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Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

February 11, 2002

Interpretive Letter #929
March 2002
12 USC 24(7)
12 CFR 28

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

Dear **[ ]**:

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

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

[1] *See* 12 U.S.C. § 24(Seventh) and 12 C.F.R. §§ 7.7010 and 28.3.

[2] *See* 12 U.S.C. § 604a; 12 C.F.R. Part 211.

II. Background

The LCH provides clearing services to its members in certain exchange-traded and over-the-counter ("OTC") markets. LCH clears: [1] futures and options contracts traded on the International Petroleum Exchange, the London International Financial Futures and Options Exchange, and the London Metal Exchange, [2] equity transactions effected on virt-x, the London Stock Exchange, and the Irish Stock Exchange (via EquityClear), [3] interest derivative contracts (via SwapClear), and [4] repurchase agreements (via RepoClear). LCH members may be members of one or more of these exchanges. LCH has approximately 113 members that include investment banks, brokerage houses, and producers.

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

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

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

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

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

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

[6] *Id.*

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

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

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

III. Discussion

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

A. National Banking Law

National bank foreign branches[13] may engage in general banking activities, which are determined under national banking law.[14] National banking law permits national banks, their operating subsidiaries, and their branches to engage in execution and clearing activities, subject

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

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

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

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

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

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

[14] *See* 12 U.S.C. § 604a; 12 C.F.R. § 211.4(a).

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

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

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

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

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

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

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

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

the business of banking, because a principal business of a bank is to extend credit, whatever its form.[21]

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

The OCC has permitted national bank operating subsidiaries to engage in clearing and execution activities identical to those of the Bank in LCH, both domestically and abroad.[24] The amount of risk a national bank may assume from exchange and clearing activities must be limited, however, due to safety and soundness concerns.[25] Thus, for example, the OCC has not permitted national banks to guarantee or become liable for customer trades executed by, or otherwise assume the liabilities of, their subsidiaries.[26]

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[21] *Id.*

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

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

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

[25] *Id.*

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

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

National banks may provide guarantees, however, if the guarantee qualifies as "incidental"or "convenient"or "useful" to the business of banking under 12 U.S.C. § 24(Seventh). This reasoning is supported by OCC Interpretive Ruling 7.1017, which confirms the authority of a national bank to lend its credit, bind itself as surety to indemnify another, or otherwise become a guarantor, if the bank has a substantial interest in the performance of the transaction involved. [31] A "substantial interest" exists if the guarantee provided by the bank is "incidental" to another of its authorized activities.[32] The nexus between the bank permissible transaction and the guarantee provides the "substantial interest" for the bank.[33] For example, the interest of a bank

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[27] 12 U.S.C. § 24(Seventh).

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

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

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

[31] 12 C.F.R. § 7.1017.

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

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

in assuring the financial performance of a co-fiduciary constitutes a sufficient interest to justify the issuance of a guarantee.[34] That relationship is analogous to the interest of a bank in assuring the financial performance of an affiliate, including a subsidiary corporation.

We believe that a national bank's provision of a default fund contribution to cover the potential default of customer transactions and, to a limited extent, the obligations of third party participant defaults as a necessary precondition to engaging in bank permissible clearing activity, qualifies as incidental to that activity. The bank has a substantial interest in providing such funds/guarantees on behalf of its branch, in order to retain the ability to provide customers bank permissible clearing and execution services, qualifying the activity as incidental to banking. The branch, as a clearing member, will not directly or indirectly guarantee the performance of its customers on the transactions it clears. Rather, the ultimate liability and investment risk for all trades lies with the customer, against whom the bank may bring an action for recovery.[35] In addition, a national bank, via its branch, may contribute to a default fund to guarantee its obligations and those of other exchange members consistent with the requirements of OCC Interpretive Ruling 7.7010 discussed above. Furthermore, Section 28.4(c) expressly permits national banks to guarantee the deposits and other liabilities of its Edge corporations, Agreement corporations, and its corporate instrumentalities in foreign countries.[36] Hence, the Bank may legally provide a default fund contribution in connection with its bank permissible clearing and execution activities, subject to the satisfaction of supervisory staff that the activity can be conducted in a safe and sound manner.

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

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

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

[36] 12 C.F.R. § 28.4(c).

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

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

B. Regulation K

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

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

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

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

IV. Conclusion

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

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[39] *See* 12 C.F.R. § 211.4.

[40] *See* 12 C.F.R. §§ 211.4(a)(1) and (a)(3)(i) and (iii).

[41] *See* 12 C.F.R. § 211.4(a)(3)(ii).

I trust the foregoing is responsive to your inquiry. If you have additional questions, please do not hesitate to contact Donald N. Lamson, Assistant Director, or Tena M. Alexander, Special Counsel, Securities & Corporate Practices Division at (202) 874-5210.

Sincerely,

/s/

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel