate market for an attractive floating rate by entering into an interest rate swap transaction with a counterparty having a lower credit rating and needing fixed rate funding. The swap transaction would obligate the bank to pay its counterparty a floating rate equal to or lower than the floating rate available to the bank in the credit market, and would entitle the bank to receive from the counterparty fixed rate payments at a premium over its fixed rate liability, but below the fixed rate available in the credit market to the counterparty. The result is that both parties benefit by reducing their cost of financing.

The use of derivative instruments to reduce risk exposures with respect to a bank’s own investment portfolio of eligible securities can protect against a decline in the portfolio's rate of return or yield and also guard against transaction exposure. For example, assume that a bank is planning to fund a large loan by converting to cash a specified amount of its portfolio. To insulate itself from any negative fluctuation in the value of the securities prior to the closing of the loan, the bank can enter into a financial futures, forward, or option contract to lock in the price at which the securities will be sold, thereby eliminating the risk that, due to transitory price fluctuations, the securities will have lost value prior to being liquidated.

Derivatives allow institutions to more effectively hedge undesired mismatches in either their assets or their liabilities. For example, the pricing mismatch that a savings and loan experiences by funding long-term fixed-rate loans with short-term floating-rate deposits can be

¹⁰. See BC-277, supra note 8 (encouraging national banks to use derivatives to efficiently reduce undesirable exposures to interest rate changes and currency fluctuations); see also Office of the Comptroller of the Currency, Banking Circular No. 79, National Bank Participation in the Financial Futures and Forward Placement Markets (Apr. 19, 1983) (replaced and superseded by BC-277) (authorizing national banks to use futures contracts to hedge exposures for mismatches in payment obligations and income sources).
hedged by using interest rate futures and swaps to ensure that the interest expense to the savings and loan for its short term deposits remains parallel to the interest income the institution will receive from the long-term loan.

In addition to the above uses, derivatives-related activities serve as a source of revenue for a number of banking institutions. They earn revenues through transaction fees, bid-offer spreads, their own trading positions, and by offering their customers risk management tools through the use of derivative financial instruments. The activities from which banking industries earn their revenue include arbitrage and market-making activities,11 brokerage related services,12 advisory services,13 and operation of commodity pools.14 National banks also offer deposit accounts with interest payments based on movements of various market measures15 and engage in derivative transactions on behalf of discretionary trust accounts.16 The variety of services available is limited only by federal law17 and the safety and soundness concerns of the federal regulators.


II. BANKING POWERS ANALYSES

For reasons other than involvement with derivatives, national banks are usually affiliates within a bank holding company system. Under this organizational structure derivatives-related activities are primarily conducted within the national bank itself, within a subsidiary of the national bank, or within an affiliated nonbank subsidiary of its bank holding company. The activities of these entities are subject to the primary supervision of either the O.C.C. or the Board of Governors of the Federal Reserve System ("the Board").

In an attempt to find a more favorable regulator, the bank holding company has the additional option of conducting certain activities within a nonmember state bank subsidiary. However, since the passage of section 303 of the FDIC Improvement Act of 1991 there is little incentive to seek more advantageous regulation because the activities and equity investments of FDIC-insured banking institutions have been limited generally to those activities and equity investments that are permissible for national banks. The derivatives-related activities of these banking institutions and their subsidiaries may be more restricted than indicated by the applicable state laws and regulations, as they defer to interpretations of the O.C.C. concerning permissible activities.

As with all other activities and investments of institutions in the banking industry, derivatives-related activities must be permitted by an enabling statute. With different regulators supervising the entities, two factors in choosing the appropriate entity within which to engage in any derivatives-related activity are the differences that may exist between the judicial and regulatory interpretations of the enabling statutes and the conditions and limitations imposed for safety and soundness purposes by the governing regulators.

20. See id. This statute and the corresponding regulations issued by the FDIC operate to restrict the activities and certain investments of insured state banks and their subsidiaries to those permissible for national banks unless the FDIC has determined that the activity would pose no significant risk to the appropriate deposit insurance fund and the state bank complies with applicable capital standards.
National banks obtain their authority to engage in derivative related activities from the National Bank Act. The powers clause, found at section 24 (Seventh), provides that a national bank shall have the corporate powers:

To exercise . . . 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 [this title] . . . . 22

While activities involving futures, forward, option, and swap contracts are not listed therein, the United States Supreme Court recently held in NationsBank v. Variable Annuity Life Insurance Co. that the “business of banking” is an expansive concept that is not limited by those activities and powers expressly enumerated in the statute. 23 Thus, the powers clause grants broad authority to engage in activities that are a part of the “business of banking” and to exercise such other powers that are reasonably necessary or incidental to carry on that business.

The OCC is the primary regulator of national banks and their operating subsidiaries. 24 Pursuant to this authority, its interpretation of the powers clause is afforded controlling weight. 25 Even prior to the recent holding in NationsBank, the OCC held the position that the business of banking should evolve to allow national banks to engage in the activities of emerging financial markets and service the changing needs of its customers. 26 Through its interpretive letters, the OCC identifies several factors used to identify the products and activities in which national banks may engage and the customers they may serve. These factors include “the financial nature of the activity, similarity to listed powers, usefulness in carrying out listed powers, customary practices of banks, expectations of the community, governmental purposes, and the convenience and needs of society’s financial functioning.” 27 Recently, it has been advocated that the reasoning of

24. See 12 U.S.C. §§ 1, 24 (Seventh), 93a; 12 C.F.R. § 5.34 (1996). Operating subsidiaries of national banks are limited to those activities of the parent bank and, therefore, they are subject to the same powers analysis. See 12 C.F.R. § 5.36.
27. OCC Interpretive Letter No. 494, supra note 12, at 71,198.
judges and bank regulators can be synthesized into three principal factors used to identify the products and activities in which national banks may engage and the customers they may serve:

1. Whether the activity in question is functionally equivalent to, or a logical outgrowth of, a recognized bank power;
2. Whether the activity benefits bank customers and/or is convenient or useful to banks; and
3. Whether the activity presents risks of a type similar to those already assumed by banks.  

According to the above analysis, derivatives-related activities that share common characteristics of, achieve the same functional effect of, or are a newly innovated equivalent of recognized banking activities, and which satisfy customers' needs and demands without exposing a bank to unfamiliar risks that adversely affect its safety and soundness should be part of the business of banking.

As previously stated, the powers clause additionally authorizes national banks to exercise such other powers that are reasonably necessary or incidental to carry on the business of banking. It is difficult to identify activities that fall outside the broad scope of the business of banking analysis but, at the same time, are sufficiently incidental to the banking business for the O.C.C. to permit the activity. In 1989, the O.C.C. explained that permissible incidental activities include those activities that are similar to an express power, relate to an express power, resemble traditional banking functions, or constitute financial activities. These factors closely resemble the factors of the above business of banking analysis.

Perhaps an incidental powers analysis may lie dormant until the limits of the business of banking analysis are challenged and subsequently established in court. When novel powers are at issue, the O.C.C. is not distinguishing between powers that are a part of the business of banking and those powers that are incidental. This can be

28. Williams & Jacobsen, supra note 1, at 798. Julie L. Williams and Mark P. Jacobsen, the Chief Counsel and Special Assistant, respectively, of the O.C.C., conducted an extensive analysis of the legislative history, case law, general circumstances, and commentators defining the business of banking. Although this business of banking test represents the views of the authors only, it would be logical to assume their views are a reflection of their positions and, considering this, their views are bound to influence future interpretations by the O.C.C. Evidence of this can be seen in A Bank May Take Physical Delivery of “Eligible Commodities” in Connection to Bank Customers’ Commodity Transactions in Order to Hedge Risks, OCC Interpretive Letter No. 684, [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,632, at 71,866 (discussing all three parts of the business of banking test) [hereinafter OCC Interpretive Letter No. 684].

29. See Williams & Jacobson, supra note 1, at 814-15.

30. See OCC Interpretive Letter No. 494, supra note 12, at 71,198.
seen in a recent O.C.C. interpretive letter which avoided the issue by stating:

[physical hedging is part of or incidental to the business of banking and a permissible activity for national banks under 12 U.S.C. § 24 (Seventh), since physical hedging allows banks to reduce the risks associated with an otherwise permissible banking activity, engaging in commodity-linked transactions. Ancillary activities associated with the physical settlement of hedging transactions, such as the transfer or receipt of documents evidencing title to commodities, and the storing, transporting, and disposing of such commodities, also are permissible for national banks.]

Although physical hedging is a permissible banking activity, the question remains whether physical hedging is either part of the business of banking or is an activity incidental thereto. Now that the "business of banking" is confirmed to be an evolving concept, perhaps incidental powers may become synonymous with ancillary activities.

The Board regulates bank holding companies and its nonbank subsidiaries pursuant to the Bank Holding Company Act ("BHCA"). Section 4(c)(8) of this Act provides that bank affiliated companies may engage in activities that are, as determined by the Board, "so closely related to banking or managing or controlling banks as to be a proper incident thereto." This has developed into a two-part analysis. First, the Board determines whether such activities are "closely related to banking." If so, the Board then determines whether particular activities are "properly incident to banking... [for the purpose of preventing] those activities which are so clearly of a purely commercial nature that the predominantly adverse effects [to the public] of a bank's engaging in them may be presumed."

Pursuant to the first analysis, any nonbanking activity, including a derivatives related activity, may be deemed to be closely related to banking if it is demonstrated that:

1. Banks generally have in fact provided the proposed services.
2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed service.

33. 12 U.S.C. § 1843(c)(8).
34. See National Courier Ass'n v. Board of Governors of the Fed. Res. Sys., 516 F.2d 1229, 1237 (D.C. Cir. 1975). Compare Bank Holding Companies and Change in Bank Control; Revision of Regulation Y, 49 Fed. Reg. 794, 806 (CFTC 1984), where the Board, citing National Courier, states the two-part test as "[first,] whether the activity is closely related to banking and a 'proper incident' to banking; and [second,] whether the benefits of a particular bank holding company engaging in a specific nonbanking activity outweigh the possible adverse effects."
35. National Courier Ass'n, 516 F.2d at 1237.
3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.\textsuperscript{36} However, these elements are not the exclusive basis for making a "closely related" determination. The Board is vested with considerable discretion to consider and weigh other factors.\textsuperscript{37} Since 1984, the Board has recognized that the banking environment is subject to change and that, in addition to the above criteria, it would consider any other factor that an applicant may advance to demonstrate a reasonable or close connection or relationship of the activity to banking or managing and controlling banks, including the expanding competitive environment and the expanded services being offered by unregulated financial services entities.\textsuperscript{38} Further, the Board will also reconsider any activity previously denied if circumstances have changed.\textsuperscript{39}

For the "proper incident to banking" analysis, the Board must consider whether the performance of the proposed activity may "reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, or gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.)"\textsuperscript{40} Additionally, the Board will evaluate the financial and managerial resources of the applicant and the effect of the proposed activities on those resources.\textsuperscript{41}

Usually, the permissible activities of bank holding company non-bank subsidiaries are considered to be more broad than the permissible activities of national banks and their operating subsidiaries. However, there are similarities between the above tests: both look to the functional equivalence of the proposed activity to recognized banking activities; both are concerned with the public benefits of the proposed activity; both include activities that are incidental to or closely connected to banking; and both recognize the evolving nature

\textsuperscript{36} Id.
\textsuperscript{38} See Bank Holding Companies and Change in Bank Control; Revision of Regulation Y, 49 Fed. Reg. at 806.
\textsuperscript{39} See id.
\textsuperscript{40} 12 C.F.R. § 225.24 (1996).
\textsuperscript{41} See id. This evaluation will include considerations of whether the activity would breach the Board's source of strength doctrine by adversely effecting the ability of a bank holding company to provide financial and managerial resources to its subsidiary banks. See 12 C.F.R. §§ 225.4(a), .142(a) (1996); Policy Statement; Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707, 15,707 (1987).
of the banking environment. Also, at times the O.C.C. has authorized national banks to engage in derivatives-related activities that the Board has not authorized for nonbank affiliates. For example, in 1989, the O.C.C. authorized national banks to engage in discretionary portfolio management with respect to futures and options on non-financial commodities.\(^{42}\) The Board did not authorize this activity for nonbank affiliates until August 1995.\(^{43}\) Most likely, this difference is attributable to the fact that prior to August 1995, the Board was not requested to authorize this activity. Regardless, this illustrates that at any given time a national bank’s powers to engage in derivatives-related activities can be more broad than its nonbank affiliate’s. But, considering the Board’s procedures (in Regulation Y) authorize nonbanking activities,\(^{44}\) any activity the O.C.C. determines to be a part of or incidental to the business of banking should meet the “closely related” standards of the Board. In fact, the Board has recently proposed revisions to its regulations in order to eliminate supervisory restrictions on BHC’s from conducting activities that would not apply to insured depository institutions.\(^{45}\)

Another situation where banking institutions encounter a different powers standard than set forth in the above powers analyses involves overseas activities. In addition to regulating the domestic activities of bank holding companies, the Board has jurisdiction over all international operations of United States banking organizations that are either members of the Federal Reserve System or bank holding companies.\(^{46}\) The rules of Regulation K of the BHCA govern the overseas activities of bank holding companies, national banks, their foreign subsidiaries, and other corporations engaging in foreign banking (i.e., “Edge corporations”).\(^{47}\)

National banks are authorized to engage in a broader range of activities overseas than they are domestically. A foreign branch of a national bank may exercise abroad all of the bank’s general banking powers and such additional powers “as may be usual in connection with the transaction of the business of banking in the places where... [the foreign branch] transact[s] business.”\(^{48}\) In section 211.3(b) of Regulation K, the Board has limited the additional powers to nine

\(^{42}\) See OCC Interpretive Letter No. 494, supra note 12, at 71,203.


\(^{44}\) See 12 C.F.R. § 225.23 (1996).


\(^{47}\) See generally 12 C.F.R. § 211.

\(^{48}\) 12 U.S.C. § 604a; see also 12 C.F.R. § 211.3(b).
listed activities and, with prior Board approval, any other activities the Board determines are in accordance with the standards set by the above stated additional powers.\textsuperscript{49} A national bank may also establish an operating subsidiary in the same country as it maintains a foreign branch, which may engage in all activities permitted to the bank and any activities incidental to those of the foreign branch.\textsuperscript{50}

Other entities, including foreign bank subsidiaries of national banks, foreign subsidiaries of bank holding companies, and Edge corporation subsidiaries of either national banks or bank holding companies, have even broader powers to engage in international banking and other overseas financial activities. Generally, the permitted activities of these entities must be, in the determination of the Board, usual in connection with the transaction of the business of banking or other financial operations abroad and consistent with the Federal Reserve Act and the BHCA.\textsuperscript{51} In reviewing proposals by United States banking organizations to engage in overseas activities, the Board requires that the activities be banking or financial in nature, but will consider other activities that will enable United States banking organizations to effectively compete with like foreign organizations.\textsuperscript{52}

Overseas activities of national banks are subject to the dual supervision of the Board and the O.C.C.\textsuperscript{53} For safety and soundness purposes, the O.C.C.’s supervision of the banks’ consolidated operations includes all foreign operations and activities.\textsuperscript{54} National banks are required to provide the O.C.C. with prior notification of establishing a foreign branch or investing in other foreign operations and to file periodic reports on other international and foreign exchange activities.\textsuperscript{55} Primarily, this information is used by the O.C.C. for its examination responsibilities and the issuance of “appropriate instructions” rather than for authorizing permissible investments and activities.\textsuperscript{56} This imposes on national banks the burdens of making separate filings with the Board and the O.C.C. In an effort to eliminate this regulatory burden, the O.C.C. proposed to update and clarify its rules to coordinate its reporting requirements with those of the Board.\textsuperscript{57}

\textsuperscript{49} 12 C.F.R. § 211.3(b) (1996).
\textsuperscript{50} See 12 C.F.R. § 211.3(b)(9).
\textsuperscript{51} See generally 12 U.S.C. §§ 615, 1843(c)(14); 12 C.F.R. § 211.5.
\textsuperscript{53} See 12 C.F.R. §§ 20.1-.10, 211.1-.8.
\textsuperscript{54} See 12 C.F.R. § 20.1-.10.
\textsuperscript{55} See id.
\textsuperscript{56} See 12 C.F.R. § 20.1(b)(3).
When considering permissible activities of subsidiaries of a national bank within a holding company system, there is the possibility that the Bank Holding Company Act restrictions may apply and, thereby, subject the activities of these subsidiaries to the overlapping jurisdiction of both the O.C.C. and the Board. To date, the Board has refrained from asserting jurisdiction and, by regulation, has authorized national bank subsidiaries of holding companies to acquire or retain subsidiaries in accordance with the rules of the O.C.C. and without the need for prior Board approval. The regulation is based on § 4(c)(5) of the BHCA, which authorizes bank holding companies to own the kinds of securities eligible for investment by national banks. The logic is that since bank holding companies can own stock in national banks and national banks can own stock in their operating subsidiaries, bank holding companies can also. Additionally, in a related issue, the Second Circuit United States Court of Appeals has held that the Board had no jurisdiction over the subsidiaries of state-chartered banks.

Nevertheless, the only time a court was presented with this issue, the court initially held that a bank holding company may not own or control, through its national bank subsidiaries, nonbank subsidiaries whose activities are deemed permissible by the O.C.C. unless those activities are also authorized under § 4(a)(2) of the BHCA. In rejecting the Board's rationale, the court refused to characterize a bank's ownership of stock of an operating subsidiary as the type of securities "eligible for investment" intended by § 4(c)(5). However, on rehearing the holding was vacated on the grounds that it was procedurally inappropriate to decide the issue because the Board was vested with initial jurisdiction to determine the merits of a BHCA challenge, with judicial review in a court of appeals appropriate only


59. See 12 C.F.R. § 225.22(d)(1); see also 49 Fed. Reg. 794, 811 (CFTC 1984) (explaining the purpose of this regulation).

60. See 12 U.S.C. § 1843(c)(5).


62. See American Ins. Ass'n v. Clarke, 865 F.2d 278, 286-87 (D.C. Cir. 1988) (holding that 12 U.S.C. § 1843(a)(2) prohibits bank holding companies from owning or controlling any company which is not a bank or bank holding company or engaged in activities other than banking and those permitted under § 1843(c)(8)).

63. See id.
after a Board determination was rendered. Should this court's interpretation eventually prevail, derivatives-related activities by operating subsidiaries of national banks in holding companies systems will require prior board approval unless the derivative products resulting from those activities are considered securities "eligible for investment" as intended by § 4(c)(5) of the BHCA.

III. DERIVATIVES-RELATED ACTIVITIES AUTHORIZED BY THE REGULATORS

In evaluating whether derivatives-related activities fit within the defined powers discussed above, the banking regulators focus on the characteristics of the products and the manner in which those products are used. At times, the power to use a derivative instrument may best be understood as an extension of the power to act with regard to the underlying instrument (such as derivative instruments involving precious metals or foreign exchange). However, futures, forward, option, and swap transactions are financial instruments in their own right and, where banking organizations have the power to engage in an activity with respect to nonderivative instruments (such as the brokerage of securities) that power has been extended to include derivative instruments. This, coupled with the safety and soundness concerns of the banking regulators, results in integrated analyses which make it difficult to simply list all the derivative instruments authorized for use. There are specific considerations, conditions, and commitments involved with each that define the limits of their permitted uses. Below is a review of some derivative-related activities typically used by the banking industry and the required conditions and commitments under which they may be used.

A. Futures Activities for Institution's Own Account

Futures activities can be categorized as either financial futures or commodity futures. "Financial futures" are those futures, option, and option on futures contracts relating to assets that a national bank may purchase for its own account, such as futures contracts on United States securities, United States government agency securities, money market instruments, bank certificates of deposit, foreign currencies,

65. See OCC Interpretive Letter No. 494, supra note 12, at 71,203.
and gold, silver, platinum, and palladium.66 "Commodity futures" are those futures, option, and option on futures contracts relating to all other assets not available for investment by national banks, such as futures contracts with regard to equities, agricultural products, and crude oil.67

Because the underlying assets from which financial futures derive their value are financial instruments in which banks already have broad powers to invest, underwrite, and deal, national bank authority to use financial futures is more broad than the authority to use commodity futures. One use of financial futures for a national bank’s own account is for risk reduction purposes in connection with its investment portfolio and asset-liability management (i.e., hedging transactions). For example, a bank can use any such contract for reducing undesirable risk exposures to interest rate changes, currency exchange fluctuations, or any other risk factor.68 The uses of these contracts are limited only by safe and sound banking practices and the O.C.C.’s risk-oriented supervision of the bank’s ability to identify, measure, monitor, and control its risk exposure in accordance with O.C.C. Banking Circular 277.69

Additionally, national banks have the power to trade in financial futures for their own account for purposes other than hedging. The O.C.C. has permitted a national bank to engage in arbitrage activities using financial futures contracts where the bank is already an active and substantial participant in the spot markets for the underlying assets.70 The O.C.C.’s approval was contingent on the following considerations and conditions:

a) non-hedging uses of futures contracts would be performed only within segregated dealer units;

b) non-hedging activities would be limited to contracts in which the bank is authorized to and does in fact deal;

66. See id. at 71,192.
67. See id. at 71,193. Note that the O.C.C. therein restated its opinion that futures and options generally are not “securities” within the meaning of the Glass-Steagall Act and, therefore, a bank’s use of futures and options are not subject to the Act’s prohibitions concerning securities. See id. at 71,201. Therefore, activities involving options that are derivatives of securities and/or options that are traded on securities exchanges have been authorized by the O.C.C. to about the same extent and subject to the same limitations as all other activities involving financial and commodity futures.
68. See BC-277, supra note 8.
69. See id.
c) the contract positions used for non-hedging purposes would be limited to amounts that do not exceed trade date position limits on related cash transactions;
d) aggregate bank-wide positions in any futures or options contract would be limited to a reasonable percentage of the total open interest in a contract month consistent with safety and soundness considerations;
e) the board of directors would approve written policies that specifically address non-hedging strategies and the approved activities will be conducted pursuant to reasonable limits established by the Board of Directors and a senior management committee;
f) appropriate record keeping, internal reporting, and internal auditing systems would be instituted to enable management to monitor and control the Bank's futures trading activities; and
g) practices and procedures set forth in Banking Circular 79 (now replaced and superseded by BC-277) would be established, consistent with safety and soundness considerations.

Subject to similar conditions as stated above, the O.C.C. has approved arbitrage and market-making operations for a bank's operating subsidiary's own account in financial futures and in futures in which the parent bank was a dealer in the spot markets. The O.C.C. also authorized this subsidiary to become a floor trader on commodity and other option exchanges to deal in interest rate denominated futures and option contracts. It required the additional conditions that any liability arising from the subsidiary's exchange membership would be limited to the subsidiary's capital only, and that the investment in and loans to the subsidiary would be limited to fifteen percent of the bank's unimpaired capital and surplus.

Unlike financial futures, commodity futures cannot be purchased by national banks for investment purposes. Activities involving commodity futures are limited to managing risks arising from other permissible banking activities. The O.C.C., in connection with its review of Chase Manhattan Bank, N.A., offering of a time deposit account that paid interest based on a financial market index (in this case, the S&P 500 Index), authorized the bank to purchase stock index futures to hedge its rate risk exposure on the deposit accounts. This activity is permissible only as a necessary compliment to the bank's deposit-taking activities and incidental to its power to offer time de-

71. See id. at 76,619.
72. See OCC Interpretive Letter No. 422, supra note 11, at 78,019.
73. See id.
74. See id. at 78,019-20.
75. See OCC Interpretive Letter No. 632, supra note 21, at 71,637.
76. See MII Decision, supra note 15.
posits and the business of banking.\textsuperscript{77} Likewise, to the extent national banks have the power to reference the interest they either pay on time deposits or receive on loan contracts to any rate, index or standard, they have the incidental power to manage the resulting risk exposures by using the most suitable options, futures, and options on futures (including commodity futures) available.\textsuperscript{78}

The O.C.C. noted that any futures activities used for asset-liability management must generally be conducted in accordance with the guidelines set forth in Banking Circular 79 (now replaced and superseded by BC-277).\textsuperscript{79} It stated "that such activities must (a) be conducted pursuant to specific written policies and procedures endorsed by a national bank’s board of directors, (b) be within position limits set by the board, and (c) conform to O.C.C. requirements regarding record-keeping and policy objectives."\textsuperscript{80}

One authorized activity, although not a derivatives transaction, evidences the extent of a national bank’s powers to hedge undesired risk exposures. In order to hedge the risk exposures originating from permitted commodity-linked transactions, generally a bank will deal in commodity futures or options contracts or other cash-settled derivative transactions that can provide an accurate hedge.\textsuperscript{81} However, there are times where these cash-settled transactions may provide less than completely accurate hedges, thereby exposing the bank to the risk of unmatched price fluctuations between the commodity-linked transactions and the hedge transactions (called "basis risk").\textsuperscript{82} In this circumstance, to the extent that access to the physical markets would provide a more accurate and precise hedge than exchanged-traded and OTC cash-settled transactions, the O.C.C. recognizes a national bank’s power to accept physical delivery of commodities.\textsuperscript{83}

This activity is authorized on the grounds that it is a logical outgrowth of or a means to reduce the risks arising from permissible

\textsuperscript{77} See id.

\textsuperscript{78} See id. (citing Letter from Owen Carney, Director, Investment Securities Division (Apr. 17, 1984) (stating that "the use of futures contracts may be incidental to the business of banking and consistent with prudent bank management, even where the underlying instruments are not bank-eligible, provided the contracts are used in a manner consistent with Banking Circular 79")); see also Bank to Act as Principal in Unmatched Commodity Price Index Swaps, OCC No Objection Letter No. 90-1, [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095, at 71,220-221 (Feb. 16, 1990).

\textsuperscript{79} See MII Decision, supra note 15.

\textsuperscript{80} Id. at n.20.

\textsuperscript{81} See OCC Interpretive Letter No. 632, supra note 21, at 71,635.

\textsuperscript{82} See id.

\textsuperscript{83} See id. at 71,638; OCC Interpretive Letter No. 684, supra note 28, at 71,864.
banking activities. Given the potential additional risks associated with physical hedging activities, the O.C.C. will not permit a national bank to engage in such activities unless it determines that the bank has the management and controls necessary to ensure that such activities are carried out in accordance with safe and sound banking practices and pursuant to the following conditions:

a) present a detailed plan to the O.C.C. and obtain the prior written authorization of the O.C.C.'s supervisory staff before engaging in physical hedging activities;

b) use such activities only to supplement a bank's existing hedging activities, only to reduce risks arising from an otherwise permissible banking activity, and only for customer driven needs and not for speculative purposes;

c) such activities shall constitute only a nominal percentage of the bank's risk management activities (i.e., no more than five percent of its total transactions involving the "eligible commodities" would involve actual physical delivery);

d) engage in physical hedging transactions only where such transactions provide a more accurate hedge than available exchange-traded or over-the-counter transactions, taking into account all of the costs associated with the physical hedging transactions; and

e) generally, must have in place controls of the type identified in BC-277, including the standards set forth in Section F.3 of BC-277 concerning physical commodity transactions.

Further, the O.C.C. expects a national bank that engages in physical hedge transactions to adopt and maintain:

i) specific written policies and procedures endorsed by the board of directors which set forth the circumstances under which physical hedging activities are permissible, establish permissible physical hedging strategies, and address the relationship between physical hedging activities and other banking activities;

ii) established position limitations;

iii) a system for monitoring credit risk exposure associated with various customers and dealers with whom operating personnel are authorized to transact business;

iv) appropriate internal controls including minimum documentation to support the authorized use of physical hedging activities, periodic reports to management, segregation of duties, and internal audit programs, designed to ensure adherence to bank policy and to prevent unauthorized trading and other abuses;

v) safeguards designed to manage the risks associated with storing, transporting, and disposing of commodities of which the bank has

84. See OCC Interpretive Letter No. 632, supra note 21, at 71,638.

85. “Eligible commodities” can include commodities for which a national bank has no authority to make or take physical delivery, subject to approval by the O.C.C. See OCC Interpretive Letter No. 684, supra note 28.

86. See id. at 71,866-867; OCC Interpretive Letter No. 632, supra note 21, at 71,638.
taken delivery, including policies and procedures designed to ensure that the bank has levels of insurance (including insurance for environmental liabilities) which, after deductions, are commensurate with the risks assumed; and

vi) minimum qualifications and appropriate training requirements for bank employees engaged in physical hedging transactions.87

Bank holding companies and their nonbank subsidiaries are authorized to engage in futures activities pursuant to a Board's statement of policy promulgated in Regulation Y at section 225.142.88 This policy statement, adopted in 1983,89 asserts that, in accordance with the principle that bank holding companies shall serve as a source of strength for their subsidiary banks, any positions taken by the bank holding company or their nonbank subsidiaries in futures, forward or options contracts should reduce risk exposure (i.e., be for hedging purposes) and not be speculative.90 However, an assessment of Board opinions and policy statements reveals that these companies are authorized to purchase and sell futures, forward, and option contracts for their own account for both hedging purposes and for purposes other than hedging.

Generally, the Board permits a bank affiliate (i.e., a bank holding company or its nonbank subsidiary) to engage in risk management activities, such as hedging, provided: (a) the bank affiliate notifies the Board within ten days after the activities are begun; (b) the company's board of directors approves prudent written policies and establishes appropriate trading limitations to insure performance in a safe and sound manner; (c) the company establishes internal controls and internal audit programs; and (d) the board of directors, a committee thereof, or an internal auditor periodically reviews contract positions to insure conformity with the company's policies and limits.91

These hedging activities are often conducted as an incidence to the underwriting and dealing activities of a bank affiliate's "Section 20" operations.92 The revenues derived from hedging activities con-

87. See id.
89. See id.
90. See id.
91. See id.
92. Section 20 operations are activities involving underwriting and dealing in securities not eligible to banks (called bank-ineligible securities) under section 16 of the Glass-Steagall Act. Section 20 of the Glass-Steagall Act prohibits the affiliation of a member bank with a company that is "engaged principally" in underwriting or dealing in bank ineligible securities. To ensure that bank affiliates will not engage principally or substantially in such activities, the Board dictates that the gross revenues from ineligible securities activities may not exceed ten percent. See, e.g., Order Approving Modification of Section 20 Orders, 75 Fed. Res. Bull. 751 (1989).
ducted as a necessary incident to bank-ineligible securities activities are treated as part of the bank-ineligible securities activities for purposes of computing the ten percent revenue limitation set forth in the Section 20 Orders. 93 To avoid this, the bank affiliate must obtain specific approval under section 4(c)(8) of the BHCA to conduct the activities independently. 94

With respect to financial futures activities, the Board has authorized these companies to trade for their own account in futures, options, and options on futures contracts on United States government and agency securities and money-market instruments, 95 certificates of deposit, 96 foreign currencies, 97 and gold, silver, platinum and palladium. 98 They may also engage in these activities for purposes other than hedging. An important factor that will sway the Board to authorize a bank affiliate to deal in financial futures is the extent of the company's experience in trading and monitoring positions held in the underlying financial assets (referred to as bank-eligible instruments by the Board) or in judging interest rate price movements. 99 The Board considers these activities to be closely related to banking because banks trade in the underlying assets and generally provide services that are operationally or functionally so similar to the trading of financial futures as to equip them particularly well to engage in the activity. 100 In addition to the company's experience with the underlying assets, the Board has relied upon the following commitments and considerations in approving the activities:

a) the company will trade in the authorized instruments in a manner consistent with its hedging methodology, as well as in accordance with the conditions set forth in the Board's previous orders approving related activities;
b) the company will take steps to reduce risks that are comparable to steps suggested in the Board's policy statement concerning bank holding companies engaging in financial futures, forward, and options contracts;
c) specific measurable limits will be adopted for each relevant risk exposure in the described activity, company senior management will

monitor adherence to established risk limits, and portfolio risk managers will perform the more immediate risk management function by utilizing periodically (at least daily) produced reports which measure adherence to the limits;

d) counterparty credit risk guidelines have been established by senior management personnel;
e) the company has substantial experience in trading derivative products based on bank-eligible securities and other assets; and
f) where the company is a registered broker-dealer, it shall be subject to the SEC's net capital rule (see 15 C.F.R. 240.15c3-1).

There can be additional conditions and considerations that the Board may require depending upon the size, scope and complexity of the activities and the risks involved. For example, when a bank affiliate proposes to engage in a broad range of derivatives activities as principal, broker, and advisor, the Board will require more detailed conditions relating to internal controls and sales practices. These additional commitments and considerations are fully discussed below when reviewing swap transactions.

One distinction from national banks is that the Board has recently expanded the authority of bank affiliates to include trading as a principal, for purposes other than hedging, in commodity futures contracts. Specifically, the Board authorized a bank holding company to engage in arbitrage operations, market-making for customer accommodation purposes, and proprietary trading (taking positions for investment purposes) using futures, options, and options on futures contracts based on certain commodities and on certain stock and bond indexes, including crude oil futures, Standard & Poor's 500 Stock Price Index futures, and municipal bond index futures. The Board reasoned that these activities were closely related to banking because: (a) banks use the instruments in question for activities similar to the above activities and banks engage in trading activities for the same purposes with similar instruments; (b) banks provide execution, clearance, and advisory services to others using the instruments; (c) arbitrage and other profit-seeking purposes are a natural outgrowth of traditional intermediation activities of banks; and (d) the process of dealing in exchange-traded commodity futures does not differ substantially from that of dealing in exchange-traded financial futures.

Approval to engage in these activities is conditioned on the bank

101. See, e.g., id. (citing 15 C.F.R. § 240.15c3-1 (1996)).
102. See id. at 196.
103. See id. at 192.
104. See id.
105. See id. at 192-93.
holding company being subject to the commitments and considerations set forth above for trading in financial futures and the below additional conditions:

a) the bank affiliate does not intend to take delivery and takes steps to avoid delivery of any commodity contract (not based on precious metals) that provides for delivery of the underlying asset at the expiration of the contract. Steps to be taken to avoid delivery include closing positions in expiring contracts during trading periods and engaging in exchange-for-physical transactions after the close of trading;

b) whenever the company takes delivery of a commodity, it will notify the Board and promptly devest itself of the commodity;

c) contracts based on a securities index may be structured in a manner that provides for delivery of the underlying securities. Revenues derived from transactions involving ineligible securities, or from any transaction that itself constitutes underwriting or dealing in ineligible securities, will be treated as ineligible revenues for purposes of complying with the Board's ten percent revenue limitation on Section 20 subsidiary's underwriting and dealing in bank-ineligible securities. Further, physical delivery of securities in any described transaction will be subject to the limits on acquisitions of securities contained in the BHCA and the Board's related policies and interpretations, including the Board's policy statement on nonvoting equity investments by bank holding companies (12 C.F.R. §225.143);

d) the company will prohibit any interaction between its trading personnel and its personnel engaged in FCM and futures advisory activities;

e) all business shall be conducted in conformity with the Board's current and future supervisory guidance with respect to customer transactions, trading and marketing practices and related systems and controls;

f) Prior to altering the manner in which the company's business is conducted and prior to conducting the activities through a nonbanking subsidiary other than specific entities previously authorized to conduct the activities, the company shall notify the Board and provide a reasonable opportunity for comment and/or a determination as to whether prior approval is required.  

B. Futures Activities on Behalf of Customers

Pursuant to the O.C.C.'s broad interpretation of the business of banking, it recognizes the power of national banks to engage in futures brokerage activities. A national bank, generally through a futures commissions merchant ("FCM") operating subsidiary, is authorized to provide execution, clearing, and advisory services in-
volving financial and commodity futures contracts and options thereon for customers.\footnote{See OCC Interpretive Letter No. 494, supra note 12, at 71,195-201, for a thorough discussion of brokerage activities as a part of the business of banking.} The authority to engage in brokerage activities is based on the financial nature of the activity and their relationship to traditional banking functions.\footnote{See id. at 71,199-201.} In Interpretive Letter No. 494, the O.C.C. reasoned that execution activities represent associated aspects of the powers of banks to trade, deal in, and invest in instruments where the bank acts as principal and of the express provision in the Glass-Steagall Act to broker securities and that execution of other financial instruments for customers is an expected and natural accompaniment to these other recognized activities of banks in the financial markets.\footnote{Id. at 71,200.} Further, it stated that the clearing function of brokerage is a form of extending credit—a primary purpose of banking institutions.\footnote{Id. at 71,203.} The most notable aspect of this interpretive letter was the O.C.C.'s recognition of futures and options as financial instruments in their own right, resulting in the empowerment of national banks to engage in activities involving these financial instruments regardless of the nature of the underlying asset.\footnote{See id. at 71,203.} This interpretation opened the door for national bank authority to hedge for their own account with commodity futures and to provide brokerage services of these financial instruments to their customers.

As always, the bank and its operating subsidiary will be required to comply with the risk-management policies of BC-277. The O.C.C.'s interpretive letters reveal other specific conditions which a national bank should follow if it intends to either establish or acquire an FCM operating subsidiary. They include:

a) non-hedging uses of financial futures will be undertaken only by dealer units and will be limited to contracts on instruments in which the Bank is authorized to deal;

b) the subsidiary's board of directors will adopt institutional limits with respect to each type of financial future or option contract. Aggregate bankwide positions in any financial futures or options contract will also be monitored and will be limited to a reasonable percentage of the total "open interest" in a contract month, consistent with safety and soundness considerations;

c) the subsidiary will maintain a contract register adequate to identify and control all financial futures and options contracts;

d) the subsidiary will account for transactions for its own account by the method required by the O.C.C.;
e) loans by the parent bank to, or any investment of the parent bank in, the subsidiary (and its partnership interests) in the aggregate may not exceed the legal lending limit at the time of the loan or investment. The parent bank shall not make investments of equity capital in the operating subsidiary that exceed the lending limit without the O.C.C.'s prior written consent. For purposes of calculating the investment limit in accordance with this investment limitation, the parent bank's investment in the subsidiary is deemed unsecured;

f) the parent bank may lend to the operating subsidiary an additional ten percent of the bank's unimpaired capital and surplus if secured by readily marketable collateral as provided in 12 U.S.C. § 84;

g) the subsidiary will not join any exchange or clearing association that requires the parent bank or any other subsidiary of the bank to guarantee or otherwise become liable for trades executed and/or cleared by the subsidiary, other than for those trades executed and/or cleared for and on behalf of the bank and any of its affiliates;

h) the subsidiary will not become a clearing member of any exchange or clearing association that requires the parent bank to also become a member of that exchange or clearing association unless the bank obtains a waiver of the membership requirement;

i) the parent bank shall not guarantee or assume responsibility for any liability of its operating subsidiary, other than for those trades executed and/or cleared for and on behalf of the bank and any of its affiliates; and

j) the subsidiary will comply with all regulatory requirements of the Commodity Futures Trading Commission as set forth in the Commodity Exchange Act, will comply with all applicable contract market regulations and all sales and supervisory personnel associated with the subsidiary will register with the National Futures Association (NFA) and pass all appropriate examinations.  

Advisory services or investment advice has traditionally been recognized as a banking activity, and the O.C.C. has authorized national banks to engage in this activity with regard to financial and commodity futures and options. Generally, national banks have the power


to provide advisory services "through personal contact and impersonal subscription services to customers including individuals, corporations, institutional investors, and correspondent financial institutions; for accounts giving full investment discretion to the bank, as well as those with shared discretion or no discretion; and for investment strategies ranging from conservative to aggressive, utilizing investment vehicles such as stocks, bonds, commodities, real estate, and tangible personal property." 

A bank or its operating subsidiary may charge separate fees for their advisory services, and, in certain instances, can base their compensation on performance.

When the investment advice involves financial and commodity futures and options, registration with the Commodity Futures Trading Commission ("CFTC") as a commodities trading advisor may be required. Where the advisory services are solely incidental to the conduct of its other banking operations, such as trust services or lending activities, and no separate fee is charged, registration is not necessary. However, where the service is provided for special compensation, an advisory fee, or to unaffiliated customers, a bank or its subsidiary must register. The statutory requirement to register is enforced by the CFTC, but the O.C.C. has conditioned its authorization to engage in advisory services on compliance with applicable registration requirements of the CFTC.

Finally, the O.C.C. has permitted a wholly-owned subsidiary of a national bank to act as sole general partner and commodity pool operator to trade, invest in, and hold forward, option, and futures contracts that are permissible for a national bank to purchase and execute.
either for their own account or for the account of their customers.\textsuperscript{119} The basis for approval of this activity is that an operating subsidiary is authorized with the same powers as a national bank and, therefore, it can conduct those powers in the performance of its obligations as sole managing general partner of a limited partnership.\textsuperscript{120} Approval is conditioned upon a national bank's compliance with the following requirements:

a) the bank would limit its liability by adequately capitalizing its subsidiary in light of the activities it is to perform and by insulating the bank from the commodity pool (the partnership) so that it will not be liable for any investment losses that the partnership may experience. Adequate capitalization for tax purposes means that the subsidiary, as the general partner in the partnership, must generally have a net worth equalling at least ten percent of the partnership's net assets;

b) the partnership agreement would define and limit the partnership's activities to those consistent with national bank powers and recognize that the partnership is subject to the O.C.C.'s regulation, supervision and examination;

c) any offering materials will state that the partnership is subject to applicable federal banking laws and regulations;

d) the subsidiary, as the sole general partner, will effectively possess veto powers over the activities of the partnership;

e) the bank and its subsidiaries and affiliates will limit their total commitment to the partnership to no more than five percent of the bank's primary capital; and

f) the investment securities limitation in 12 C.F.R. § 1 will apply to the subsidiary's indirect investment, through the partnerships, in Type III investment securities and derivatives thereof. Accordingly, the bank must implement controls to assure that any such investments, when aggregated with other direct or indirect investments of the bank, do not exceed the applicable limits.\textsuperscript{121}

Interestingly, although the O.C.C. advises that a bank may find it prudent to implement management controls similar to those described in BC-277, because an operating subsidiary's primary role as a commodity pool operator is to invest customer's funds rather than the bank's own funds, strict compliance with the restrictions described in BC-277 is not necessary when certain additional conditions are imposed.\textsuperscript{122} These additional conditions include:

\textsuperscript{119} See OCC Interpretive Letter No. 496, \textit{supra} note 14, at 71,206-207.

\textsuperscript{120} See \textit{id.} at 71,207.

\textsuperscript{121} See \textit{id.}

\textsuperscript{122} See Margaret M. Grieve, OCC Interpretive Letter (Jan. 30, 1992), \textit{available in} 1992 WL 125228 (O.C.C.), at 3. Note, because this decision was rendered in 1992, it referred to Banking Circular 79 and not to BC-277. BC-277 was first issued in 1993 and it replaced and superseded Banking Circular 79.
i) the subsidiary's investment will be minimal. The subsidiary's investment in a commodity pool (a partnership) will be limited to the minimum amount required for the partnership to qualify as a partnership under federal tax law (the lesser of $500,000 or one percent of the amount invested in a partnership);

ii) income from fees will outweigh any investment risk to the subsidiary from futures and options;

iii) in addition to management fees, the bank and its subsidiaries are likely to earn other fees as a consequence of additional services provided to the partnership;

iv) the partnership will be structured in such a way that either the subsidiary's investment will be protected by a principal protection feature or the total income to the subsidiary from fixed management fees to be charged to the partnership, less all expenses incurred by the subsidiary in connection with the partnership, will exceed the subsidiary's exposure to futures and options through its investment in the partnership.

Many banks with an FCM operation are subsidiaries within a holding company system and operate the FCM as an affiliate of the bank. Unlike the bank-FCM subsidiary, the bank-FCM affiliate is regulated by the Board. Authorization for bank holding companies to engage in futures activities on behalf of their customers begin with the Board's list of permissible nonbanking activities found in Regulation Y.123 Pursuant to section 225.25(b)(18) of Regulation Y, a bank holding company may act as an FCM for nonaffiliated persons in the execution and clearance on major commodity exchanges of futures contracts and options thereon for financial futures.124 The requirements imposed by the Board to engage in these activities are set forth in the regulation:

a) the FCM services must be provided through a separately incorporated company;

b) the company will not become a clearing member of any exchange or clearing association that requires the parent corporation of the clearing member to also become a member of that exchange or clearing association unless a waiver of the requirement is obtained;

c) the company will not trade for its own account except for the purpose of hedging a cash position in the related financial futures instruments;

d) the company will time stamp orders of all customers to the nearest minute, execute all orders strictly in chronological sequence to the extent consistent with the customers' specifications, and execute

124. Id. Note, the Board has recently proposed to expand this regulatory authorization to also include FCM brokerage activities for commodity futures. See 61 Fed. Reg. 47,242, 47,244 (CFTC 1996).
all orders with reasonable promptness with due regard to market conditions;
e) the company will not extend credit to customers for the purpose of meeting initial or maintenance margins required of customers except for posting margin on behalf of customers in advance of prompt reimbursement; and
f) the company has and will maintain capitalization fully adequate to meet its own commitments and those of its customers, including affiliates.125

A noteworthy difference between authorization by the O.C.C. and that of the Board is that a bank-FCM subsidiary may trade financial futures for its own account for purposes other than hedging where the above regulation specifically limits the bank-FCM affiliate to hedging activities only. However, the Board recently authorized a bank holding company's Section-20 subsidiary to trade for the subsidiary's own account for purposes other than hedging both financial and commodity futures and to act as an FCM for nonaffiliated persons in the execution and clearing of those same instruments.126

The activities listed in section 225.25 of Regulation Y are identified by the Board as being so closely related to banking as to be a proper incident thereto.127 For all activities outside the limits of Regulation Y, application for prior Board approval is required and the activity's relation to the business of banking must be established. A number of bank holding companies have obtained Board permission to provide brokerage services on a variety of exchanges with respect to futures contracts and options thereon for various commodity futures.128 Generally, approval of these activities is based on reasons similar to those posited by the O.C.C. The Board reasoned that brokerage of commodity futures129 is closely related to banking because acting as an FCM for derivative instruments involving commodity fu-

125. See 12 C.F.R. § 225.25(b)(18) (1996). Note, the Board has recently proposed a comprehensive amendment of Regulation Y which would revise the rule concerning FCM activities by removing the conditions (c), (d), (e), and (f) because these conditions are addressed in rules of either the CFTC or other self-regulatory organizations. See 61 Fed. Reg. 47,242, 47,253 (CFTC 1996).
tues is operationally and functionally similar to the execution and clearance of financial futures and option contracts that previously have been approved by the Board. \(^{130}\) "In both cases, an FCM monitors customer credit risk and trading exposure; assesses and collects initial and maintenance margins from customers; and brokers, executes, and clears trades." \(^{131}\) The Board decisions reveal that providing execution and clearing services with respect to commodity futures must be conducted in conformity to the following limitations and conditions:

a) all FCM activities will be conducted in accordance with the conditions and restrictions on FCM activities set forth in 12 C.F.R. § 225.25(b)(18);

b) the FCM-subsidiary will not provide brokerage services with respect to exchange traded commodity futures and options thereon for any account over which it has discretionary authority and the company will not provide brokerage services with respect to these derivatives for retail customers, unaffiliated locals or market makers;\(^{132}\)

c) the FCM-subsidiary may provide brokerage services of commodity futures only to institutional customers;\(^{133}\)

d) the FCM-subsidiary will apply its current credit approval procedures to its managed commodity pool customers and their managers;

e) none of the FCM's customers will be managed commodity pools owned by, sponsored by, or otherwise affiliated with, the parent bank holding company and the FCM-subsidiary will not act as a commodity pool operator;

f) the bank holding company will provide the Board with prior written notice of any material change in the characteristic of the FCM-subsidiary's customer base;

g) the FCM-subsidiary will not enter into any impermissible tying arrangements with lending affiliates;

h) all customer positions carried by the FCM-subsidiary will be marked-to-market at least daily;

i) in order to minimize risks associated with the delivery of commodity futures should a customer have an open position in a contract after the termination of futures trading, and the customer is unable or unwilling to make or take delivery, the FCM-subsidiary will (1) re-tender or redeliver the commodity; (2) offset the cus-


131. Id.

132. Note that in J.P. Morgan & Co., 80 Fed. Res. Bull. at 152-53, the Board authorized FCM-subsidiaries to provide full brokerage services (and also clearing-only and execution-only services) to customers even though the customers "may become market makers in new financial contracts in order to facilitate the introduction of the contracts, or to assist in the ongoing trading of the contracts." Id. at 152 n.4.

133. Pursuant to Board regulations, "institutional customer" includes an organization or natural person whose net worth exceeds $1 million. See 12 C.F.R. §§ 225.2(g)(1), (3) (1996).
tomber's open position through an exchange-for-physical transaction; (3) offset the commodity in the cash market; and (4) seek to avoid delivery through some other mechanism; j) the FCM-subsidiary shall maintain capitalization fully adequate to meet its own commitments, those of its customers and those of its affiliates; k) the FCM-subsidiary will not serve as the primary or qualified clearing firm for any unaffiliated party.134

Technically, Board regulations require approval for each exchange and each derivative instrument in which an FCM-subsidiary proposes to engage. In the past, this required a bank holding company that had approval to engage in FCM activities with respect to certain financial instruments to reapply each time it intended to provide FCM brokerage services with respect to other financial instruments.135 It did not matter that the financial instruments were similar to ones for which the bank holding company had previous approval or that FCM activities with regard to the financial instruments were approved for other bank holding companies.136

In May 1993, the Board established expedited procedures to approve proposals of bank holding companies that have previously received approval to engage in FCM activities under either Board Order or sections 225.25(b)(18) and (19) of Regulation Y.137 Without further Board approval or application, such bank holding company FCM-subsidiaries are authorized to act as a FCM with respect to any additional financial instrument (beyond those instruments specifically approved for that bank holding company) that has been reviewed or approved previously for any other bank holding company, either under Regulation Y or Regulation K.138 Attached to FCM SR Letter 93-27 is a list of approved financial instruments for each approved exchange.139 This list is updated by the Legal Division of the Board as new instruments and exchanges are approved.140

Recently, the Board issued a notice proposing a comprehensive revision of Regulation Y.141 The proposal would revise and update the Board's description of derivatives-related activities to "eliminate

136. See id.
137. See Letter No. SR 93-27 (FIS), supra note 128.
138. See id.
139. Id.
140. See id.
any requirement that the Board specifically review and approve new derivatives [sic] instruments or trading on new exchanges." 142

When an FCM seeks approval to provide clearing-only services (as opposed to both execution and clearing), the Board requires a different set of commitments and limitations because:

by not engaging in both the execution and clearance of a trade, a bank-affiliated FCM would not be able to decline transactions that presented unacceptable risk. In this regard, the clearing FCM would have been obligated to settle each trade entered into by its customers, even if the customer did not have the financial resources to honor its obligations. . . . [T]his inability of the FCM to control the risks it would undertake, together with the fact that clearing agents must guarantee the financial performance of their customers to the clearing houses of the exchanges on which they operate . . . [can] present( ) substantial credit risk exposure to the parent bank holding company . . . 143

However, these concerns can be addressed by accepting clearing-only trades that have been executed by unaffiliated brokers pursuant to customer "give-up agreements." 144 In these agreements, the FCM reserves the right to decline acceptance of those trades that, within its sole discretion, present unacceptable risks, and retains the right to cancel or liquidate any of its customers' outstanding trades whenever it deems necessary for its own protection. 145 The give-up agreement transfers back to the executing FCM the liability for executing trades that possess unacceptable risks to the clearing FCM. 146 This causes the executing FCM to evaluate more closely the financial solvency of its customers because, once the clearing FCM rejects a trade, the executing FCM or its primary clearing firm would be responsible to clear the trade. 147 Accordingly, the Board has authorized clearing-only services for FCM-subsidiaries of a bank holding company subject to the following limitations and commitments:

a) all clearing-only services will be conducted in accordance with the conditions and restrictions on FCM activities set forth in 12 C.F.R. 225.25(b)(18);

142.  Id. at 47,249.
144.  A "give-up agreement" occurs where "the executing floor broker (or "give-in broker"), pursuant to a customer's instructions, gives up an executed order for clearance to a clearing member other than the executing broker's primary clearing member (or qualifying clearing member)."  Id. at 729 n.6.
145.  See id. at 730 & n.15.
146.  See id. at 730 n.15.
b) the FCM subsidiary will seek to ensure that the executing brokers are independent from the customers and that they will have the opportunity to evaluate the trades before they are executed; \(^{148}\)

c) the FCM subsidiary will not conduct clearing-only activities for locals, market makers, \(^{149}\) specialists or other professional floor traders that are trading for their own accounts;

e) the FCM subsidiary will not serve as the primary or qualifying clearing firm for any unaffiliated customer;

f) all clearing-only activities will be conducted pursuant to give-up agreements or other customer agreements which provide for the FCM subsidiary to have the right to refuse for clearance any customer trade that it deems unsuitable in light of market conditions, the customer's financial circumstances or the customer's trading objectives and to have the right to restrict the number and types of positions held by a customer;

g) the compliance and operations director and chief operating officer of the FCM subsidiary will review the credit worthiness and other characteristics of each potential customer, and, based on such review, will approve or reject the potential customer and establish appropriate trading, credit, margin, and exposure limits for each customer;

h) the customer base will consist solely of institutional investors with sophisticated business experience and extensive prior professional experience with financial futures instruments;

i) procedures shall be in place to monitor the intra-day trading activities and risk exposure of its customers. The FCM subsidiary shall compare client positions with margin limits each morning, maintain watch lists for all accounts that have positions approaching the margin limit, and employ client activity tally sheets to monitor customer trading on a real-time basis. In the event a trade would cause a customer's trading position to exceed the margin limit, it shall choose to:

1) decline to accept the trade;

2) accept the trade but notify the client and executing brokers that it will not accept any additional trades except liquidating trades;

3) ask the client to liquidate or transfer other contracts to reduce the customer's trading position below the margin limit; or

4) liquidate a customer's position, or may consider a request by the customer to increase the margin limit. \(^{150}\)

148. Note again J. P. Morgan & Co., 80 Fed. Res. Bull. 151 (1994). In another unique aspect of this case, the Board authorized FCM-subsidiaries to clear-only trades of customers pursuant to give-up agreements even where the FCMs executing the trades were not necessarily independent from the customers.

149. But see supra note 133 (authorizing an FCM-subsidiary to provide brokerage services to customers that may become market makers).

Bank holding companies have also obtained authorization to pro-
vide, through nonbank subsidiaries, execution-only services.\textsuperscript{151} Initially, the Board required FCM-subsidiaries that served as their own primary clearing firms to observe all the same credit-approval and risk-management procedures used in providing both execution and clearing activities and clearing-only activities for their execution-only services because the FCM-subsidiary is ultimately liable to clear all trades that it executes but gives up to another FCM for clearing.\textsuperscript{152} Additionally, the Board required the FCM-subsidiary to obtain from and "comply with all customer trading limits conveyed to . . . [it] by a customer's clearing FCM pursuant to a give-up agreement."\textsuperscript{153} However, in J. P. Morgan, the Board accepted the applicant's assertion that there is reduced credit exposures and levels of risk involved in execution-only services when compared to execution-and-clearing ac-
tivities and clearing-only activities.\textsuperscript{154} The Board authorized the J. P. Morgan's FCM-subsidiary to engage in execution-only activities using different credit review procedures than previously authorized.\textsuperscript{155} The FCM-subsidiary committed to accept a client as an execution-only customer only when:

the company's senior management is satisfied that the acceptance of the client as an execution-only customer would not subject the com-
pany to unacceptable levels of credit risk based on:

(i) The market reputation of the client (or its advisor), or the senior management's general knowledge of the credit worthiness of the client; and

(ii) The market reputation of the client's give-up clearing firm.\textsuperscript{156}

In contrast to providing clearing services, the FCM-subsidiary was not required to have its compliance and operations director and chief op-
erating officer review each execution-only customer's credit worthi-
ness and other characteristics and, if approved, establish appropriate trading, credit, margin, and exposure limits.

Other evidence indicates that the Board is willing to reduce the conditions and limitations imposed on a bank holding company engag-


\textsuperscript{153} Id.


\textsuperscript{155} See id. On at least one other occasion, the Board has authorized an applicant to use the same credit review procedures as set forth in J.P. Morgan. See Citicorp, Inc., 81 Fed. Res. Bull. 164, 165 (1995).

ing in brokerage activities. In *J. P. Morgan*, the Board allowed a FCM-subsidiary to provide brokerage services of commodity futures to market makers and clearing-only services to customers not necessarily independent from the FCM's execution of the customers' trades.\textsuperscript{157} There was no explanation for these liberalizations in the former conditions and limitations.

In another matter, the Board has authorized an exception to the requirement that all brokerage-related activities involving commodity futures and execution-only and clearing-only, services involving financial futures be provided to institutional customers only.\textsuperscript{158} In *Societe Generale*, the Board authorized an FCM-subsidiary to provide full brokerage, execution-only, clearing-only, and advisory services with respect to financial and commodity futures to "non-institutional \[sic\] commercial hedger customers."\textsuperscript{159} The Board required Societe Generale to abide by all the limitations designed to address the potential risks from providing clearing-only, and execution-only services, and additionally required the FCM-subsidiary to:

i) obtain from appropriate customers a written statement that they would only engage in "bona fide hedging transactions," as defined by the CFTC in 7 C.F.R. § 1.3(z);\textsuperscript{160}

ii) "establish an initial credit review process to determine whether a non-institutional \[sic\] commercial hedger customer's proposed hedging activities are appropriate, in light of the customer's net worth and business activities;"\textsuperscript{161}

iii) deny requests by "a non-institutional \[sic\] commercial hedger customer to trade in any commodities other than those that the customer would trade to hedge risks that arise from its commercial activities;"\textsuperscript{162} and

iv) "establish a system to detect any unauthorized trading activities."\textsuperscript{163}

The purpose of limiting the transactional and advisory services to areas in which the customer has special expertise is to address the Board's concern that the customer may rely unduly on the FCM-sub-

\textsuperscript{157} *Id.* at 152-53.


\textsuperscript{159} *Id.* A noninstitutional commercial hedger customer is engaged, or affiliated with a commercial enterprise that is engaged, in producing, manufacturing, processing, or merchandising products or providing services related to the commodities underlying the futures and options on futures contracts in which the customer would trade and is not engaged in execution of their own trades on the floor of an exchange—such as a farmer. See *id*.

\textsuperscript{160} *Id*.

\textsuperscript{161} *Id*.

\textsuperscript{162} *Id*.

\textsuperscript{163} *Id*.
sidiary’s advice or may be unable to detect conflicts of interest or advice that is motivated by the FCM-subsidiary’s self-interest.164

As indicated above, bank holding companies are also authorized to provide investment advice on financial futures and commodity futures. By regulation, subsidiaries of bank holding companies are authorized to provide investment advice on financial futures either as an FCM authorized under section 225.25(b)(18) of Regulation Y or as a registered commodities trading advisor (“CTA”) with the CFTC.165 Implied by the authority of an FCM to provide advisory services is the authority to engage in other authorized FCM activities in combination with the advisory services.166 In addition to any other conditions and limitations imposed due to other activities (i.e., such as the FCM complying with the conditions for its brokerage activities), the limitations imposed by regulation upon the FCM and the CTA are: (i) the company will not trade for its own account except for the purpose of hedging a cash position in the related bank-eligible instrument; and (ii) the company will limit its advice to financial institutions and other financially sophisticated customers that have significant dealings or holdings in the underlying commodities, securities or instruments.167

The Board has also approved applications for providing investment advice as either an FCM in combination with brokerage services or as a CTA with respect to the purchase and sale of commodity futures.168 The Board reasoned that this activity was closely related to banking because providing investment advice with respect to commodity futures is the “functional equivalent” of providing investment advice with respect to financial futures.169 In each case, the bank holding company subsidiary would be furnishing advice with respect to the trading of financial instruments to sophisticated clients.170 The commitments and considerations imposed by the Board for this activity are:

a) the activities must be conducted in accordance with, and subject to, the limitations set forth in 12 C.F.R. 225.25(b)(18);

164. See id.
167. See 12 C.F.R. §§ 225.25(b)(19)(i), (ii). Note, the Board’s proposed comprehensive revision of Regulation Y includes a proposal to remove the requirement that investment advice regarding derivatives transactions be provided only to institutional investors, thereby allowing the advice to be provided to retail customers. See 61 Fed. Reg. 47,242, 47,252 (CFTC 1996).
169. See id. at 127.
170. See id.
b) the company will disclose to each customer offered investment advice, both at the beginning of the customer relationship and upon confirmation of any order, that it may be trading for its own account the same or similar contracts on which it is advising the customer;  
c) the advisory services will be offered only to sophisticated customers that would be unlikely to place undue reliance on investment advice received from a banking organization and may not be able to detect investment advice that is motivated by the advisor's self-interest;  
d) an investment advisor shall not share with affiliates nonpublic customer information without the express written consent of the customer; and  
e) advisory services shall be rendered without regard to a customer's account balances at affiliated financial institutions.  

In the Board’s recent proposal to revise Regulation Y, it proposes to broaden the types of investment and advisory services permitted by regulation. One result of this revision would be to authorize bank holding companies and their subsidiaries to provide investment advice regarding financial and commodity futures to any person without restriction. Regardless of whether this proposal is adopted, it demonstrates that the Board is prepared to authorize investment advisory activities beyond the scope of the advisory activities currently permitted.

When a bank holding company has authorization to conduct FCM brokerage and advisory services in combination with other banking activities (especially proprietary trading and authorized activities of a Section 20 subsidiary), the Board imposes additional conditions to ensure safe and sound banking practices. The Board has imposed additional conditions to prevent potential conflicts of interest and related risks where a subsidiary-FCM is authorized to provide brokerage and advisory activities to customers and it or an affiliate is authorized to engage in proprietary activities with respect to the same or similar futures and option contracts. These conditions have included such restrictions as: (a) no interaction between an entity's trading personnel and personnel engaged in FCM and futures advisory activities; (b) the only interaction between an affiliate's futures trading personnel and the personnel of the subsidiary-FCM engaged in futures brokerage and advisory services will be in connection with the

173. See id.
execution and clearance by the FCM of trades made by the affiliate for its own account; and (c) in any case in which a subsidiary-FCM knowingly executes a transaction to which an affiliate is a party, the FCM will make prior disclosure of that fact to its customer and obtain the customer's prior consent to the arrangement.\textsuperscript{174}

In June 1996, the Board authorized a bank holding company subsidiary to act as sole general partner and commodity pool operator ("CPO") of limited partnerships that invest in a wide variety of exchange-traded and over-the-counter financial futures and commodity futures.\textsuperscript{175} The Board reasoned that, since state-member banks and national banks may serve as a CPO and since bank holding companies are authorized to trade financial futures and commodity futures, serving as a CPO is closely related to banking.\textsuperscript{176} The Board's approval was conditioned on compliance with the following:

(a) the bank holding company's subsidiary must register as a CPO with the CFTC and, thereby, be subject to the Commodity Exchange Act and the regulatory oversight of the CFTC and the National Futures Association;

(b) the subsidiary will not provide investment advice directly to the partnerships but would employ unaffiliated investment advisers to manage the investments of the partnerships;

(c) investments by the partnerships in other commodity pools will be limited to less than five percent of the outstanding voting securities of any commodity pool and to less than ten percent of the total equity of any commodity pool;

(d) the partnerships will not register as an investment company under the Investment Company Act of 1940, consequently limiting each partnership to not more than one hundred investors, and interests in the partnerships will be privately placed with institutional investors by the bank holding company's subsidiary banks;

(e) the bank holding company will limit its exposure to the CPO activities by committing that it will not: (1) guarantee the obligations of its subsidiary or the partnerships or enter into any guarantee or similar arrangement intended to protect an investor in a partnership from losses associated with the investor's interest in a partnership; (2) provide funds to the subsidiary of the partnerships to repay creditors or investors in the partnerships in the event of losses; (3) purchase assets from or sell assets to the partnerships; (4) extend credit to the partnerships; or (5) purchase any limited partnership interest from the partnerships;

(f) where the subsidiary is a sole general partner for the partnerships and the partnerships will employ leverage to fund their activi-


\textsuperscript{176} See id.
ties, the bank holding company must consolidate the assets and liabilities of the partnerships with the financial statements of the bank holding company for regulatory capital purposes;
(g) the bank holding company and its subsidiary must establish adequate controls and systems to manage and monitor the risks associated with these activities including establishing investment and position limits that will be monitored through a computer system for the partnerships and separate limits for each investment advisor and establishing procedures to address potential conflicts of interest.\textsuperscript{177}

C. Over-the-Counter Activities

There is little distinction between activities involving over-the-counter ("OTC") forward and option contracts and the activities involving exchange-traded futures and option contracts. They are functionally similar and have many of the same safety and soundness concerns. The O.C.C.'s BC-277, its predecessor BC-79, and the Board's Policy Statement at 12 C.F.R. § 225.142 discuss the management guidelines for the use of futures, option and forward contracts concurrently.

While similar in purpose, there are certain important distinctions between exchange-traded transactions and OTC-traded transactions. Exchange-traded contracts feature standardization in their terms, margin requirements, daily settlement of gains and losses on all open positions, and guarantees of contract performance by exchange clearinghouses. These aspects ensure liquidity of the market and significantly reduce counterparty credit risk. On the other hand, OTC contracts contain varying terms that are custom-tailored to meet the individual needs of the parties and tend to have longer maturities. During the term of the OTC contract, the counterparties remain obligated to each other and, due to the individualized terms, an OTC contract can be difficult to terminate or offset. Therefore, in contrast to exchange-traded transactions, the counterparties bear increased exposure to default or counterparty credit risk. It is more important that the parties of OTC transactions perform credit analyses to determine the need for credit enhancements or other arrangements to reduce counterparty credit risk. For example, BC-277, which focuses principally on OTC, customized, derivative financial transactions, requires national banks to develop and implement policies and procedures that address significant counterparty exposures, concentrations, credit ex-

\textsuperscript{177} See id.
exceptions and risk ratings.\textsuperscript{178} Likewise, the Board requires specific commitments that address counterparty credit risk in authorizing activities involving OTC derivatives.\textsuperscript{179}

Despite the counterparty credit risk concerns, OTC derivatives are very alluring due to their customized nature. The national amount of United States banks' over-the-counter derivatives is a hefty $15.5 trillion.\textsuperscript{180} National banks' use of OTC derivative transactions accounts for approximately eighty-five percent of all derivatives contracts, compared to approximately fifteen percent for exchange-traded contracts.\textsuperscript{181} There are four major categories of OTC derivative transactions: interest rate contracts;\textsuperscript{182} foreign exchange rate contracts;\textsuperscript{183} equity derivative contracts;\textsuperscript{184} and commodity derivative contracts.\textsuperscript{185} Within each category are the basic OTC products, namely forward, option, and swap contracts. Generally, the banking regulators have authorized banking institutions to engage in activities involving most forward and option OTC contracts to the same extent and pursuant to similar limitations and conditions as their exchange-traded counterparts.\textsuperscript{186} However, bank regulator authorization of swap transactions has developed more independently.

1. \textit{Swap Transactions}: While the O.C.C. and the Board authorize similar activities involving swap transactions, the Board views swaps (especially commodity-linked and equity linked swaps) somewhat differently and requires more specific considerations, conditions, and limitations to engage in such activities than does the O.C.C.

For the O.C.C., a swap transaction is the functional equivalent of, or the logical outgrowth of, a recognized banking power. A national

\textsuperscript{178} BC-277, \textit{supra} note 8.
\textsuperscript{182} These include single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate options (including caps, collars, and floors).
\textsuperscript{183} These include cross-currency interest rate swaps, forward foreign exchange contracts, currency options, and any other instrument linked to exchange rates.
\textsuperscript{184} These include equity-linked swaps, equity-linked options, forward equity-linked contracts, and any other instrument linked to equities.
\textsuperscript{185} These include commodity-linked swaps, commodity-linked options, forward commodity-linked contracts, and any other instrument linked to commodities.
\textsuperscript{186} Obviously, because there is no exchange, the conditions and limitation applicable to activities relating to either the execution and clearing of derivative related contracts or membership on an exchange should not apply to derivatives related activities involving OTC transactions.
bank’s power to engage in swap transactions is derived from their general lending and deposit taking powers and from the general aspects of the business of banking, such as funds intermediation and providing credit enhancement.\(^{187}\) As a bank accepts deposits from some customers and then loans those funds to other customers, it is acting as a funds intermediary between the depositors and the borrowers.\(^{188}\) The bank will be required to make payments to the depositors for the use of their money and to assume a certain level of credit risk with respect to the loans that the bank has made to its borrowers.\(^{189}\) A swap transaction contains all aspects of this process except no principal is received or disbursed by the bank.\(^{190}\)

For example, in simple matched swap transactions (i.e., each swap is hedged by another simultaneously created, offsetting swap) the bank acts as an intermediary for its customers to receive payments from one customer and make payments to another customer depending on the fluctuations of the contracted reference rate.\(^{191}\) The customer that receives payments from the swap transaction is analogous to a depositor receiving interest on his deposits.\(^{192}\) The customer that is obligated to make payments is analogous to a borrower making interest payments on his loans.\(^{193}\) Furthermore, the bank assumes credit risk with these transactions based on the possibility a customer may default.\(^{194}\) In such a case, the bank may be required to continue making payments to the customer of the offsetting swap.\(^{195}\) These pay-

---

187. See OCC No Objection Letter No. 87-5, supra note 26, at 76,639-640 (reviewing the substance, rather than form, of matched interest rate swaps and matched commodity price index swaps in relation to the traditional forms of the business of banking such as lending, funds intermediation, and credit enhancement); OCC No Objection Letter No. 90-1, supra note 78, at 71,219-220 (authorization to act as principal in unmatched commodity price index swap transactions); Under the National Bank Act, A National Bank and Its Two Wholly Owned Operating Subsidiaries Were Able to Offer Equity Derivatives Swaps, Where Consistent with “Safety and Soundness,” OCC Interpretive Letter No. 652, [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600, at 71,149 (Sept. 13, 1994) (authorization to engage in equity swap transactions and equity index swap transactions).

188. See OCC No Objection Letter No. 90-1, supra note 78, at 71,220.

189. See id.

190. See id. at 71,221.


192. See id.

193. The O.C.C. has authorized national banks to engage in unmatched swap transactions because the bank’s risk exposures associated with variations in the underlying reference rate of the unmatched swap can be hedged by not only entering into a perfectly matched offsetting swap transaction but also by purchasing and selling appropriate futures contracts, options, other cash-settled OTC contracts. See OCC No Objection Letter No. 90-1, supra note 78, at 71,220; OCC Interpretive Letter No. 652, supra note 187, at 71,749-50.

194. See OCC No Objection Letter 87-5, supra note 26, at 76,640.

195. See id.
ments are analogous to an extension of credit to the defaulting customer.\textsuperscript{196}

Also, a bank acting as principal in swap transactions is interposing itself between potential counterparties to lend its creditworthiness to the transactions.\textsuperscript{197} By acting as principal, the bank is accepting the obligations to perform and relieving (to some degree) its customers from the credit analysis burden and the resulting credit risk.\textsuperscript{198} This activity is analogous to traditional banking services of offering letters of credit and loan commitments.\textsuperscript{199} The O.C.C. recently stated that "[n]ational banks are natural intermediaries in the swaps market because they are accustomed to assuming the credit risk involved in customer exposure to price movements . . . . Banks are uniquely able to analyze credit risk and find an appropriate counterparty for the . . . swap transaction."\textsuperscript{200}

Since banks are authorized to reference payments made on deposits and received on loans to any index or standard as long as the bank complies with safe and sound banking principles, swap transactions—the functional equivalent of deposit and loan contracts—may also be referenced to any index or standard.\textsuperscript{201} The O.C.C. has recognized a bank’s authority to engage in, as intermediary or principal, swap transactions with payments referenced to interest rates, foreign exchange rates, commodity price indexes, equity prices, and equity price indexes.\textsuperscript{202}

A review of prior opinions of the O.C.C. reveals the conditions under which national banks may engage in activities involving swap transactions (including intermediation by acting as originator, principal, or broker, and investment advisory services). They include:

a) all transactions must be carried out in accordance with safe and sound banking principles. At a minimum, the bank or its subsidiary should observe the guidelines in BC-277, including specific written policies endorsed by the board of directors governing the operation of the swap program and addressing overall risk;

\textsuperscript{196} See id.
\textsuperscript{197} See id.
\textsuperscript{198} See id.
\textsuperscript{199} See id.
\textsuperscript{200} OCC Interpretive Letter No. 652, supra note 187, at 71,750.
\textsuperscript{201} See id. at 71,750; OCC Interpretive Letter No. 90-1, supra note 78, at 71,220; OCC No Objection Letter No. 87-5, supra note 26, at 76,640-641.
b) commodity price index, equity and equity index swap transactions may not be entered into for speculation purposes, and all payments (including those from hedging activities) must be settled in cash (there can be no physical delivery of the underlying commodity or security); 203

c) risk related to price fluctuations in reference rates can be minimized by matching a swap contract with an offsetting swap transactions; structuring the terms of a swap contract to include a cap and a floor to price variations; hedging unmatched swaps, either individually or on a portfolio basis when related unmatched swaps are warehoused; and by purchasing and selling the appropriate exchange-traded futures, options, government securities, and similar cash settled OTC instruments;

d) the credit risks associated with each counterparty, including exchange clearinghouses and market-makers, must be analyzed and internal credit limits with each counterparty must be observed;

e) when entering into swaps with producers and users of the underlying commodity, transactions must reduce the commodities price risk associated with the customer's business. 204

The Board has taken a more incremental approach to the authorization of swap transactions for bank holding companies. First, the Board authorized by regulation the providing of "financial and transactional advice regarding the structuring and arranging of swaps, caps, and similar transactions relating to interest rates, currency exchange rates or prices, and economic and financial indices, and similar transactions." 205 Section 225.25(b)(4) of Regulation Y imposes the following requirements on this activity:

a) the financial advisory services may be provided only to corporations, to financial and nonfinancial institutions, and to natural persons whose individual net worth (or joint net worth with a spouse) at the time the service is provided exceeds $1,000,000.00; and

b) financial advisory activities may not encompass the performance of routine tasks or operations for a customer on a daily or continuous basis, and the financial advisor shall not make available to any

203. Although not yet addressed by the O.C.C., a national bank should be able to invest (speculate) in and/or take delivery of the underlying commodity or security of swap contracts with payments based on assets that a national bank may purchase for its own account, such as United States securities, United States government agency securities, money-market instruments, bank certificates of deposit, foreign currencies and gold, silver platinum and palladium. This result would conform to the standards set by the O.C.C. with respect to financial futures and commodity futures. Similarly, swap transactions could be referred to as "financial swap transactions" and "commodity swap transactions."

204. See OCC Interpretive Letter No. 652, supra note 187, at 71,750; Margaret M. Grieve, OCC Interpretive Letter (Jan. 30, 1992), available in 1992 WL 125228 (O.C.C.), at *3; OCC Interpretive Letter No. 90-1, supra note 78, at 71,221; OCC No Objection Letter No. 87-5, supra note 26, at 76,659.

205. 12 C.F.R. § 225.25(b)(4)(vi)(2) (1996). Transactional services with respect to intermediating matched foreign exchange swaps among customers with complementary exposures is also authorized pursuant to 12 C.F.R. § 225.25(b)(17).
of its affiliates confidential information regarding a party obtained in the course of providing any financial advisory services except as authorized by the party.\textsuperscript{206}

By order, the Board has authorized bank holding company non-bank subsidiaries to engage in intermediating by acting as originator, principal, or broker, and providing investment advice with respect to interest rate and foreign exchange swaps and swap derivative products\textsuperscript{207} relating thereto ("financial swap transactions").\textsuperscript{208} The Board, relying on the grounds that an activity is closely related to banking for purposes of section 4(c)(8) of the BHCA if banks generally have, in fact, provided the proposed activity, authorized these activities because "[m]ajor U.S. money-center banks were among the larger intermediaries in the international swap market. In addition, for several years, banks have participated in the swap market as end-users, entering into swaps and purchasing swap derivative products in order to hedge other business risks or to match assets and liabilities."\textsuperscript{209} The extensive list of commitments, considerations, and limitations include:

a) the subsidiary will provide credit screening for all potential counterparties;

b) in appropriate cases, the subsidiary will obtain a letter of credit on behalf of, or collateral from, a counterparty;

c) the subsidiary will establish separate credit and exposure limits for each swap counterparty and will monitor this exposure on an ongoing basis, in the aggregate and with respect to each counterparty;

d) in order to manage "price risk," the subsidiary shall match all the swaps and related instruments in which it is a principal and will hedge any unmatched positions pending a suitable match. The subsidiary will not enter into unmatched or unhedged swaps for speculative purposes;

e) management will impose absolute limits on the level of price risk, basis risk, and volatility risk to which the subsidiary's swap portfolio may be exposed;

f) the subsidiary's exposure to price risk and basis risk will be monitored by both business management and internal auditing personnel to guarantee compliance with the risk limitations imposed by management;

\textsuperscript{206} 12 C.F.R. § 225.25(b)(4). Note, the Board's proposed comprehensive revision of Regulation Y would remove these conditions from the regulation. See 61 Fed. Reg. 47,242, 47,252 (CFTC 1996). However, the nature of the OTC swap market and CFTC regulations (i.e., 17 C.F.R. Part 35) will continue to limit participation to those entities with a net worth exceeding one million dollars.

\textsuperscript{207} "Swap derivative products" means caps, floors, collars, and options on swaps, caps, floors, and collars.


\textsuperscript{209} Id. at 583.
g) auditing personnel will report directly to senior management to ensure that any violations of portfolio risk limitations are reported and corrected;

h) if the level of risk threatens to exceed the limits at any time, the subsidiary will actively seek to enter into matching transactions for its unmatched positions;

i) the subsidiary shall minimize operations risk through the recruitment and training of an experienced back-office support staff and the use of a separate operational and data processing structure for processing swap and hedging transactions;

j) the subsidiary shall minimize any possible conflicts of interest between its role as a principal or broker in swap transactions and as advisor to potential counterparties by disclosing to each customer the fact that the subsidiary may have an interest as a counterparty principal or broker in the course of action ultimately chosen by the customer, in any case in which it actually has an interest in a specific transaction as an intermediary or principal, the subsidiary shall advise the customer of that fact before recommending participation in that transaction, and in any transaction in which the subsidiary arranges a swap transaction between an affiliate and a third party, the third party will be informed that the subsidiary is acting on behalf of an affiliate;

k) advisory services will be offered only to sophisticated customers who would be unlikely to place undue reliance on investment advice received and better able to detect investment advice motivated by self-interest;

l) the subsidiary will disclosure to each potential client the identity of the bank holding company to which it is affiliated;

m) the subsidiary shall not share with affiliates non-public customer information without the express written consent of the customer;

n) advisory services shall be rendered without regard to a customer's correspondent account balances maintained at affiliated financial institutions; and

o) the subsidiary's financial advisory activities will not encompass the performance of routine tasks or operations for a client on a daily or continuous basis.210

With respect to foreign exchange-related activities, section 225.25(b)(17) of Regulation Y authorizes foreign exchange advisory and transactional services “provided the activity is conducted through a separately incorporated subsidiary of the bank holding company that... [d]oes not take positions in foreign exchange for its own account [and that]... [d]oes not itself execute foreign exchange transactions.”211 The rule exists to address the potential for conflicts of interest that could arise from the combined conduct of these activities.


In contrast with this regulation, the Board has recently authorized (in limited circumstances) bank holding company subsidiaries to provide foreign exchange-related advisory and transactional services while simultaneously purchasing and selling foreign exchange and foreign exchange derivative products for their own accounts. When the purpose of purchasing and selling foreign exchange for a subsidiary's own account is ancillary to other legitimate activities and not for speculation, the Board has authorized the subsidiary to also provide foreign exchange-related advisory and transactional services. Circumstances where the combination of these activities have been approved include: purchasing and selling foreign exchange for the purposes of hedging a subsidiary's proposed underwriting and dealing activities; hedging positions in permissible interest rate and currency swap transactions; and hedging the parent bank holding company's financial statement translations of income as necessary for the payment of invoices in foreign currencies. To obtain authorization to combine these activities, several additional conditions are imposed. They include commitments that: (a) the subsidiary will not enter into a foreign exchange transaction for its own account with a customer if the customer is receiving foreign exchange services from the subsidiary relating to such transaction; and (b) the subsidiary's personnel engaged in purchasing and selling for the company's account will not have access to information about the foreign exchange trading activities of customers, and the subsidiary's customer representatives will not have access to information about the foreign exchange activities of its own account.

Bank holding companies are also authorized to act as originator, principal, or broker and to provide investment advice with respect to swaps and swap derivative products linked to commodity prices, security and/or bond indexes, and a hybrid of interest rates and commodity prices, or securities and/or bond indexes ("commodity and index swap transactions"). The Board supported its authorization of these activities by recognizing that the O.C.C. has permitted na-

tional banks to engage in matched and unmatched commodity and index swap transactions and that these transactions were "operationally, structurally, and functionally similar to financial swap transactions." All of these activities represent forms of financial intermediation in which banks have historically engaged. To engage in these activities, the applicant bank holding company and its subsidiary are subject to the commitments and considerations listed above for financial swap transactions, plus the additional limitations:

a) commodity and index swap transactions will generally "provide for cash payments based on the underlying assets, rates, or indices and, in general, will not provide for the delivery of any security or commodity;" however, transactions calling for physical delivery of precious metals is authorized;

b) "revenues derived from any transaction that provides for delivery of ineligible securities, or from any transaction that itself constitutes underwriting or dealing in ineligible securities, should be treated as ineligible revenues for purposes of calculating compliance with the Board's ten percent revenue limitation on [a Section 20 subsidiary's] bank-ineligible securities underwriting and dealing activities;" and physical delivery of securities in any securities-based transaction is subject to the limits on acquisitions of securities contained in the BHCA and the Board's related policies and interpretations, including the Policy Statement on Non-voting Equity Investments by Bank Holding Companies (12 C.F.R. § 225.143), and

c) the bank holding company may not conduct the activities of trading derivative instruments for its own account through any non-bank subsidiary other than a company authorized by order of the Board before consulting with the Federal Reserve System to determine whether prior approval would be required.

In Swiss Bank Corp., a bank holding company sought authority for its subsidiary to act as principal, broker, and/or investment advisor with regard to a wide range of securities-related and derivative-related transactions, including exchange-traded futures, option, and option-on-futures contracts; financial, commodity, and index swap transactions; and other OTC derivative transactions. The Board carefully considered the risk management policies, procedures, systems, and controls, paying particular attention to the market and other risks inherent in conducting a wide range of derivatives-related activities.

218. See id. at 191 n.39.
219. Id.
220. Id. at 191 n.39, 192.
221. Id. at 186 (the securities-related transactions included full-service securities brokerage and advisory activities and securities underwriting and dealing activities).
222. See id. at 195.
The order approving Swiss Bank's application identifies a host of additional commitments and considerations relating to internal controls. The Board recognized that to conduct the combined activities in a safe and sound manner, "additional sophisticated and comprehensive risk management policies and procedures and related computer and accounting systems and internal controls" must be established, and "personnel with expertise sufficient to implement and adhere to the systemic protections" must be employed.\textsuperscript{223} Some of the internal controls relied on by the Board included:

a) credit limits for counterparties are established by the applicant's credit committee "after extensive analysis of counterparty's financial strength, and are reviewed periodically and more frequently when warranted by possible changes in a counterparty's financial condition;"

b) counterparty credit risk guidelines have been established by senior management personnel of the bank holding company and said guidelines shall be applicable to all of the holding company's affiliates engaged in derivatives trading activities;

c) "[e]very transaction must conform to . . . [the holding company's] credit policies, and a computerized credit risk monitoring system would be used to determine whether a proposed transaction is within the credit available to the counterparty;"

d) "senior management personnel of . . . [the holding company] have adopted written policies and risk limits for each derivative product traded by" its subsidiary;

e) "[t]raditional volume restrictions are supplemented by loss limits, which set trading limits in terms of the maximum potential loss to be allowed in any trading book," and said loss limits have been established both for the subsidiary and for the consolidated organization;

f) "transactions are entered into the trading operation's computerized market risk control system upon execution, and market prices are updated continuously, thereby permitting the real-time, on-line monitoring of market risk,"—market values are updated over-night resulting in daily recalibration of replacement values for all transactions and producing limit excess reports that are reviewed at least daily by senior management personnel;

g) "[r]isk control reports . . . are monitored and reviewed throughout the day by portfolio risk managers, and are reviewed daily by the global risk management group . . . to ensure compliance with bank-approved market risk limits," risk will be measured independently for each trading area without assuming any correlation between business sectors, and the risk exposure for the entire portfolio is computed as the sum of the individual risk exposures for each area;

\textsuperscript{223} Id. at 196.
h) once a transaction is effected and the position becomes part of the company's overall portfolio, control over the position is transferred from the traders to risk managers; risk managers and traders should be in contact throughout the day to ensure specific risk attributes are appropriately adjusted during the course of a trading session;

i) "[r]isk control reports are ... balanced with back office accounting systems for position and profit and loss purposes," and senior risk managers use these reports to "monitor loss limits constantly and adjust the risk attributes of each trading book to avoid exceeding such limits," and, should a limit be exceeded, immediate steps will bring the relevant trading book to desired risk levels;

j) the subsidiary will utilize a portfolio risk management strategy that contemplates two levels of hedging of the specific transaction and subsequent hedging of the entire portfolio;

k) "risk management systems would be tested periodically, both by comparing actual with simulated profitability to ensure model integrity, and by evaluating the reasonableness of the assumptions underlying established risk parameters;"

l) the "derivatives activities will be integrated with ... [the subsidiary's] trading operations in the underlying securities markets and other cash markets, and will not function as an independent unit seeking separate profits solely from the derivatives markets;"

m) the subsidiary shall "maintain a comprehensive set of front-office and back-office procedures, including constant verification of trade data by back-office personnel, for position and profit and loss balancing to ensure that all positions are properly recorded and understood by risk managers and the global risk control group;"

n) "[p]rofits from a nonconforming transaction would be removed from the trading book, thereby eliminating any incentive to exceed limits, and any trader or risk manager exceeding risk limits more than once would be subject to disciplinary sanctions . . . ."224

These conditions and considerations are also reflected in the Board's detailed supervisory guidelines for derivatives-related activities known as the Trading Activities Examiner Guidelines.225

E. Time Deposits of National Banks

Receiving deposits is a core activity of national banks. It is an expressly authorized power of the National Bank Act and constitutes a fundamental element of the "business of banking."226 Today, many

224. Id. at 195-96.


banking organizations receive time deposits that pay interest at rates based on the price of a commodity, an index of securities, or other standards rather than traditional interest rates. In an extensive analysis concerning the offering of certificates of deposits with interest payments based on the Standard & Poor's 500 Index, the O.C.C. stated that "there is no legal restriction on the type or amount of interest a bank may pay on time deposits, nor is there any restriction against a time deposit accruing interest at a variable rate based on an index or standard ostensibly unrelated to interest rates or compiled by an entity other than the bank." Further, the O.C.C. asserted that the national banking laws specifically prohibit the banking regulators from controlling the rates payable on time deposits. Accordingly, banking institutions have offered time deposits on a variety of indexes and standards. In addition to the S&P 500 index, the interest rates on time deposits have been based on the value of gold, indexes tied to the inflation rate, indexes based on the cost of a college education, yields on United States Treasury securities, commodity prices, equity indexes, and other economic measures.

F. Structured Debt Obligations

Structured debt obligations ("structured notes") are debt securities whose coupon, redemption amount, and/or stated maturity adjusts depending upon movement in one or more foreign exchange rates, commodity prices, or equity indexes that have embedded forward-like or option-like features. These debt securities exhibit risk and return characteristics similar to related derivative contracts and, therefore, the risk management aspects of structured notes are covered by the O.C.C. guidelines in BC-277. Particularly, the O.C.C. expects investors in these instruments to understand the market price risk, the liquidity risk, and how the economic value and cash flows of the notes fluctuate due to changes in relevant circumstances.

---

227. MII Decision, supra note 15.
228. See the Depository Institutions Deregulation Act, 12 U.S.C. § 3501-3524 (1994) (DIDA), and the regulations promulgated thereunder. The original DIDA mandated that the regulations be revoked; therefore, all limitations on the amount of interest payable on time deposits have been eliminated from the Code of Federal Regulations. See MII Decision, supra note 15, at n.29.
231. See id.
232. See id.
While most of the structured notes have been issued by United States government-sponsored enterprises such as the Federal Home Loan Banks, the Student Marketing Association, and the Federal Home Loan Mortgage Association, various private corporations, foreign banks, and multilateral development banks have also issued structured notes. Being securities, structured notes are available for underwriting, dealing, and investing by national banks pursuant to the Glass-Steagall Act restrictions, and by bank holding companies to the same extent as other types of government or corporate debt securities.

G. Overseas FCM and Swap Activities

Overseas nonbanking activities of United States bank holding companies, national banks, and their subsidiaries are authorized pursuant to section 211.5(d) of Regulation K. United States banking institutions are authorized to engage in activities that the Board has determined in section 225.25(b) of Regulation Y to be closely related to banking under section 4(c)(8) of the BHCA. Accordingly, overseas activities should include financial and transactional advice regarding financial swap transactions, foreign exchange advisory and transactional services (which includes derivatives-related foreign exchange transactions), and FCM and advisory activities with regard to financial futures products. In addition to this general authorization, acting as an FCM and engaging in swap transactions as principal or agent are specifically authorized under Regulation K.

The Board authorizes foreign subsidiaries to engage in FCM activities with regard to financial instruments of the type, and on exchanges, that the Board has previously approved under Regulation K. This authorization is subject to two limitations: first, the activities must be conducted in accordance with the standards set forth in section 225.25(b)(18) of Regulation Y; second, prior Board approval is required before a foreign subsidiary becomes a member on an ex-
change that requires members to guarantee or otherwise contract to cover the losses suffered by other members (a "mutual exchange").

The type of financial instruments previously approved under Regulation K include instruments for which FCM activities have been authorized domestically under section 225.25(b)(18) of Regulation Y, and the foreign equivalents of such instruments, including futures and options on stock indices, bond indices, other interest rate contracts, and foreign exchange contracts. FCM SR Letter 93-27, referred to above during the discussion of Board-approved FCM brokerage activities, identifies a list of the approved foreign derivatives-related instruments for each approved exchange.

Under Section 211.5(d)(18) of Regulation K, foreign subsidiaries of United States banking organizations are authorized to act as a principal or agent in swap transactions subject to the same limitations applicable to state member banks under the Board's Regulation H, except that commodity-linked swap transactions must provide an option for cash settlement and that option must be exercised upon settlement.

Foreign subsidiaries may engage in financial swap transactions outside the United States without prior approval, but the Board requires prior approval before a foreign subsidiary may engage in commodity-linked swap transactions other than such transactions that are either perfectly matched or linked to gold or silver. In contrast, there is no requirement for prior authorization to engage in equity-linked swap transactions overseas because these transactions are authorized under a different section of Regulation K.

**Conclusion**

The growing financial derivatives markets present great opportunities to the banking industry to conduct its own banking business more safely, and to generate additional income from the advisory and brokerage services offered their customers. Pursuant to the broad interpretations afforded the banking powers enabling statutes, national

---

239. See id.
241. Letter No. SR 93-27 (FIS), supra note 128. The list is updated by the Legal Division of the Board as new instruments and exchanges are approved. Copies of the updated list are available from the Legal Division’s Washington, D.C. office.
243. See 12 C.F.R. § 211.5(d)(18).
244. See 12 C.F.R. § 211.603 (referring to the text in § 208.128).
245. See id.; 12 C.F.R. § 211.5(d)(18) n.14.
banks and bank holding companies are empowered to engage in a wide variety of derivatives-related activities. The published interpretive letters and orders of the banking regulators chronicle the ever increasing list of activities available to banking organizations. However, due to their safety and soundness concerns, the regulators rely on many conditions, commitments, and limitations to ensure that appropriate risk management systems and other internal controls are established. Despite the apparent burdensome nature of the controls required by the regulators, events such as the bankruptcy of Barings Bank confirm the need to properly manage these risk-transferring products. As an added benefit, the required risk management techniques and other internal controls can result in more effective management of all of a banking organization’s risk-taking activities.
STUDENT NOTES AND COMMENTS