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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

**Interpretive Letter #1026**  
**May 2005**  
**12 USC 24(7)**

April 27, 2005

Re: Authority of a National Bank to Engage in Securities Conduit Lending Services

Dear [ ]:

This letter is in response to your request on behalf of [ ] (“Bank”) for confirmation that the Bank’s proposed securities conduit lending services are legally permissible for a national bank. Based on the specific facts and circumstances represented by the Bank and for the reasons discussed below, we find that the Bank’s proposed activities as a conduit lender are permissible.<sup>1</sup>

### **Background**

The Bank currently engages in securities lending activities as custodian to various types of institutional customers as well as to customers for which the Bank may not be custodian (on a third-party agency basis). As custodian, the Bank provides safekeeping for the securities owned by its customers, as well as other administrative services related to the securities held. The Bank also offers its custodial and non-custodial customers various programs to assist the customer in enhancing the return on the securities.<sup>2</sup> Securities lending agents, such as the Bank, typically also provide an indemnity to their customers should the borrower fail to return the securities.

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<sup>1</sup> The Bank has requested confidential treatment pursuant to 5 U.S.C. § 553(b)(4). The Bank represents that its letter, the appendices, and its original submission contain confidential business information that if released would be detrimental to the Bank’s business.

<sup>2</sup> For example, under the Bank’s agency securities lending program, the Bank is appointed as an agent of the customer in order to find borrowers for the customer’s lendable securities. The Bank locates borrowers, assists in the delivery of the securities to a borrower, receives and administers the collateral for the customer, and provides other administrative services such as marking the trade to market, making collateral calls, and general recordkeeping.

The Bank now proposes to act in the capacity of a “conduit lender” to provide additional return enhancements to its securities lending customers.<sup>3</sup> Currently, the Bank’s customer chooses various potential borrowers from a list of usual borrowers.<sup>4</sup> However, the customer may decide not to “approve” all of the borrowers on the list, resulting in some customers that will not permit their securities to be lent directly to certain borrowers.<sup>5</sup> Yet, a certain borrower may desire to borrow securities that only may be found in accounts of customers that have not approved the borrower.<sup>6</sup>

To engage in the conduit lending services, the Bank would borrow the desired securities as principal from the customer that had declined to approve the borrower, and then on-lend those same securities as principal to the borrower.<sup>7</sup> The Bank plans to accomplish this by listing itself on the list of potential borrowers attached to the agency securities lending agreement. The Bank notes that a customer is not required to approve the Bank or to participate in the conduit lending program at all. The Bank represents that a customer choosing to participate in the program will receive appropriate disclosures regarding those situations when the Bank may act as principal.<sup>8</sup>

The Bank would receive the usual securities lending collateral from the borrower and post such collateral or similar collateral to the lending customer. In effect, the Bank merely is acting as an intermediary by interposing its own credit for that of the borrower. The Bank would receive a fee based on a spread between the two lending rates, and the customer would receive income that it would not have received otherwise under the current securities lending program. The Bank

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<sup>3</sup> The Bank clarifies that in the securities lending context, the Bank’s customer is the lender client. The Bank does not provide securities lending services, including the proposed conduit lending services, to the borrower, i.e., the borrower is not provided services other than as counterparty to the securities loan transaction.

<sup>4</sup> The list is provided as an attachment to the Bank’s agency agreement, and the Bank has performed a credit analysis on, and set its own credit limits for, each of the potential borrowers.

<sup>5</sup> For example, a customer may choose not to lend securities to an unfamiliar borrower, or a borrower with credit ratings that fall below a certain threshold, or where a conflict of interest exists, or with a foreign entity. The Bank provides the customer-lender flexibility in their selection and thus the Bank explains there could be any number of reasons why a particular lender may not choose to approve a borrower. Significantly, however, the Bank has done a credit analysis on each of the potential borrowers prior to giving the list to the customer lending the securities.

<sup>6</sup> The Bank explains that, as agent, it may use certain systems to broadcast generally the portfolios available in the accounts of customers. For example, for U.S. equities and corporate bonds, the Bank uses the LOANET system which connects an extremely large number of borrowers and agents in the U.S. market. Other similar systems are available for other types of securities.

<sup>7</sup> The Bank represents it will not execute a conduit lending transaction unless it already has a commitment from the borrower. When a transaction terminates, the Bank will either have a replacement borrower for the transaction or return the securities to the original lender client. *See infra* note 24.

<sup>8</sup> The Bank states the parameters of its proposed conduit lending program anticipate excluding certain customers from being a lender, such as any fund or plan subject to the Employee Retirement Income Security Act of 1974 (“ERISA”); any “affiliate” as defined pursuant to 12 U.S.C. § 371c; and accounts that the Bank or one of its affiliates acts as trustee with investment discretion, unless specific authorization exists.

represents it will not be holding itself out as a dealer or market-maker in securities, and will be exempt from registration as a “dealer” under the federal securities laws.<sup>9</sup>

## Discussion

### A. Securities Lending Generally for National Banks

National banks have long engaged in securities lending activities.<sup>10</sup> Banks may borrow and lend their own investment and trading account securities as well as customers’ securities held in custody, safekeeping, trust, or pension accounts.<sup>11</sup> Typically securities lending involves an open-end loan agreement designed to provide a safe return of the securities in addition to normal interest or dividends. Securities loans generally are collateralized by U.S. government or federal agency securities, cash, or letters of credit at a predetermined margin.<sup>12</sup> At maturity or termination, the collateral is returned to the borrower and the loaned securities are returned to the lender. The lender and the customer account owning the securities usually divide the fees. When cash collateral is involved, the borrower receives a negotiated rate of return (the “rebate” rate) on the collateral. Typically, the lender and customer account owning the securities split the excess income earned on the reinvestment of the cash collateral.

The OCC adopted the Federal Financial Institutions Examination Counsel (“FFIEC”) policy statement on prudent controls for securities lending in Banking Circular 196.<sup>13</sup> The policy provides detailed interagency guidelines designed to ensure banks conduct their activities in a

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<sup>9</sup> The Bank represents that the conduit lending program has been designed to conform fully with the Securities and Exchange Commission (“SEC”) Rule 15a-11 exempting certain securities lending transactions as a conduit lender from the definition of “dealer.” 15 C.F.R. § 240.15a-11.

<sup>10</sup> See, e.g., Interpretive Letter No. 380 (Dec. 29, 1986) (recognizing permissible securities lending services); Interpretive Letter No. 376 (Oct. 25, 1986) (services incidental to authorized brokerage activities and margin lending). See also Comment Letter to the Securities and Exchange Commission (“SEC”) from J. Virgil Mattingly, Board of Governors of the Federal Reserve System (“Board”); William F. Kroener, FDIC; and Julie L. Williams, OCC (Dec. 10, 2002) (on SEC’s proposed dealer rule, agencies provide that custodial and non-custodial securities lending services have grown out of, and remain integrally related to, the custody business of banks and are offered “as part of” customary custody services) (“General Counsels Letter”).

<sup>11</sup> See *id.* Banks may engage in securities lending transactions when they do not have custody of the securities. Typically, a non-custodial securities lending arrangement permits a customer to select one party to handle custody and another party to provide the securities management services. See generally Comptroller’s Handbook, *Custody Services* (Jan. 2002) (“Custody Services Handbook”).

<sup>12</sup> Broker-dealers and commercial banks are often borrowers under securities lending arrangements. A broker-dealer borrowing securities is subject to the Board’s Regulation T, which specifies acceptable borrowing purposes and types of collateral. 12 C.F.R. § 220.10. Lenders of securities typically are institutional investors with large investment portfolios, such as mutual funds, pension funds, insurance companies, and endowments. See *Custody Services Handbook* at 28.

<sup>13</sup> BC-196, *Securities Lending* (May 7, 1985) (endorsing and attaching the uniform supervisory policy issued by the FFIEC) (“BC-196”). The FFIEC policy also has been adopted by the other banking agencies. See F.R.R.S. 3-1579.5 (Board of Governors of the Federal Reserve System); 62 Fed. Reg. 40,816 (FDIC (updated 1997 version)).

safe and sound manner and consistent with sound business practices and applicable law. The policy recognizes that securities lent may include customers' corporate equity or debt obligations. In addition, the policy discusses the various capacities in which banks may engage in securities lending activities, including a bank acting as principal when lending securities from its own account, acting as an "undisclosed principal" when offering customers' securities, or acting as an agent, fiduciary, or finder. In connection with securities lending programs, the policy recognizes that banks may offer indemnification against losses, including all financial loss, losses from a borrower default, or losses from collateral default.<sup>14</sup> The OCC has found this type of indemnification permissible for national banks.<sup>15</sup>

## **B. National Banks Acting as a Securities "Conduit Lender"**

Most often banks act in an agency capacity with respect to securities borrowing and lending transactions. However, at times banks may engage in these types of transactions as principal. As recognized in BC-196, banks may lend securities from their own accounts as principal.<sup>16</sup> More recently, the industry has recognized securities lending activities where banks serve as a "conduit" or credit "intermediary" between a borrower and the owner of the securities, thus taking on a principal role with respect to securities that may be ineligible for a national bank to purchase for its own account. The OCC has not opined specifically on conduit lending activities for a particular bank, although as discussed below in the context of the Securities and Exchange Commission's ("SEC") dealer rule there already is general recognition of these activities in the industry.

The legal framework for assessing the permissibility of the conduit lending activities is under the authority of 12 U.S.C. § 24(Seventh).<sup>17</sup> The Supreme Court has held that this authority is a broad grant of powers to engage in the business of banking, including, but not limited to, the enumerated powers and the business of banking as a whole.<sup>18</sup> Judicial cases affirming OCC interpretations of this authority over the years have established that an activity is within the scope of the "business of banking" if the activity: 1) is functionally equivalent to or a logical

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<sup>14</sup> BC-196 at 8; *see also* Custody Services Handbook at 31 (it is common for a bank to offer indemnification against borrower default).

<sup>15</sup> *See, e.g.*, Interpretive Letter No. 376, *supra* (bank is not selling its indemnity as a primary product, but rather it is merely a minor part of a much larger package of banking services); Custody Services Handbook at 31.

<sup>16</sup> BC-196 reflects early recognition supporting a bank's role as principal in certain instances, although in BC-196 the reference is to securities permissible for a national bank to purchase and hold for its own account.

<sup>17</sup> Twelve U.S.C. § 24(Seventh), in part, provides a national bank is authorized to engage in "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 . . . . The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities . . . ."

<sup>18</sup> *NationsBank v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("VALIC").

outgrowth of a traditional banking activity;<sup>19</sup> (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.<sup>20</sup> In our opinion based on the Bank's representations and the following discussion, the conduit lending services proposed by the Bank satisfy these tests.

Conduit lending services are functionally equivalent to recognized banking functions. For example, the Bank's proposed principal role as a conduit lender is analogous to a bank acting as a riskless principal. The OCC has long concluded that "riskless principal" transactions are permissible for national banks.<sup>21</sup> In such a transaction, the bank is engaged in the purchase, as principal, and immediate sale of a security at the request of a customer.<sup>22</sup> For example, the OCC has explained the bank should have "no obligation to purchase a particular security from a third party seller unless it has an offsetting order from a third party purchaser, and no obligation to sell that particular security to a third party purchaser unless it has an offsetting order from a third party seller."<sup>23</sup> Similarly, here the Bank represents it will not execute a conduit lending transaction unless it already has a commitment from the ultimate borrower – therefore, it will not engage in "speculative" borrowing, nor will it be borrowing as principal to retain an inventory of securities for lending.<sup>24</sup>

The OCC specifically has found that riskless principal activities are permissible under Section 16 of the Glass Steagall Act (12 U.S.C. § 24(Seventh)) and do not violate any of the Glass-Steagall restrictions on underwriting and dealing.<sup>25</sup> Likewise, the Board recognizes riskless principal activities as permissible for bank holding companies in Regulation Y.<sup>26</sup>

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<sup>19</sup> The D.C. Circuit Court of Appeals has expressed the view that the "logical outgrowth" rationale needs to be kept within reasonable bounds but endorsed the "functional equivalent" component of the test. *Independent Ins. Agents of America, Inc. v. Hawke*, 211 F.3d 638 (D.C. Cir. 2000).

<sup>20</sup> See, e.g., *Merchant Bank v. State Bank*, 77 U.S. 604 (1871); *American Insurance Association v. Clarke*, 865 F.2d 278, 282 (2d Cir. 1988); *M&M Leasing Corporation v. Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978).

<sup>21</sup> See, e.g., Interpretive Letter No. 371 (June 13, 1986); Interpretive Letter No. 626 (July 7, 1993).

<sup>22</sup> The OCC has indicated that several hours may elapse (but not more than a day) between receipt and execution of an order. See Interpretive Letter No. 626, *supra*. This is in accord with the SEC's rule permitting "contemporaneous" lending and borrowing by a bank as a conduit lender. The SEC's rule also allows continued qualification as a conduit lender and replacement of the securities by a bank conduit lender in the circumstances where a transaction terminates and the transaction is replaced "within one business day" by another lending or borrowing transaction involving the same securities. See 15 C.F.R. § 240.15a-11(d)(1). To the extent the Bank may engage in any activities of this nature, the Bank represents that its actions will be consistent with the SEC's rule.

<sup>23</sup> Interpretive Letter No. 626, *supra*.

<sup>24</sup> The Bank represents it will only initially borrow the securities when it has a committed borrower, but may in certain cases if the initial borrow terminates in a short time frame, lend the securities again if there is an immediate borrower present. See Interpretive Letter No. 992 (May 10, 2004); (riskless principal activities present none of the hazards of speculation the Glass-Steagall Act was intended to prevent); Interpretive Letter No. 626, *supra* (recognizes that the bank will not hold an inventory in any security purchased in a riskless principal transaction (except in the case of a *bona fide* settlement default, in which case the security is sold as soon as possible)).

The proposed conduit lending activities also are a reasonable and already recognized outgrowth of banks' well-established securities lending activities. The Board has approved the borrowing and lending activities related to the securities of a non-customer third party as "closely related to banking" and a "proper incident thereto," under the tests set forth in section 4(c)(8) of the Bank Holding Company Act ("BHCA").<sup>27</sup> The Board reasoned "that banks generally perform services that are operationally or functionally so similar to the proposed conduit services as to equip them particularly well to provide these services."<sup>28</sup> The Board determined that the substitution of a third party in place of a trust or other customer of the bank does not change significantly the functional or operational activities.<sup>29</sup> Further, the Board also recognized that the risks involved were substantially the same as a situation involving the lending of a bank's own securities or those of its customers. Significantly for risk mitigation, the potential borrower and lender are matched before the transaction.<sup>30</sup>

The SEC also has recognized banks' securities conduit lending activities.<sup>31</sup> In its rule on exemptions from the definitions of "broker" and "dealer" for banks engaging in certain securities lending transactions, the rule defines the term "conduit lender" as "a bank that borrows or loans securities, as principal, for its own account, and contemporaneously loans or borrows the same

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<sup>25</sup> See *id.* The Bank represents it will not hold itself out as a market maker or a dealer in securities. Further, the Bank will not retain either the borrowed securities or the collateral in the transaction, as the securities will be passed through to the ultimate borrower and the collateral or similar collateral will be passed through to the securities owner/lender.

<sup>26</sup> See 12 C.F.R. § 225.28(b)(7)(ii). In 1997, the Board eliminated earlier restrictions on riskless principal transactions and now broadly provides that bank holding companies and their subsidiaries may engage in "buying and selling in the secondary market all types of securities on the order of customers as a 'riskless principal' to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer." See 12 C.F.R. § 225.28(b)(7)(ii)(A) and (B). The SEC also has noted the similarity of conduit lending to banks' riskless principal activities. See 68 Fed. Reg. 8686, 8692 n. 51 (Feb. 24, 2003) (exemptions from the definitions of "broker" and "dealer" for certain securities lending transactions).

<sup>27</sup> See *Saban, S.A.*, 78 Fed. Res. Bull. 955 (Dec. 1992) (order under section 4 of the BHCA to act as a "conduit" in securities borrowing and lending). The Board explained the company would seek out counterparties for borrowing and lending transactions and would assume much the same risk as if the company was borrowing and lending its own securities or its customers' securities.

<sup>28</sup> *Saban, supra* at 957.

<sup>29</sup> The Board noted the "same steps and procedures necessary to effectuate the loan of a customer's securities are followed in loaning the securities of a third party." *Saban, supra* at 958.

<sup>30</sup> The Board explained that the risk to the company in acting as a conduit is limited to ensuring that the collateral posted by the borrower reflects continuously the market value of the securities loaned. The company committed to mark the collateral to market daily and to make calls for supplemental collateral as needed. Further, in this situation, the company represented it would not indemnify any non-customer third party lenders of securities.

<sup>31</sup> See 68 Fed. Reg. 8686, 8692 (Feb. 24, 2003) (final rule on exemptions from the definitions of "broker" and "dealer" for certain securities lending transactions).

securities, as principal, for its own account.”<sup>32</sup> The SEC indicated this exemption was included in part based on input from banking industry representatives.<sup>33</sup> The SEC rule also provides that a bank’s activities in this respect may include indemnification of the lender.<sup>34</sup>

The conduit lending services also respond to customer needs and benefit both the bank and its customers. As represented by the Bank, there are situations where customers do not approve certain borrowers for various reasons and otherwise would be unable to earn income on certain securities held in customers’ accounts. The availability of conduit lending services will provide customers greater opportunities to increase their yields, as well as convenience and flexibility in their securities lending business. The Bank also benefits by its ability to borrow securities as a conduit lender, thus significantly enhancing its own role in the marketplace as an intermediary in these transactions. In addition the Bank benefits by receiving fee income and providing additional services for customers. As previously noted, banks have historically played a key role as custodians and non-custodial agents or intermediaries in facilitating securities lending and borrowing transactions, and the role of conduit lender simply serves as a further refinement of those activities.

Further, conduit lending services involve the same or similar risks to those already assumed by national banks. The Bank represents that the risks from the proposed activities are no greater than the risks presented as a riskless principal from a purchase and sale transaction.<sup>35</sup> By indemnifying its customer, the conduit lender is not exposed to risks that are any different or greater than those risks associated with the typical indemnity in an agency securities lending program.<sup>36</sup> Moreover, the conduit loan carries the same exposure risks.<sup>37</sup> As a risk mitigant, the

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<sup>32</sup> 15 C.F.R. § 240.15a-11(d).

<sup>33</sup> See 68 Fed. Reg. at 8692. In their joint comment letter, the federal banking agencies recognized the conduit lending activities of banks and noted the detailed interagency guidelines that exist with respect to securities lending activities generally. See General Counsels Letter, *supra* at 4-5; see also Comment Letter to SEC from Edward J. Rosen, Cleary, Gottlieb, Steen & Hamilton, on behalf of the “Coalition of Banks” (Dec. 9, 2002). Further, in this context, neither the banking regulators nor any other commenter addressed any risks arising from banks’ securities lending activities, including acting as a conduit lender.

<sup>34</sup> 15 C.F.R. § 240.15a-11(c)(6).

<sup>35</sup> While there are differences, such as a conduit lending transaction being of longer duration than a straight purchase and sale, other mitigating factors are present. The conduit loan is a credit exposure and is no different from the exposure that a national bank typically assumes in any loan transaction. Further, the conduit loan exposure is collateralized, and the transaction is marked daily and subject to daily collateral calls.

<sup>36</sup> Industry practices associated with securities lending activities often include indemnification against borrower default. See Custody Services Handbook, *supra* at 31; BC-196. A bank’s indemnity typically is limited to the difference, if any, between the value of the lent securities on the date of the borrower’s failure to return the securities and the value of the collateral posted by the borrower. Because a bank, as part of its administrative services to a customer, performs the mark-to-market and the collateral calls, the bank is in the best position to mitigate the risk of having to pay out under the indemnity. Here, for example, the Bank represents it has never had to pay for borrower default under the indemnity it offers to customers in its agency securities lending program.

<sup>37</sup> In other words, if the borrower fails to return the securities, the bank will be in the position of not being able to return the securities to the lender. The maximum amount that the bank could be exposed to would be the difference

Bank only will act as a conduit for situations where the ultimate borrower already had made a commitment with respect to the on-lend transaction. As such, the Bank represents all transactions are customer-driven. Further, the Bank represents it will not be holding itself out as a dealer or market-maker in securities, and will be exempt from registration as a “dealer” under the federal securities laws. The Bank also represents it will comply with the extensive guidance set forth in BC-196, as it already does in conjunction with its current securities lending program, and will comply with other appropriate disclosure principles, agency principles, and as applicable principles from 12 C.F.R. Part 9. The Bank also represents that its compliance program will provide appropriate testing, monitoring, and reporting of activities to document ongoing compliance.

## **Conclusion**

Based on the Bank’s representations, the described facts and circumstances, and the analysis provided, we find that the Bank’s proposed securities conduit lending activities are permissible. If you should have any questions concerning this matter, please contact Suzette H. Greco, Special Counsel, Securities & Corporate Practices Division, at 202/874-5210.

Sincerely,

/s/

Daniel P. Stipano  
Acting Chief Counsel

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between the value of the securities and the value of the collateral. In that case, the bank would make up the difference between the market value of the loaned securities and the market value of the collateral. The Bank represents its collateral consists of either cash or U.S. treasuries, and thus is extremely reliable.