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The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking"

Saule T. Omarova

Cornell Law School, sto24@cornell.edu

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The Quiet Metamorphosis: How Derivatives Changed the “Business of Banking”

SAULE T. OMAROVA†

In the wake of an unprecedented global financial crisis, one of the fundamental questions preoccupying policymakers and students of financial regulation worldwide is “How did we get here?” This Article uncovers and analyzes an important part of our recent regulatory history, which provides a key to understanding some of the deeper, hidden causes of the crisis but whose significance legal scholars have so far failed to appreciate.

The Article examines interpretive letters issued by the Office of the Comptroller of the Currency (OCC), the primary regulator of federally chartered U.S. banks, interpreting the National Bank Act of 1863 to allow banks to trade and deal in derivatives, potentially complex and risky financial instruments once famously characterized by Warren Buffet as “financial weapons of mass destruction.” The Article argues that, between the mid-1980s and the end of 2008, the OCC utilized three principal tools of interpreting the statutory language to authorize bank derivatives activities: the “look-through,” the “functional equivalency,” and, finally, the most radically expansive “elastic definition” approach. In these interpretive letters, the OCC articulated an excessively broad definition of the statutory concept of the “business of banking” to mean all types of financial intermediation and dealing in all forms of financial risk.

The Article further argues that the OCC’s highly expansive interpretation of the “business of banking” in the context of bank derivatives activities served to undermine the integrity and efficacy of the U.S. system of bank regulation. Through the seemingly routine and often non-transparent administrative actions, the OCC effectively enabled large

† Assistant Professor, University of North Carolina at Chapel Hill School of Law. The author would like to thank Lissa L. Broome, Vincent M. DiLorenzo, Adam Feibelman, Tom Hazen, Donald Hornstein, Melissa Jacoby, Adam Levitin, Patricia A. McCoy, Richard Myers II, Eric L. Muller, Christopher M. Pietruszkiewicz, Heidi Mandanis Schooner, Arthur E. Wilmarth, and the participants in University of Connecticut Junior Scholars’ Workshop in Banking and Consumer Financial Services Law, the Annual Program of the American Association of Law Schools (AALS) Section on Financial Institutions and Consumer Financial Services, the New Scholars Workshop at the Southeastern Association of Law Schools Sixty-First Annual Meeting, and Chicago-Kent College of Law Faculty Workshop. All errors are solely those of the author.

U.S. commercial banks to transform themselves from the traditionally conservative deposit-taking and lending institutions, whose safety and soundness were guarded through statutory and regulatory restrictions on potentially risky activities, into a new breed of financial “super-intermediaries,” or wholesale dealers in pure financial risk. By indirectly removing most of the restrictions on activities of commercial banks, the OCC’s interpretive efforts had an ironic effect of prolonging the life of an obsolete statute and potentially impeding legislative reforms necessary to bring the regulatory framework in line with the changing business and risk profile of modern financial institutions.

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INTRODUCTION

In 2008, the world entered its first truly global and systemic financial crisis, forcing a painful reassessment of the norms and assumptions underlying our understanding of the operation of financial markets. At the center of the current crisis were the world’s largest banking institutions, struggling to survive under the crushing weight of “toxic” assets

on their balance sheets and the threat of nationalization.¹ As severe credit and liquidity problems in the banking sector reverberated throughout the entire global economy, policymakers, industry experts, and academics worldwide began searching for ways to arrest the downward spiral and resume normal functioning of the financial system. Not surprisingly, the need for a comprehensive regulatory reform in the financial services sector is currently at the forefront of intense policy debates in the United States, as well as in other countries.² However, designing a crisis-resistant future requires a thorough understanding of the crisis-prone past. Thus, the most important question that we must address before embarking on the path of long-term regulatory reform is “How did we get here?” Conventional explanations point to significant factors that contributed to the recent financial turmoil but, unfortunately, tend to paint a picture that is either over-simplified or incomplete.³

This Article offers a critical perspective on where things have gone

1. See, e.g., Francesco Guerrera, *Nationalisation Is Most Likely Way Out of US Banking Mess*, FIN. TIMES (London), Feb. 21, 2009, at 15.

2. For recent regulatory reform proposals, see, for example, MARKUS BRUNNERMEIER ET AL., INT’L CTR. FOR MONETARY & BANKING STUDIES, *THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION* (2009), available at <http://www.voxeu.org/reports/Geneva11.pdf>; CONGRESSIONAL OVERSIGHT PANEL, *MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY* (2009), available at <http://cop.senate.gov/documents/cop-012909-report-regulatory-reform.pdf>; GROUP OF THIRTY, *FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY* (2009), available at <http://www.group30.org/pubs/reformreport.pdf>. For recent examples of the official sector approach to regulatory reform see, U.S. Dep’t of the Treasury, *Financial Regulatory Reform: A New Foundation* (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf; HM Treasury, *Reforming Financial Markets* (2009), available at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf; Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Financial Crisis* (2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf. While this issue is beyond the scope of this Article, I address the problem of designing a comprehensive reform of financial regulation elsewhere. See Saule T. Omarova & Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881 (2009).

3. Numerous conventional accounts of what caused the crisis range from criticizing central banks’ monetary policies to blaming specific groups of “bad actors” in financial markets (such as unscrupulous mortgage brokers, greedy investment bankers, or incompetent rating agencies) or stressing human psychology as the ultimate source of our recurring economic blunders. See, e.g., COUNTERPARTY RISK MGMT. POLICY GROUP III, *CONTAINING SYSTEMIC RISK*, at iii (2008), available at <http://www.crmpolicygroup.org/docs/CRMPG-III.pdf>; Memorandum from Henry M. Paulson, Jr., U.S. Sec’y of the Treasury, U.S. Dep’t of the Treasury 2 (Mar. 13, 2008); Ralph Atkins, *Central Bankers Take Flak for Crisis*, FT.COM, Feb. 22, 2009, http://www.ft.com/cms/s/0/aee71338-0106-11de-8f6e-000077b07658.html?ncllick_check=1. Some critics view the latest crisis as a direct product of the “deregulatory” legislation passed during the Clinton era, such as the Gramm-Leach-Bliley Act of 1999 or the Commodity Futures Modernization Act of 2000, or the growth of the “shadow” system of finance outside the regulated banking industry. See, e.g., Timothy F. Geithner, President & Chief Executive Officer, Fed. Reserve Bank of N.Y., *Reducing Systemic Risk in a Dynamic Financial System: Remarks at the Economic Club of New York* (June 9, 2008).

wrong. In a broad sense, the Article analyzes a vitally important phenomenon that the prevailing narrative of the crisis largely ignores: the role of regulatory agencies in shaping the course of financial innovation and enabling regulated financial institutions to take increasingly greater and more complex risks, which eventually threatened their very existence as a viable economic enterprise. Contrary to an implicit assumption underlying most conventional explanations, the financial innovation of recent decades did not happen “naturally”; it was not some generalized evolutionary force but, to great extent, a product of policy choices and decisions by regulatory agencies.⁴ Moreover, some of the most influential of those decisions escaped public scrutiny because they were made in the subterranean world of administrative action invisible to the public, through agency interpretation and policy guidance.⁵

The U.S. banking industry provides a clear example of this dynamic. It was not the highly visible acts of Congress but the seemingly mundane and often nontransparent actions of regulatory agencies that empowered the great transformation of the U.S. commercial banks from traditionally conservative deposit-taking and lending businesses into providers of wholesale financial risk management and intermediation services.⁶ This Article tells a story of one U.S. regulatory agency, the Office of the Comptroller of the Currency (OCC),⁷ gradually and deliberately expanding the ability of large U.S. commercial banks⁸ to engage in trading and dealing in complex over-the-counter derivatives

4. In that sense, this Article is a contribution to the growing body of legal scholarship seeking to deconstruct and demystify the process of “financial innovation.” See, e.g., Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007); Charles R.P. Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 SMU L. REV. 505 (1998).

5. The process of administrative decision-making through the use of agency interpretations, policy statements, guidance, manuals, and similar methods is a subject of growing interest among scholars of administrative law. See, e.g., Robert A. Anthony, “Interpretive” Rules, “Legislative” Rules and “Spurious” Rules: *Lifting the Smog*, 8 ADMIN. L.J. AM. U. 1 (1994); M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383 (2004). However, a detailed discussion of the issues addressed in that body of literature is beyond the scope of this Article.

6. For an insightful account of this general process of transformation in the banking industry, see Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215.

7. The Office of the Comptroller of the Currency is the oldest federal banking agency, established as a bureau within the Treasury Department. It is charged with the administration and implementation of the National Bank Act of 1863 and serves as the chartering authority, and primary regulator, of national, i.e., federally chartered, commercial banks. See RICHARD SCOTT CARNELL ET AL., *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 10, 60, 74–75 (4th ed. 2009).

8. The term “commercial banks” generally denotes U.S. deposit-taking institutions chartered as “banks” and subject to regulation and supervision by the relevant federal or state banking

and emerge as the leading players in global derivatives markets.⁹

Derivatives are financial instruments whose value is “derived” from the value of another asset, referred to as the underlying or reference asset.¹⁰ These extremely malleable, and potentially extraordinarily complex, financial instruments serve as the modern means of isolating, unbundling, and transferring economic risk.¹¹ At the same time, as the recent financial crisis so forcefully underscored, derivative instruments and markets themselves pose significant potential risks, including systemic financial risks,¹² whose nature and true extent are difficult to understand and measure.¹³

Today, active participation of large U.S. banks in global derivatives markets is such a basic fact of life that their legal authority to do so is taken for granted. However, U.S. laws and regulations impose strict limitations on commercial banks’ business activities and investments, in the

authorities. This term is used typically to distinguish banks from “investment banks” and other financial institutions that are not subject to U.S. banking laws and regulations. *Id.* at 18.

9. See, e.g., 2009 OCC’S Q. REP. ON BANK TRADING & DERIVATIVES ACTIVITIES, THIRD QUARTER, 1, 1, available at <http://www.occ.treas.gov/ftp/release/2009-72a.pdf> (stating that the notional value of derivatives contracts held by U.S. commercial banks in the third quarter of 2009 was \$202.0 trillion, with five largest dealer-banks holding ninety-six percent of all derivatives).

10. See, e.g., Kimberly D. Krawiec, *More than Just “New Financial Bingo”: A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 6 (1997); Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 2 (1996); Adam R. Waldman, Comment, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance Into the Abyss*, 43 AM. U. L. REV. 1023, 1026 (1994). An underlying asset can be a security, an index, a commodity price, an interest or currency exchange rate, or any other relationship that can be measured and assigned a value. While some derivatives are traded on exchanges, most derivatives contracts are bilaterally negotiated and executed in over-the-counter (OTC) markets.

11. As a general matter, derivative instruments allow counterparties either to buy protection from certain risks they are not willing to bear (hedging, or risk management) or to replicate exposure to certain defined risks in expectation of economic profit (synthetic investment, or speculation).

12. Systemic risk may be defined as a “risk that a disturbance will impair the efficient functioning of the financial system and, at the extreme, cause its complete breakdown.” Krawiec, *supra* note 10, at 47. Systemic risk arises from the possibility of a large institution’s failure having a “domino effect” and from the potential losses to the federal deposit insurance funds and government budget, e.g., in the case of a government bailout. For a broad discussion of the nature of systemic risk in the financial sector, see Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008).

13. For instance, derivatives transactions typically have a high degree of embedded leverage, which creates potential for magnifying losses associated with these instruments. Rapidly growing and largely unregulated over-the-counter, or OTC, derivatives markets are characterized by a high level of opacity and complexity. In the absence of public market and open information dissemination, many complex, individually tailored OTC instruments are difficult to value and highly illiquid. Finally, the ability of derivatives markets to “slice and dice” financial risk makes it extremely difficult to monitor where the risk is concentrated at any given moment. The recent global financial crisis has clearly demonstrated that these characteristics of derivatives markets pose a significant threat to financial stability.

name of preserving their safety and soundness.¹⁴ Under the U.S. regulatory scheme, commercial banks may conduct only activities authorized by their chartering statutes, which generally do not expressly authorize derivatives trading and dealing.¹⁵ It is not widely known that an unprecedented expansion of commercial banks' derivatives business in recent years is a direct result of interpretation by the OCC of the "bank powers" clause in § 24(Seventh) of the National Bank Act of 1863.¹⁶ This clause grants national banks general authority to engage in activities necessary to carry on the "business of banking," a term not defined in the statute.

This Article analyzes the OCC's interpretive letters, issued between mid-1980s and 2008 in response to requests by individual banks, authorizing various derivatives transactions as incidental to or part of the "business of banking" and develops a typology of the interpretive methods used by the OCC to achieve that result.¹⁷ It argues that the OCC has utilized three principal tools of interpreting the bank powers clause in the context of bank derivatives activities: what is called here the "look-through" method, the more universally used (and best-known) "functional equivalency" method, and, finally, the most radically revisionist and expansive approach this Article refers to as the "elastic definition" method. The Article further argues that, in these interpretive letters, the

14. The fundamental assumption underlying this regulatory approach is the concept of banks as "special" types of financial intermediaries performing vitally important public functions, such as providing transaction accounts and operating as the backup source of liquidity and the transmission belt for monetary policy. *See, e.g.,* E. Gerald Corrigan, *Are Banks Special? A Revisitation*, REGION, Mar. 2000; E. Gerald Corrigan, *Are Banks Special?*, 1982 FED. RES. BANK OF MINNEAPOLIS ANN. REP., <http://www.minneapolisfed.org/pubs/ar/ar1982a.cfm> [hereinafter Corrigan, *Are Banks Special?*].

15. For a general discussion of the basic principles and operation of the U.S. system of bank regulation and supervision, see LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES (2004); RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS (2009); HOWELL E. JACKSON & EDWARD. L. SYMONS, JR., REGULATION OF FINANCIAL INSTITUTIONS (1999); and KENNETH SPONG, BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION, AND EFFECTS (2000).

16. 12 U.S.C. § 24(Seventh) (2006). The unique structural feature of the U.S. regulatory framework is the existence of so-called "dual banking system," under which depository institutions may be chartered either by the federal government or by individual states. The National Bank Act, administered by the OCC, technically governs only the activities of national, or federally chartered, banks. However, under a different statutory provision, business activities of state-chartered banks are explicitly limited to activities permissible to national banks. *See* 12 U.S.C. § 1831a. Thus, the OCC effectively has the power to set activity boundaries for the entire U.S. commercial banking industry.

17. This is the first attempt to analyze and systematize the entire body of the OCC's legal interpretations that remain the sole source of U.S. national banks' legal authority to engage in derivatives transactions. Until 2001, the OCC did not publish its interpretive letters on a regular basis. *See infra* note 163 and accompanying text. The OCC's interpretive letters are currently available at OCC, Published Corporate Decisions, <http://www.occ.treas.gov/interp/monthly.htm> (last visited May 10, 2009).

OCC articulated an overly expansive definition of the “business of banking” as financial intermediation and dealing in financial risk, in all of its forms, and that this pattern of analysis allowed the OCC to expand the range of bank-permissible activities virtually without any statutory constraint. Defining the statutory concept of the “business of banking” as a broadly understood process of financial intermediation, rather than any particular form thereof, effectively rendered this concept meaningless as a potentially limiting device and transformed it into a potent source of the agency’s power to reshape, unilaterally and in a nontransparent manner, substantive legal and regulatory boundaries.

The OCC’s method of expanding banks’ derivatives powers through superficially reasoned interpretations has far-reaching regulatory implications. On the one hand, the OCC’s efforts to elasticize the concept of the “business of banking” empowered the largest U.S. commercial banks to emerge, in the last twenty plus years, as a new breed of financial super-intermediary—a wholesale dealer in financial risk, conducting a wide variety of capital markets and derivatives activities, trading physical commodities, and even marketing electricity. On the other hand, the OCC’s permissive approach had an ironic effect of artificially prolonging the life of an obsolete statute by impeding much needed public debate on the optimal regulatory design for the modern financial services sector and potentially hindering a broader legislative reform. In that sense, the agency’s actions served to undermine the integrity and efficiency of the existing system of U.S. bank regulation and supervision based on a fundamental assumption, inherited mostly from the 1930s, that the main business of banks is a stable and conservative combination of deposit-taking and lending.¹⁸

Tracing the evolution of the concept of “business of banking” through examination of the OCC’s interpretations regarding the permissibility of bank derivatives transactions, in and of itself, is a useful exercise in regulatory history. Although much is written about the process of commercial banks’ expansion into insurance and securities underwriting, and the role of federal banking regulators and courts in that process,¹⁹ to date, there has been no in-depth academic treatment of the similar pro-

18. See, e.g., Michael Taylor, *The Search for a New Regulatory Paradigm*, 49 MERCER L. REV. 793, 795 (1998). For an insightful and comprehensive analysis of the policy justifications for regulation of different types of financial transactions and institutions, see Howell E. Jackson, *Regulation in a Multisector Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319 (1999).

19. See, e.g., Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 J. CORP. L. 723 (2000); Tamar Frankel, *Bank Powers To Sell Annuities*, 49 BUS. LAW. 1691 (1994); Michael P. Malloy, *The Sound of Two Hands Flapping: Insurance-Related Activities of National Banks*, 41 ST. LOUIS U. L.J. 75 (1996); Wilmarth, *supra* note 6.

cess in the derivatives arena.²⁰ The fact that the OCC's decisions allowing bank derivatives activities have never been challenged in court, due mainly to the absence of a rival "derivatives" industry fighting against banks' encroachment upon its turf, further explains the continuing obscurity of this significant topic.²¹

More importantly, however, knowing and understanding this history provides valuable context for the ongoing debate on the future of financial sector regulation. The difficult task of designing a comprehensive regulatory reform requires a deeper appreciation of the lessons this story has to offer, with respect to the role of administrative agencies in the process of financial innovation and the importance of aligning regulatory framework with the business and risk profile of the financial institutions subject to it. In this respect, this Article is also of potentially great interest to students of the regulatory state, exploring general issues of statutory interpretation, administrative process, and agency accountability. Some of its insights may be transferable across substantive subject-matter boundaries, as "quiet metamorphoses" of important statutory concepts through agency interpretation may be taking place in a variety of areas outside the financial services sector.

Part I of this Article provides some background for the discussion by outlining key themes in the long-running debate among academics, judges, and regulators over the meaning of the statutory concept of the "business of banking." Part II examines the evolution of the "look-through" and "functional equivalency" approaches to interpretation of the bank powers clause in the OCC's early decisions granting national banks permission to conduct derivatives activities. Part III focuses on the evolution and the outer limits of the current definition of the "business of banking" as modern financial intermediation and analyzes recent trends in the OCC's ongoing quest to elasticize the conceptual boundaries of the bank powers clause in the context of derivatives activities. Part IV discusses the broader regulatory implications of the OCC's expansive interpretation of the concept of the "business of banking." Finally, the Conclusion highlights some of the key lessons of this story from the perspective of regulatory reform in the financial sector.

I. AN ELUSIVE CONCEPT: THE "BUSINESS OF BANKING"

One of the fundamental principles of U.S. banking law and regula-

20. The only article on this topic was published over a decade ago and described generally the scope of then permissible derivatives activities of banks and bank holding companies. See Steven McGinity, *Derivatives-Related Bank Activities as Authorized by the Office of the Comptroller of the Currency and the Federal Reserve Board*, 71 CHI.-KENT L. REV. 1195 (1996).

21. See *infra* notes 243-44 and the accompanying text.

tion is the separation of banking and commerce.²² This regulatory principle is implemented through an intricate system of restrictions on activities and investments of commercial banks and their affiliates, primarily in order to protect the safety and soundness of banks and to prevent systemic crises likely to result from widespread bank failures.²³

As a general rule, federally chartered banks in the United States are permitted to conduct only the activities authorized under the National Bank Act of 1863. Section 24(Seventh) of the National Bank Act grants national banks the power 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.²⁴

This “bank powers clause” is the conceptual cornerstone of a complex statutory and regulatory scheme restricting the business activities of banking organizations in the United States.²⁵ The Glass-Steagall Act, adopted in 1933, amended the National Bank Act by imposing further restrictions, including an explicit prohibition on banks’ authority to deal in and underwrite corporate equity securities.²⁶ A number of other provisions of federal law deny banks power to engage in other lines of business, such as real estate ownership²⁷ and insurance underwriting.²⁸ The Bank Holding Company Act of 1956 effectively extended activity restrictions to entities affiliated with commercial banks within a common “bank holding company” (BHC) structure.²⁹ Under the BHC Act

22. See, e.g., Bernard Shull, *The Separation of Banking and Commerce in the United States: An Examination of Principal Issues*, FIN. MARKETS, INSTITUTIONS & INSTRUMENTS, May 1999, at 1, 1–3. For a discussion of the historical underpinnings of this principle, see, for example, Joseph G. Haubrich & João A.C. Santos, *Alternative Forms of Mixing Banking with Commerce: Evidence from American History*, FIN. MARKETS, INSTITUTIONS & INSTRUMENTS, May 2003, at 121. For an example of a recent, more nuanced, academic analysis of the practical operation and continuing relevance of the separation of banking and commerce, see Adam Feibelman, *Commercial Lending and the Separation of Banking and Commerce*, 75 U. CIN. L. REV. 943 (2007).

23. See, e.g., Shull, *supra* note 22, at 7–14.

24. 12 U.S.C. § 24(Seventh) (2006).

25. The National Bank Act does not directly apply to state banks, whose primary regulators are the relevant state banking authorities and whose activities are governed by state law. However, because the Federal Deposit Insurance Corporation Act of 1991 explicitly mandates that, with certain limited exceptions, federally insured state banks are not allowed to engage in any activities not permissible to national banks, state-chartered banks are generally subject to the same activity restrictions as those applicable to national banks. See 12 U.S.C. § 1831a.

26. See *id.* § 24(Seventh).

27. See *id.* § 29.

28. See 15 U.S.C. § 6712(a).

29. See 12 U.S.C. §§ 1841–1850. The Bank Holding Company Act of 1956 (BHC Act) is

and the Federal Reserve's regulations implementing it, banking organizations are generally prohibited from engaging in any business activities other than banking, controlling, or managing banks and activities "closely related" to banking.³⁰

The entire history of banking industry and regulation in the United States may be viewed as an elaboration on the meaning of the bank powers clause of § 24(Seventh) in light of the evolving banking practices. The banking industry's efforts to develop new products and find new ways of running a profitable business forced banking regulators to re-assess continuously the boundaries of the statutory grant of powers to banks, which in turn shaped and re-shaped the industry's business trajectory—a process aptly dubbed the "regulatory dialectic."³¹ These efforts intensified in the era of bank "disintermediation," when U.S. commercial banks came under increasing competitive pressure from securities firms and other financial institutions encroaching upon banks' traditional turf.³² It is no coincidence, therefore, that the period from mid-1980s to late 2008 saw marked regulatory expansion of the scope of bank activities permissible under the National Bank Act.

Historically, there were three principal approaches to interpreting the bank powers clause of § 24(Seventh): a "narrow view" limiting the scope of permissible banking activities strictly to the enumerated five powers; a "broad view" that considered the phrase "business of banking" a separate grant of power open to constant change and capable of including any financial activity of the day; and an "intermediate view" articulated in 1983 by Professor Edward L. Symons, Jr., who argued that the powers clause authorized any activity that was a type of "deposit taking, credit granting, or credit exchange" as an activity "encompassed by the principles underlying the general grant of power to engage in the busi-

implemented and administered by the Board of Governors of the Federal Reserve System (the Federal Reserve), which acts as the "umbrella" regulator and supervisor for all U.S. BHCs.

30. See *id.* § 1843(a),(c). The Gramm-Leach-Bliley Act of 1999 (GLB Act) amended the BHC Act by allowing certain well-capitalized and well-managed BHCs to elect a status of a "financial holding company" (or FHC), which are allowed to engage (through their nonbank subsidiaries) in a broader range of activities "financial in nature," including securities underwriting, merchant banking, and insurance underwriting. See *id.* § 1843(k). However, even FHCs' activities remain subject to a variety of limitations designed to maintain the separation between banking and commerce.

31. William L. Silber, *Innovation and Regulation in Financial Markets*, 38 BUS. LAW 668, 670 (1983); see, e.g., James R. Smoot, *Financial Institutions Reform in the Wake of VALIC*, 29 CREIGHTON L. REV. 691, 700 (1996).

32. The phenomenon of bank "disintermediation" is associated primarily with the increasing popularity, in the 1970s and 1980s, of money market funds that provided an attractive alternative to bank deposit accounts and the growth of commercial paper markets as a source of nonbank financing of corporate activities. See, e.g., Wendy Cassity, Note, *The Case for a Credit Union Community Reinvestment Act*, 100 COLUM. L. REV. 331, 340 n.57 (2000).

ness of banking.”³³ By the mid-twentieth century, the “narrow” interpretation of the bank powers clause, found primarily in some early judicial decisions,³⁴ had largely lost its practical significance, as courts consistently allowed national banks to offer services and undertake activities not explicitly enumerated in the bank powers clause.³⁵ The real debate over the proper boundaries of the “business of banking” unfolded primarily between proponents of the highly permissive “broad” view and supporters of the more cautiously circumscribed “intermediate” approach seeking to keep the expansion of bank powers within certain limits.³⁶

Since the 1960s, the OCC has been an increasingly strong advocate of the broad interpretation of the bank powers clause of § 24(Seventh).³⁷ The agency articulated its view of the bank powers clause of § 24(Seventh) and the meaning of the “business of banking” in Interpretive Letter No. 494, issued in 1989.³⁸ There, the OCC explicitly stated that the “business of banking” was not limited to the five enumerated powers but was “comprised of all those powers which are the recognized incidents or features of that business.”³⁹ According to the letter, the features of the “business of banking” reflected

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 need of society’s financial functioning.⁴⁰

This extremely broad formulation tied the meaning of the statutory language directly to the evolving business practices and activities of

33. Edward L. Symons, Jr., *The “Business of Banking” in Historical Perspective*, 51 GEO. WASH. L. REV. 676, 682 (1983).

34. See, e.g., *First Nat’l Bank in St. Louis v. Missouri*, 263 U.S. 640 (1924); *Logan County Nat’l Bank v. Townsend*, 139 U.S. 67 (1891).

35. For a detailed discussion of the relevant case law, see Symons, *supra* note 33; and Peter D. Wimmer, Note, *Are the Floodgates Now Open for the “Business of Banking” After NationsBank of North Carolina, N.A., v. Variable Annuity Life Insurance Co.?*, 15 ST. LOUIS U. PUB. L. REV. 505 (1996).

36. See Symons, *supra* note 33, at 678–84; Theodore A. Schroeder, Note, *Nationsbank v. VALIC: Landmark or an Illusion? The Quest To Define the Business of Banking Continues*, 57 U. PITT. L. REV. 983, 984 (1996).

37. Under the Comptroller of the Currency James J. Saxon (1961 to 1966), the OCC began aggressively expanding the scope of bank-permissible activities. The subsequent Comptrollers continued following this trend, which became particularly pronounced in the 1980s and onward. See, e.g., EUGENE N. WHITE, *THE COMPTROLLER AND THE TRANSFORMATION OF AMERICAN BANKING, 1960–1990* (1992).

38. OCC Interpretive Letter No. 494, [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083 (Dec. 20, 1989), focused on permissibility of dealing and brokerage in commodities futures in options under § 24(Seventh).

39. *Id.* ¶ 83,083, at 71,195. The OCC stressed that “[m]any other activities are also inherent parts of the business of banking.” *Id.*

40. *Id.* at 71,198.

commercial banks and, thus, opened the door for future expansive interpretations of banks' statutory powers.⁴¹ Significantly, the OCC concluded that the execution and clearance of customer transactions in financial instruments, such as securities, futures and options, regardless of the nature of the underlying asset—i.e., brokerage of financial instruments—was an attribute of the “business of banking” and was, therefore, permissible under the National Bank Act.⁴²

Judicial review of the Comptroller's decisions granting banks additional powers followed a more complex pattern.⁴³ While, in most cases, courts consistently affirmed expanding bank activities beyond the five enumerated powers, several important decisions sought to impose limits and to develop a general test for what constituted a bank-permissible activity under the language of the powers clause.⁴⁴ The First Circuit, in *Arnold Tours v. Camp*, held that an activity was “incidental” to the “business of banking” and therefore permissible for national banks if it was “convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act.”⁴⁵ The Ninth Circuit, in *M&M Leasing Corp. v. Seattle First National Bank*, further elaborated on the *Arnold Tours* test by imposing an additional limitation that an otherwise “convenient and useful” activity would not be permissible to the extent it posed “significant financial risks” beyond those present in standard loan transactions.⁴⁶ This line of cases, while clearly refusing to follow the static “narrow” interpretation of the bank powers clause, stopped short of endorsing the “broad” reading of the statutory language.⁴⁷

In a landmark case decided in 1995, *NationsBank of North Carolina v. Variable Annuity Life Insurance Co. (VALIC)*, the U.S. Supreme

41. See Smoot, *supra* note 31, at 734. Professor Smoot welcomes this interpretation as “hospitable to further use of the functional analysis and evolving character approaches to bank power expansion.” *Id.*

42. OCC Interpretive Letter No. 494, *supra* note 38, at 71,198–99. It is worth noting that the OCC based its conclusion that brokerage of financial instruments was a permissible bank activity on three specific considerations: (1) the “financial nature” of such brokerage activity, (2) the fact that clearing activities were essentially a form of extension of credit, and (3) historical recognition of brokerage as part of customary banking services. *Id.*

43. A detailed analysis of court decisions on the meaning of the “business of banking” is beyond the scope of this article. See *supra* note 35.

44. See, e.g., *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977) (holding that national banks had the power to lease personal property as incidental to the express banking power to loan money on personal security); *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 438 (1st Cir. 1972) (holding that operating a general travel agency, authorized by the OCC regulation, was an impermissible bank activity).

45. 472 F.2d at 432.

46. 563 F.2d at 1383. This requirement is consistent with the traditional principle of bank safety and soundness.

47. See Symons, *supra* note 33, at 714; Schroeder, *supra* note 36, at 991.

Court upheld the OCC's decision allowing a national bank to act as an agent in sales of annuities.⁴⁸ In the famous footnote two, the Court explicitly rejected the narrow interpretation of the powers clause in § 24(Seventh):

We expressly hold that the "business of banking" is not limited to the enumerated powers in § 24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated. The exercise of the Comptroller's discretion, however, must be kept within reasonable bounds. Ventures distant from dealing in financial investment instruments—for example, operating a general travel agency—may exceed those bounds.⁴⁹

The *VALIC* Court's inference that "dealing" in "financial investment instruments" is part of the "business of banking" has been criticized as "an extremely elastic interpretation" of the National Bank Act because "any financial intermediary function could be viewed as offering customers an 'opportunity to invest in' what could be called 'financial investment instruments.'"⁵⁰ On the other hand, some commentators praised the decision as a welcome "interpretive unshackling" of the historically rigid concept of the "business of banking."⁵¹ Yet others expressed doubt as to the *VALIC* Court's success in validating a truly broad view of the powers clause and argued that, in rejecting the already defunct narrow view, the Court failed to articulate a clear principled standard of what constituted the "business of banking."⁵²

The OCC's top legal staff has interpreted *VALIC* as a full endorsement of the agency's long-held broad view of the bank powers clause. Shortly after *VALIC* was decided, the OCC's Chief Counsel, Julie Williams, co-authored an article with another OCC staff member, Mark Jacobsen, setting forth the test for what constituted the "business of banking."⁵³ Under the Williams/Jacobsen proposed test, the "business of banking" includes activities that (i) are "functionally equivalent to, or a logical outgrowth of, recognized bank functions"⁵⁴; (ii) "benefit bank customers or . . . are convenient or useful to banks"⁵⁵; and (iii) "present[] risks of a type similar to those already assumed by banks."⁵⁶ The

48. 513 U.S. 251, 254 (1995).

49. *Id.* at 258 n.2.

50. See Malloy, *supra* note 19, at 78.

51. See e.g., Smoot, *supra* note 31, at 726.

52. See, e.g., Schroeder, *supra* note 36, 995–96.

53. Julie L. Williams & Mark P. Jacobsen, *The Business of Banking: Looking to the Future*, 50 BUS. LAW. 783 (1995).

54. *Id.* at 798.

55. *Id.* at 805.

56. *Id.* at 798. Two years later, Julie Williams published a companion article setting forth the OCC's new, expanded post-*VALIC* concept of bank powers "incidental" to the "business of

first and the third prongs of this test sought to preserve, albeit in a generalized and more open-ended manner, the requirement of a link between each new activity and the core of traditional bank activities and risks articulated by courts before *VALIC*. The second prong of the test, however, was potentially extremely elastic and could provide the basis for expanding bank powers without any substantive limits.⁵⁷ Specifically, it completely removed the key requirement under the *Arnold Tours* test that an activity be related to an expressly granted authority under the bank powers clause.⁵⁸

The OCC promptly adopted the Williams/Jacobsen test as its official test to be applied to specific determinations of permissibility of proposed bank activities.⁵⁹ The agency also deliberately, and quite successfully, sought to articulate and popularize an expansively broad post-*VALIC* doctrine of the “business of banking” in the academic and industry press.⁶⁰ In the post-*VALIC* environment, it appeared that the OCC’s broad view fully and finally prevailed over any “intermediate” interpretations seeking to impose principled limitations on the meaning of the “business of banking.”

Two important observations, however, should be made about footnote two in the *VALIC* decision. First, despite the OCC’s attempt to use it as a blanket endorsement of its extremely broad view of the bank powers clause, the Court’s pronouncement may be significantly more circumscribed in its scope. For instance, it would be fully consistent with the Court’s statement to view the “business of banking” not as the entire universe of activities that may be viewed as “dealing in financial investment instruments” but rather as a specific subset of such activities.⁶¹ Second, in rejecting the rigidity of the narrow approach to inter-

banking.” See Julie L. Williams & James F.E. Gillespie, Jr., *The Business of Banking: Looking to the Future—Part II*, 52 BUS. LAW. 1279 (1997).

57. The OCC’s test was criticized for being overly expansive and intellectually insufficient and for creating a danger of “bootstrapping” by allowing activities as incidental to other incidental activities. See, e.g., Schroeder, *supra* note 36, at 1000–02.

58. As a matter of formal distinction, the Williams/Jacobsen test focused on the attributes of the general “business of banking” as a separate grant of authority under the statute, while the *Arnold Tours* test dealt with powers “incidental” to the “business of banking.” However, as a practical matter, the difference between powers that form the “business of banking” and “incidental” powers is not very significant. The OCC often used these two standards as mutually complementary methods for finding a particular activity permissible under § 24(Seventh).

59. See, e.g., OCC Interpretive Letter No. 684 (Aug. 4, 1995), 1995 WL 786838.

60. See, e.g., Julie L. Williams et al., *After Barnett: The Intersection of National Bank Insurance Powers and State Regulation*, 1 N.C. BANKING INST. 13, 35 (1997); Julie L. Williams & James F.E. Gillespie, Jr., *The Impact of Technology on Banking: The Effect and Implications of “Deconstruction” of Banking Functions*, 5 N.C. BANKING INST. 135, 140–60 (2001).

61. Under this interpretation, an activity falling outside the outermost limits of the broader universe of “dealing in financial investment instruments” (such as running a general travel agency) would be a clear example of what the “business of banking” does not encompass. This

preting the powers clause, the Court stated that the OCC's discretion in determining bank-permissible activities must be kept "within reasonable bounds." The fundamental problem that remains unresolved by the Court's pronouncement in *VALIC* is how to draw the proper boundaries of "reasonableness," how to promote financial innovation without simultaneously dismantling a regulatory framework within which the business of banking was to occur.⁶²

It is clearly within the discretion of the OCC, as the primary federal regulatory agency charged with the administration of the National Bank Act, to determine what business national banks should be permitted to conduct and what those "reasonable bounds" are.⁶³ However, the regulatory agencies' discretion is not unlimited, and the expectation is that the courts and, in certain cases, the Congress will intervene if the OCC abuses its discretion. Far from closing the issue, footnote two frames the ongoing relevant inquiry: Are the OCC's determinations of what constitutes the "business of banking" in the modern world "within reasonable bounds?" And how effective are the courts and the lawmakers in monitoring the OCC's exercise of discretion?⁶⁴

The evolution of the OCC's approach to the permissibility of derivative transactions under the bank powers clause, both prior to and following the *VALIC* decision, offers a unique opportunity to gain insight into these issues.

II. THE OCC'S EARLY AUTHORIZATIONS OF BANK DERIVATIVES ACTIVITIES—FROM "LOOK-THROUGH" TO "FUNCTIONAL EQUIVALENCY"

From the perspective of the U.S. banking law, commercial banks' trading and dealing in derivatives instruments generally raise two

fact, however, does not mean that every type of "dealing in financial investment instruments" would necessarily form a part of "business of banking" within the meaning of the National Bank Act. The Court's cautious use of a single example, running a travel agency, an activity that had already been determined by a federal court not to be a permissible banking activity, hardly constitutes a meaningful guide for drawing boundaries within the growing universe of "dealing in financial investment instruments."

62. See, e.g., Smoot, *supra* note 31, at 726.

63. See *NationsBank of N.C. v. Variable Annuity Life Ins. Co. (VALIC)*, 513 U.S. 251, 254 (1995).

64. Interestingly, the issue of what constitutes the "business of banking" seems to have completely dropped off legal scholars' radars shortly after *VALIC* was decided. Since the mid-1990s, there has been no serious academic analysis of the evolution and scope of this fundamental concept in banking law. Partly, this loss of interest may be a result of the OCC's successful campaign to assert its broad view as the dominant theory blessed by the U.S. Supreme Court. Part of the explanation may be the passage of the GLB Act in 1999, which resolved some of the key practical issues driving the debate by allowing affiliations among banks, securities firms, and insurance companies.

closely related but separate issues: whether the bank (or its subsidiary) has legal authority to enter into the relevant derivative transaction, and whether it has legal authority to enter into a related hedging transaction for purposes of managing its exposure under such derivative contract. Although the legal analysis generally follows the same logic in both instances, hedging activities tend to pose potentially more difficult questions of legal interpretation because they frequently involve a bank (or its subsidiary) purchasing or holding assets, such as corporate stock or commodities, which commercial banks are not allowed to purchase or hold for their own account.

Beginning in the early 1980s, the OCC has been facing these legal issues in an increasingly complicated context, as the country's largest national banks aggressively developed and expanded their derivative businesses. This Part explores the initial stages in this process and identifies and analyzes two key interpretive methods the OCC used in determining that certain derivatives transactions were permissible under the bank powers clause of § 24(Seventh).

The OCC's initial approach to whether or not proposed derivatives activities were permissible under the bank powers clause was to "look through" the nature of an activity to the nature of the underlying asset. This interpretive method ignored the form of a transaction and held that, if banks were permitted to trade in the underlying asset, they were also permitted to trade in the related derivative instrument. Under this "look-through" approach, the OCC in the early to mid-1980s approved banks' trading and dealing activities in derivatives linked to interest rates, currency exchange rates, and certain precious metals.

As banks sought to expand their derivatives business to include transactions linked to nonfinancial commodities and equity securities, the OCC utilized one of its most powerful interpretive tools at the time, the concept of "functional equivalency," to authorize commodity and equity swaps and commodity-linked deposit products. The OCC pushed the limits of the functional equivalency approach to hold that banks' derivatives activities were permissible to the extent they were "functionally equivalent" either to an expressly authorized banking activity under the bank powers clause (typically, lending and deposit-taking) or to any other derivatives transaction that, although not expressly authorized by the statute, was previously deemed to be permissible by the OCC. As this Part demonstrates, this approach allowed the OCC to create strings of permissible derivatives activities with an increasingly attenuated connection to any express banking powers.

A. *The “Look-Through” Approach: It’s All About the Asset*

The OCC’s initial approach to whether or not banks’ derivatives activities were permissible under the powers clause was to look through the nature of an activity to the nature of the underlying asset itself. In effect, this approach ignored the form of a transaction and held that, if banks were permitted to invest or trade in the underlying asset, they were permitted to trade in the related derivative instrument.

The main advantages of the “look-through” approach were its simplicity and high degree of effectiveness. Indeed, it is difficult to argue that, if a national bank can own a physical asset, such as gold or silver, and accept all risks inherent in such direct ownership, it cannot gain exposure to the same risks indirectly. The key limitation of this approach was that it did not address the broader issue of permissibility of derivatives transactions per se, as a new type of financial activity sought by banks. In that sense, the “look-through” approach was, and still is, the most conservative and the least controversial in the OCC’s arsenal of statutory interpretation tools.

Not surprisingly, the OCC’s early interpretations authorizing derivatives activities on the “look-through” basis were fairly low-profile and straightforward. Thus, in mid-1983, the OCC authorized a national bank to purchase and sell for its own account exchange-traded options⁶⁵ on debt securities that themselves are permissible investments for national banks, subject to certain safety and soundness procedures.⁶⁶ The OCC’s core argument stated the general “look-through” principle:

As options relate directly to the underlying instrument, we must conclude that a national bank may only buy and sell options to the extent that it is allowed to buy and sell the underlying instrument. Thus, national banks may buy and sell options, for instance, on U.S. government securities and CDs. As national banks are not, as a general rule, allowed to purchase and sell corporate stock for their own account, they may not buy and sell options on S&P index futures currently offered by certain boards of trade.⁶⁷

On this basis, the OCC concluded that purchasing and selling exchange-traded options on bank-eligible debt securities for purposes of

65. An “option” is a derivative instrument that gives the buyer of an option a right, but not an obligation, to buy or sell a specified underlying asset at a specified price (the strike/exercise price), either at a fixed future date or during a fixed period. The buyer of an option pays the seller a premium for such right, so the buyer’s potential loss is limited to the amount of such premium, whereas the seller’s potential loss may be unlimited. See JOHN MARTINSEN, *RISK TAKERS: USES AND ABUSES OF FINANCIAL DERIVATIVES* 9 (2d ed. 2008).

66. OCC Interpretive Letter No. 260 (June 27, 1983), 1983 WL 54147.

67. *Id.* The last sentence in this quote came to haunt the OCC five years later, when it was asked to permit a national bank to offer time deposits with interest rates linked to the performance of S&P index and hedge by buying and selling exchange-traded S&P futures.

managing risks arising out of expressly permitted banking activities was permissible as an "incidental banking activity" under the National Bank Act.⁶⁸ The OCC analogized trading and dealing in financial options to trading and dealing in financial futures and forward contracts,⁶⁹ which were previously recognized by the OCC as bank-permissible activities, subject to the key condition that such trading and dealing activities were conducted (i) for the purposes of hedging banks' interest rate risks arising from their traditional banking business, and (ii) in accordance with specific policies and procedures, including position limits, designed to ensure that futures activities did not threaten the bank's safety and soundness.⁷⁰ The OCC concluded that options on bank-eligible debt securities could be used as a functional equivalent of futures contracts and, therefore, could be conducted within the same limits as those applicable to futures under the existing OCC precedent.⁷¹

Under this approach, the OCC approved banks' trading and dealing activities in derivatives linked to interest rates and currency exchange rates as activities directly related to the most fundamental, explicitly authorized banking powers of lending and dealing in currency.⁷² Simi-

68. According to the OCC,

[B]anks may use these contracts to manage certain risks resulting from their expressly permitted banking activities. In these areas, the use of options is connected to the underlying banking activities, such as managing risks in the bank's investment portfolio and dealer-bank activities, and managing interest rate risks associated with asset/liability management.

OCC Interpretive Letter 260, *supra* note 66.

69. A "forward contract," or "forward," is an instrument that creates an obligation, on the part of the buyer, to accept and, on the part of the seller, to deliver, a designated quantity of the underlying asset, at a specified price, at a specified future date (although forwards may also be settled in cash). Forwards are a zero-sum game, so that the loss to one party equals the gain to the other. "Futures" are essentially standardized forward contracts traded on exchanges and typically settled in cash instead of physical delivery. *See* MARTINSEN, *supra* note 65, at 5-7.

70. *See* OCC Banking Circular BC-79 (Rev.) (Apr. 19, 1983), 1983 WL 135299 [hereinafter BC-79] (recognizing national banks' trading and dealing activities in financial futures and forward contracts, subject to certain conditions). OCC Banking Circular BC-79 (BC-79) was later superseded by the OCC Banking Circular BC-277 (BC-277). *See* OCC Banking Circular BC-277 (Oct. 27, 1993), 1993 WL 640326 [hereinafter BC-277].

71. OCC Interpretive Letter No. 260, *supra* note 66.

72. *See, e.g.*, OCC Interpretive Letter No. 414, [1987-1988 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,638 (Feb. 11, 1988) (stating that an operating subsidiary of a national bank is permitted to buy and sell foreign exchange in forward markets and OTC options on foreign exchange, for purposes of hedging and arbitrage); OCC No Objection Letter No. 87-5, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 (July 20, 1987) [hereinafter Matched Swaps Letter] (allowing bank act as a principal in commodity price index trades); OCC Interpretive Letter No. 372, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,542 (Nov. 7, 1986) (permitting an operating subsidiary of a national bank to act as a broker-dealer and market maker of exchange-traded options on foreign currencies, as an activity incidental to the express authority of national banks to buy and sell "exchange, coin and bullion," both for their own account and for the account of customers). Part of the OCC's reasoning in allowing the use of OTC options for arbitrage was that such options were effectively equivalent to the use of

larly, derivatives activities linked to certain precious metals—gold, silver, platinum,⁷³ palladium,⁷⁴ and copper⁷⁵—were authorized as part of an express power to trade in “coin and bullion.”⁷⁶ The OCC set forth the guidelines for banks’ trading and dealing activities in coin and bullion.⁷⁷

Because U.S. banking laws and regulations impose severe restrictions on the range of assets commercial banks are permitted to invest or trade in, the “look-through” approach focusing on the nature of the underlying asset is of limited usefulness in most cases involving newly proposed derivatives activities of banking institutions. However, the importance of this tool in the OCC’s arsenal of statutory interpretation cannot be underestimated. This line of argument allowed commercial banks to broaden the range of their financial activities to include trading and dealing in options, futures, forward contracts, and swaps,⁷⁸ albeit only as long as they involved bank-permissible assets. Not surprisingly, the OCC continues to use the “look-through” method whenever possible, particularly in situations involving trading for the bank’s own account.⁷⁹

exchange-traded futures contracts on bank-eligible assets, which was previously approved by the OCC in OCC No Objection Letter No. 86-13, [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,019 (Aug. 8, 1986).

73. See OCC Interpretive Letter No. 553, [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,300 (May 2, 1991) (permitting a national bank’s operating subsidiary to engage in brokerage of platinum coins and bullion).

74. See OCC Interpretive Letter No. 685, [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,999 (Aug. 4, 1995) (allowing national bank to buy and sell palladium coins and bullion).

75. See OCC Interpretive Letter No. 693, [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-008, at 90,222 (Nov. 14, 1995) (allowing national bank to buy and sell copper pursuant to an express power to buy and sell “coin and bullion” and conduct financial derivatives activities with regard to copper).

76. The issue of permissibility of such activities was linked to the OCC’s definition of “coin and bullion.” OCC Banking Circular No. BC-58, at 1 (Nov. 3, 1981) [hereinafter BC-58] (superseding an earlier circular version of 1974). BC-58 did not specify particular metals that could be used for minting “coin” and defined the term “bullion” narrowly as “uncoined gold or silver in bar or ingot form.” *Id.* Through its interpretations, the OCC expanded its definitions to include platinum, palladium, and copper as precious metals that qualify as “bullion.”

77. BC-58 required a bank’s board of directors to evaluate the risks associated with buying and selling coin and bullion, monitor the management’s expertise in conducting and supervising the bank’s operations in this area, and establish formal policies and procedures governing the bank’s coin and bullion activities. *Id.* Such program policies and procedures should, among other things, clearly identify the purposes of the bank’s activities in the coin and bullion markets, establish generally conservative position limits for each category of such activity, and mandate the establishment of internal reporting and control systems. See *id.* at 1–2.

78. A “swap” is a bilateral contract under which the parties exchange periodic payments calculated on the same notional amount but on the basis of two different variables (e.g., one counterparty makes payments based on a fixed rate and another based on a specified floating rate formula). See Krawiec, *supra* note 10, at 10–11. Along with options and forwards, swaps constitute the “building blocks” that counterparties may use, in different combinations, to create a virtually endless variety of derivative instruments with different risk profiles. See *id.* at 9.

79. For instance, in early 2005, the OCC authorized a national bank to buy and sell, for its

B. *The “Functional Equivalency” Approach: It’s All About the Form*

In the mid-1980s to early-1990s, national banks started moving into commodity derivative markets, both exchange-traded and OTC. In approving these types of transactions, where the ultimate underlying assets (e.g., oil, wheat, non-precious metals, etc.) were not eligible for the banks to trade in directly, the OCC utilized one of its most powerful tools of statutory interpretation at the time—the concept of “functional equivalency.”

The principle of “functional equivalency” is the exact opposite of the “look-through” principle. Instead of disregarding the form of a transaction and analyzing exclusively the underlying asset, this approach disregards the nature of an underlying asset and focuses on the form of the financial transaction. Under this approach, all that matters is the nature of the financial activity and the risks inherent in that activity, regardless of the risks associated with any specific reference asset. The OCC used this concept of functional equivalency very aggressively and successfully in the context of certain other, politically more salient, issues, such as expansion of national banks’ powers to include trading and brokerage in certain insurance and securities products.⁸⁰ Applying the functional equivalency approach to various commodity derivative activities, and later to equity derivatives activities, the OCC argued that these activities were functionally equivalent either to an expressly authorized banking activity under the powers clause or to another banking activity that, while not expressly enumerated in the statute, was previously authorized by the OCC. This approach allowed the OCC to “bootstrap” permissible activities, whereby activity A was deemed permissible because it had a special relation or functional equivalence to an express banking power, and then a different activity B, lacking any such special relation, was nevertheless deemed permissible because it was, in turn, found to be

own account (i.e., for investment purposes) exchange-traded units of beneficial interests in gold (“Gold Shares”) issued by an investment trust sponsored by an association of gold-mining companies. See OCC Interpretive Letter No. 1013, at 1 (Jan. 7, 2005). The Gold Shares were exchangeable for a certain amount of gold owned by the issuer-trust, and the bank intended to acquire the Gold Shares to hedge its positions in physical gold. *Id.* at 2–3. The OCC ruled that (i) the Gold Shares were economic equivalents of gold bullion and national banks had clear express authority to buy and sell them for their own account and (ii) national banks were authorized by the OCC regulations to hold interests in entities holding bank-permissible assets. *Id.* at 4–5. Since purchasing Gold Shares was found to be a permissible banking activity, the OCC concluded that it was not prohibited by the Glass-Steagall Act. See *id.* at 6.

80. See generally Keith R. Fisher, *Orphan of Invention: Why the Gramm-Leach-Bliley Act Was Unnecessary*, 80 OR. L. REV. 1301 (2001) (arguing that majority of commercial banks were able to exercise many of the powers officially bestowed upon them by the GLB Act before that law’s passage).

“functionally equivalent” to activity A.⁸¹

1. FIRST STEPS INTO THE NEW TERRITORY: COMMODITY DERIVATIVES

Commodity derivative transactions generally raise potentially difficult issues under the federal banking laws because of the general prohibition on nonfinancial, commercial activities by banks. A derivative instrument requiring or even merely allowing a bank to make or accept physical delivery of a nonfinancial commodity (such as oil or wheat) underlying such instrument may be viewed as an impermissible dealing or trading directly in the underlying commodity. Hedging in connection with commodity derivative transactions presents the same concerns.

Commodity swaps, or swap transactions based on the price of a commodity or commodity index, were the first types of derivatives activities authorized by the OCC.⁸²

a. Perfectly matched commodity swaps as part of the “business of banking”

In 1987, the OCC for the first time approved a proposal by a national bank, the Chase Manhattan Bank, to engage in perfectly matched commodity price index swaps.⁸³ In a perfectly matched commodity swap, the bank takes opposite positions in two separate swap transactions with identical key economic terms (such as the underlying commodity or index, the notional amount of the contract, maturity, settlement periods, etc.).⁸⁴ Under this scheme, the bank’s payment obligations under the two contracts are designed to offset each other so that, as long as the bank’s counterparties perform their respective obligations under the contracts, the bank should remain indifferent to the direction in which the price of the underlying commodity moves.

In OCC No Objection Letter No. 87-5 (Matched Swaps Letter), the OCC criticized a narrow view of the bank powers clause and cited judi-

81. See Schroeder, *supra* note 36, at 1001.

82. For a definition of a swap, see *supra* note 78.

83. See Matched Swaps Letter, *supra* note 72.

84. Under Chase Manhattan’s proposal, its counterparties in matched swap transactions were producers and users of certain commodities, seeking to hedge their respective exposures to fluctuations in commodity prices. See *id.* at 76,638. Under the swap contract with producers of the underlying commodities, Chase Manhattan would have had to make a payment to the producer-counterparty only in the event the commodity index decreased, *id.* at 76,639; thereby protecting the producer against loss caused by the falling commodity prices, and would have had a right to receive a payment from the producer-counterparty if the commodity index increased. By contrast, in swap transactions with commodity users, Chase Manhattan would have had a payment obligation only in the event the commodity index increased, *id.*; thereby alleviating the negative impact on the user of the rising commodity prices, and would have had a right to receive a payment from the user-counterparty if the commodity index decreased. All payments were to be made on a net basis at the end of each specified settlement period. *Id.*

cial decisions that viewed the business of banking from a "forward-looking, conceptual perspective" and allowed banks to conduct various activities not expressly enumerated in the statute.⁸⁵ Based on this broad concept of the powers clause, the OCC concluded that the proposed commodity price index swaps were both (i) incidental to the express power of national banks to lend money (and could become an exercise of an express lending power in the event of default by one counterparty), and (ii) constituted "part of the general 'business of banking' as a form of funds intermediation."⁸⁶

The OCC's primary reliance was on the swaps' connection to the expressly granted power of banks to lend money. The OCC argued that, in a perfectly matched swap, market risk⁸⁷ was effectively eliminated and the bank remained exposed only to the counterparties' credit risk,⁸⁸ which made this transaction functionally equivalent to any other traditional bank activity in which the bank essentially lends its credit to the customers, such as issuing commercial or standby letters of credit or making loan commitments. The OCC concluded that, since bank loan commitments, commercial letters of credit, and standby letters of credit were all activities "incidental to the express power to loan money," so was the proposed swap activity.⁸⁹

Only after establishing this nexus to an express banking power did the OCC proclaim that the proposed swap activities "involve[d] not merely the advancing of the Bank's own credit but a modern concept of banking as funds intermediation."⁹⁰ However, in the Matched Swaps Letter, the OCC did not elaborate on the meaning of "funds intermediation" beyond general (and essentially circular) references to the changing role of national banks increasingly functioning as "receivers and transmitters of funds and intermediaries in complex financial transactions."⁹¹ By way of a conclusion, the OCC asserted that, in a modern economy, the role of national banks as financial intermediaries expanded beyond the "textbook sense of transforming savings into capital to acting

85. Matched Swaps Letter, *supra* note 72, at 76,639. The OCC quoted an old Supreme Court case, *Auten v. United States National Bank of New York*, for the proposition that "[t]he very object of banking is to aid the operation of the laws of commerce by serving as a channel for carrying money from place to place, as the rise and fall of supply and demand require." 174 U.S. 125, 143 (1899).

86. Matched Swaps Letter, *supra* note 72, at 76,640.

87. Market risk, or price risk, is the risk of loss from the adverse movement in the market price of the asset.

88. Credit risk, generally, is the risk of loss to the creditor in the event of the borrower's failure to repay.

89. Matched Swaps Letter, *supra* note 72, at 76,640.

90. *Id.* at 76,641.

91. *Id.*

as pure funds intermediaries or processors.”⁹²

To the extent the OCC advanced an argument in support of its “funds intermediation” theory, it was, once again, based on the functional equivalency of the proposed commodity swap transactions to interest rate swaps previously approved by the OCC. According to the Matched Swaps Letter, proposed commodity swaps and perfectly matched interest rate swaps involving the exchange of two streams of payments on a loan—one based on a fixed interest rate and the other based on a floating interest rate—constituted the same type of “funds intermediation,” in which the bank lent its own credit and accepted credit risk.⁹³

To bolster its point, the OCC dismissed the importance of potential market, or commodity price, risk involved in commodity swaps.⁹⁴ The OCC stressed that, in the proposed swaps, the bank was not undertaking to make or take physical delivery of the underlying commodity, and, therefore, it was not “speculating on future price fluctuations in a commodity.”⁹⁵ According to the OCC, the entire transaction was a purely financial arrangement, in which the underlying commodity index was “simply a tool for determining the variable aspect of the swap,” serving the same purpose as an interest rate index in an interest rate swap.⁹⁶

b. Commodity-linked deposits

In 1988, in what came to be known as the “MII Deposit Decision,” the OCC concluded it was permissible for national banks to offer vari-

92. *Id.*

93. As the OCC emphasized,

Interest rate swaps which are engaged in on a matched basis with customers are permissible as incidental to general aspects of the business of banking, such as funds intermediation and providing financial expertise to customers, in addition to being incidental to the express power to lend money.

Id.

94. According to the OCC,

While the volatility of the commodities market may affect the creditworthiness of the parties who use and produce these commodities, the impact of price fluctuations on the accuracy of evaluations of creditworthiness has always been a factor in lending transactions with Users and Producers. Part of the traditional business of banking has been to “know your [sic] customer,” or to be familiar with the factors causing price instability in certain industries leading to inability to repay debts or insolvency. This type of financial analysis of a customer’s financial condition is the essence of the business of banking. In the years in which interest rate swaps have been part of the financial marketplace, banks have clearly demonstrated that they are capable of successfully managing the risks involved, which are virtually identical to those presented here.

Id.

95. *Id.* at 76,640.

96. *Id.* at 76,638.

ous commodity-linked certificates of deposit, including deposits linked to commodity or stock indices.⁹⁷ The OCC's decision came in response to a request by Chase Manhattan to offer non-transferable time deposits paying the interest linked to the performance of S&P 500 stock index.⁹⁸ The OCC's rationale was that the bank's proposal directly involved an expressly granted banking power to receive deposits, as the instrument in question was a deposit.⁹⁹ The OCC stated that banks were authorized to establish the basis for calculating interest payments on their deposits, including linking such payments to the performance or value of a stock or commodity index.

The OCC further held that national banks were also permitted to buy and sell exchange-traded futures contracts for the purposes of hedging their exposure arising out of the use of indices as the basis for establishing interest rates to be paid on their deposits. According to the OCC, using futures for risk management purposes in connection with an expressly authorized banking activity, such as deposit-taking, was an activity incidental to the business of banking and, therefore, permissible for national banks.¹⁰⁰

The MII Deposit Decision established the legal basis for commercial banks' offerings of a broad range of deposit products with interest rates linked to a variety of standards, including the value of gold, the inflation rate, and the cost of college tuition.¹⁰¹ This decision also played a very important role in shaping the OCC's subsequent decisions permit-

97. See Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A., To Offer the Chase Market Index Investment Deposit Account, OCC Interpretive Letter (Aug. 8, 1988) [hereinafter MII Deposit Decision].

98. See *id.* at 1-2. The mutual fund industry challenged the OCC's decision in court but was eventually defeated. See *Inv. Co. Inst. v. Ludwig*, 884 F. Supp. 4 (D.D.C. 1995).

99. The OCC went through a highly detailed analysis of various factors that made Chase Manhattan's proposed time deposit a "deposit" for the purposes of the U.S. banking law, including the fact that it was insured by the Federal Deposit Insurance Corporation (FDIC).

100. See MII Deposit Decision, *supra* note 97, at 42-43. The OCC noted that it had previously allowed national banks to buy and sell futures as an activity incidental to its *lending*, as opposed to *deposit-taking*, business. See, e.g., OCC Interpretive Letter No. 356, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,526 (Jan. 7, 1986). In the MII Deposit Decision, the OCC rejected an apparent inconsistency with its own prior analysis in the OCC Interpretive Letter No. 260, which focused on the nature of the underlying asset and emphasized that national banks were not allowed to buy and sell exchange-traded options on S&P Index futures because they were not allowed to buy and sell for their own account the underlying corporate stock. The OCC stated that, despite its reasoning in the OCC Interpretive Letter No. 260, it adhered to the position that Chase Manhattan's use of S&P Index futures "solely as a hedging tool is permissible notwithstanding that it would not be allowed to trade for its own account in the stocks comprising that index." MII Deposit Decision, *supra* note 97, at 50.

101. See McGinity, *supra* note 20, at 1243. The ability of commercial banks to offer such products became particularly important in the late 1990s, when global market for structured products—time deposits and debt securities with payoffs linked to performance of different assets, including various combinations of equity and commodity indices—experienced explosive growth.

ting national banks to enter into unmatched commodity swaps and equity swaps.

c. Unmatched commodity swaps and “swap warehousing”

In 1990 through 1992, the OCC permitted commodity swaps on a nonmatched, or portfolio, basis as the more efficient and convenient method of providing the same type of financial intermediation, as long as the bank did not use them for speculative purposes.¹⁰² Under this authority, banks were also allowed to hedge commodity price risk under the swaps through various OTC derivatives and exchange-traded futures, including those involving commodities *closely related* to the commodities underlying the swaps.

In the Unmatched Swaps Letter, the OCC considered a new proposal by Chase Manhattan seeking to expand its existing, perfectly matched, commodity price index swap program and to conduct its commodity swap activities “in the same manner as its interest rate and currency swaps by acting as principal in unmatched as well as matched commodity price swaps.”¹⁰³ Under the proposed program, the bank did not have to enter simultaneously in two perfectly offsetting swap transactions, but instead could hedge any unmatched commodity price risk exposure by purchasing exchange-traded futures on the underlying commodity, with the intention of entering into perfectly matching swaps when they became available.

In approving Chase Manhattan’s swap program, the OCC maintained that unmatched commodity swaps were functionally equivalent to the previously approved *matched* commodity swaps and reiterated its earlier position in the Matched Swaps Letter that commodity swaps in general were functionally equivalent to interest rate and currency swaps traditionally conducted by commercial banks.¹⁰⁴ The OCC concluded its letter by requiring that Chase Manhattan’s unmatched commodity swap program be conducted in a “safe and sound” manner and be subject to controls of the type placed on its interest rate derivatives activities under

102. See OCC Interpretive Letter from Horace G. Sneed, Senior Attorney, Legal Advisory Servs. Div. (Mar. 2, 1992), 1992 WL 125220 [hereinafter Swap Warehousing Letter]; OCC No Objection Letter No. 90-1, [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095 (Feb. 16, 1990) [hereinafter Unmatched Swaps Letter].

103. Unmatched Swaps Letter, *supra* note 102, at 71,219.

104. As the OCC stated,

A swap contract in which payments are based on commodity prices instead of interest rates or currency exchange rates fits within the powers of national banks because it is simply a new way of tailoring traditional intermediation services of commercial banks to meet the needs of bank customers.

Id. at 71,220.

BC-79.¹⁰⁵

The key factor in the OCC's analysis was that, similarly to the matched commodity swaps, Chase Manhattan's proposed unmatched commodity swap activities were functionally equivalent to, and posed the same risks as, general lending and deposit-taking activities of banks expressly authorized by § 24(Seventh). Citing its earlier MII Deposit Decision, the OCC further emphasized that hedging commodity swaps through exchange-traded commodity index futures would be similar to the hedging programs national banks already had in place as a result of their existing authority to offer deposits with interest payments linked to the value of various indexes. According to the OCC,

A bank entering into unmatched commodity price swaps is essentially engaging in activities which have previously been approved for national banks in other forms. A commodity price swap contract involves the same type of payments that a bank makes and receives in connection with its deposit and loan contracts. However, unlike a deposit or loan, no principal is received or disbursed by the bank with a swap. Instead, payments are made based on a notational amount of the commodity and changes in an agreed upon commodity price index. Moreover, the purchase and sale of futures to hedge unmatched swaps is equivalent to using futures to hedge exposure on deposits or loans with interest rates linked to movements in the price of a commodity.¹⁰⁶

In effect, the OCC argued that the method of hedging a swap (either a precisely matched offsetting transaction or purchase of commodity futures and options) was irrelevant to its permissibility under the National Bank Act. In both matched and unmatched commodity swaps, the bank would be acting solely as "a financial intermediary on behalf of its customers, making and receiving payments" and hedge the transferred commodity price risk so that the only risk retained by the bank would be credit risk, the same risk the bank assumed when it made a loan.¹⁰⁷ Thus, the OCC concluded, "by entering into unmatched commodity price swap contracts, a bank does not undertake any risks that

105. BC-79 required banks to establish an internal risk management system in order to ensure safety and soundness of their derivatives operations. *See* BC-79, *supra* note 70. Under BC-79, the core elements of a risk-management system included, e.g., adopting specific written policies and procedures on conducting derivatives activities, which had to be endorsed by the bank's board of directors, and establishing various internal reporting and approval requirements. *See id.* BC-277, which superseded BC-79, essentially retained the same generalized "safety and soundness" requirements. *See* BC-277, *supra* note 70.

106. Unmatched Swaps Letter, *supra* note 102, at 71,221. The OCC cited the MII Deposit Decision that recognized a national bank's authority to use futures to hedge its payment obligations linked to stock indexes.

107. *Id.* The OCC emphasized that a swap program would allow the bank to help its customers reduce financial risks associated with the fluctuations in the underlying commodity prices by

are qualitatively different from those met in the course of two of banking's most fundamental activities: making loans and taking deposits."¹⁰⁸

In 1992, the OCC expanded on the same theme allowing "swap warehousing," i.e. hedging the banks' exposure from unmatched commodity swaps on a portfolio basis, rather than separately hedging each swap transaction.¹⁰⁹ The OCC argued that a commodity swap warehousing program was merely a variation of the program authorized in the Unmatched Swaps Letter, whereby the bank entered into commodity swaps and used other financial instruments to hedge its commodity price risks until it obtained a swap offsetting the original transaction "in whole or in part."¹¹⁰ The OCC also permitted national banks to use OTC options and other derivatives, in addition to exchange-traded futures, to hedge the swap portfolio.¹¹¹ Finally, the OCC authorized cross-hedging of commodity swaps in the banks' portfolio, whereby banks could hedge exposure from swaps linked to a certain commodity with offsetting derivatives linked to a *different but closely related* commodity.¹¹²

In the Swap Warehousing Letter, the OCC reiterated its earlier conclusion that unmatched commodity swaps were "a form of financial intermediation incidental to the bank's traditional role as a credit intermediary."¹¹³ According to the OCC, all swaps, regardless of the underlying asset, were essentially streams of payments functionally equivalent to the payments of interest on banks' deposits and loans: The customer receiving the bank's payments under the swap was analogous to a depositor receiving interest payments on its deposit, and the customer making payments to the bank under the swap was analogous to the borrower making payments of interest on the loan from the bank.¹¹⁴

"acting as a conduit to pass the risk on to others who are willing to assume those financial risks." *Id.*

108. *Id.*

109. Swap Warehousing Letter, *supra* note 102.

110. *See id.* Importantly, however, the OCC did not address the full range of consequences of allowing banks to hedge commodity derivatives on a portfolio basis. It is worth noting that portfolio hedging allows, and even encourages, an expansion of the portfolio: The bigger the portfolio, the easier it is to find natural offsets. From this perspective, the requirement of perfect matching may have served as a built-in limit on the banks' commodity derivatives portfolios.

111. *Id.* In granting its approval, however, the OCC stressed that national banks were not permitted to purchase commodities or commodities futures and options as investments but were permitted to "use these instruments to manage risks arising from a permissible banking activity." *Id.*

112. Although the issue of permissibility of cross-hedging was not addressed in the Unmatched Swaps Letter, the OCC did not elaborate on its reasons for allowing "matching" swaps based on different underlying commodities. It mentioned, rather briefly, that cross-hedging creates the potential for price mismatches in the portfolio of commodities (what is generally known as "basis risk") and that the bank must take these risks into account in conducting its hedging activities.

113. *Id.*

114. *Id.*; *see also* McGinity, *supra* note 20, at 1234 (explaining swap transactions). The OCC

The Unmatched Swaps Letter and the Swaps Warehousing Letter marked an important transition in the OCC reasoning, laying the foundation for a broader concept of the business of banking as “financial intermediation” involving exchanges of payments among banks and their customers, which would be developed more fully after 1995. However, in these interpretations, the main emphasis still remained on the functional similarity between proposed commodity-based swaps and the traditional banking function of extending credit and accepting deposits. As the OCC put it,

Even though swap contracts are a relatively new means by which banks offer financial intermediation services, they are related to the deposit and lending activities authorized for national banks under 12 U.S.C. § 24(7). In performing its deposit-taking and lending functions, a bank acts as an intermediary between customers who wish to receive income for the use of their money and those who need financing and are willing to pay for the use of borrowed funds. The bank satisfies these needs by acting as principal in individual contracts that result in payments being transferred between depositors and borrowers. As part of the process of intermediating between these customers, the Bank undertakes to make payments to depositors and, based on its evaluation of creditworthiness of the borrowers, it assumes the credit risk that the borrowers will not make payments required under their loan contracts with the bank.¹¹⁵

Interestingly, during this period, the OCC seemed to be aware that banks’ authority to engage in commodity-based derivatives had a somewhat more limited basis than their authority to engage in derivatives based on bank-permissible assets. Thus, in May 1992, the OCC permitted a national bank’s operating subsidiaries to conduct a wide range of interest rate, currency, and cash-settled commodity swaps and related

emphasized that banks’ “swap warehousing” programs should conform to the same general supervisory limitations set forth in the Unmatched Swaps Letter, including the requirement to put in place written policies and procedures governing each bank’s commodity swap activities and approved by its board of directors, in accordance with procedures mandated for risk management of interest rate derivatives set forth in BC-79. *See* Swap Warehousing Letter, *supra* note 102. Interestingly, the OCC made a point that, although the Unmatched Swap Letter conditioned the approval of the swap program on the bank entering into swaps only with the producers and users of commodities, the Unmatched Swap Letter did not prevent national banks from entering into commodity swaps with other financial institutions.

115. Unmatched Swaps Letter, *supra* note 102, at 71,220.

derivative products—including swaptions,¹¹⁶ caps,¹¹⁷ floors,¹¹⁸ collars,¹¹⁹ and other “option-like products.”¹²⁰ The OCC cited a long line of precedents allowing national banks and their operating subsidiaries to trade, originate, and deal in interest rate and currency derivatives and other bank-permissible assets, “broadly based on the rationale that permissible bank activities with respect to the underlying instruments and commodities (and their intrinsic attributes of interest rate and currency) extend to their derivatives.”¹²¹ With respect to commodity-based swaps, however, the OCC’s tone was noticeably more cautious, as it noted that its “consideration of other [proposed derivatives products]—particularly commodity price index swaps in which bank authority with respect to the underlying commodity is not clearly established—has heretofore been more limited.”¹²² Nevertheless, these rare traces of caution soon disappeared from the increasingly expansive OCC interpretations of the bank powers clause.

2. FROM COMMODITIES TO EQUITIES: EQUITY SWAPS AS PART OF THE “BUSINESS OF BANKING”

Once the OCC allowed national banks to enter into commodity-based swaps, as long as their activities met certain minimum safety and soundness standards, it was not long before banks sought the OCC’s confirmation of their authority to engage in swap transactions in which the underlying reference asset was individual equity stock or stock indices.

As a general rule, derivatives involving corporate securities, either debt or equity, posed particularly difficult issues with respect to bank powers because of section 16 of the Glass-Steagall Act, enacted in response to widespread bank failures in the early 1930s, which expressly prohibited national banks from underwriting securities and dealing in

116. “Swaption” is an option to enter into a swap. *See, e.g.*, R. STAFFORD JOHNSON, INTRODUCTION TO DERIVATIVES: OPTIONS, FUTURES, AND SWAPS 750 (2009).

117. “Cap” is an option that provides a payoff when the price of the underlying asset is above a specified price level. *See* JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 751 (2006).

118. “Floor” is an option that provides a payoff when the price of the underlying asset is below a specified price level. *Id.*

119. “Collar” is a combination of a cap and a floor, with different strike prices. *See id.*; JOHNSON, *supra* note 116, at 734.

120. *See* OCC Interpretive Letter from Jimmy F. Barton, Deputy Comptroller, Multinational Banking (May 13, 1992), 1992 WL 266700.

121. *Id.*

122. *Id.* The OCC specifically cited the Matched Swaps Letter and the Unmatched Swaps Letter as establishing permissibility of commodity derivatives for national banks and their operating subsidiaries and as setting forth the supervisory conditions under which such activities were to be carried out. *Id.*

securities for its own account.¹²³ Despite these prohibitions, in 1994, the OCC for the first time permitted national banks to engage in equity swaps and equity index swaps.¹²⁴ The OCC's analysis proceeded in two steps. Using the functional equivalency approach, the OCC analogized equity swaps to commodity swaps, previously approved by it as a bank-permissible activity, and effectively replicated its prior reasoning with respect to commodity swaps to conclude that equity swaps were incidental both to the expressly granted banking powers to lend money and accept deposits and to the general "business of banking" as "a form of funds intermediation."¹²⁵ Only after establishing the general permissibility of equity swaps under the bank powers clause did the OCC conclude, in a somewhat circular manner, that the specific prohibition on dealing in equity securities under the Glass-Steagall Act did not apply to national banks' equity swaps determined to constitute permissible banking activities.

In OCC Interpretive Letter No. 652, the OCC argued that the key factor with respect to permissibility of equity swaps under the bank powers clause was the *form* of transaction, or the nature of the proposed *activity*, rather than the nature of the underlying *asset*. According to the OCC, equity swaps were merely a subset of a broader category of financial instruments—"notional principal contracts"—which included interest rate, currency, and commodity swaps.¹²⁶ Citing heavily its own prior decisions allowing commodity swaps (including the Matched Swaps Letter, the Unmatched Swaps Letter, the Swap Warehousing Letter, and the MII Deposit Decision), the OCC argued that all swaps, including equity swaps, essentially involved "payments that [we]re analogous to those made and received in connection with a national bank's express powers to accept deposits and loan money."¹²⁷

123. See 12 U.S.C. § 24(Seventh) (2006).

124. See OCC Interpretive Letter No. 652, [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600, at 71,748 (Sept. 13, 1994). OCC Interpretive Letter No. 652 was issued in response to a request by Citibank, N.A., seeking clarification that the OCC's prior approval of its operating subsidiaries' swap activities, issued on May 13, 1992, included an approval of cash-settled equity derivative swaps. *Id.*

125. *Id.* at 71,749–50. Thus, according to the OCC, "[e]quity derivative swaps, like [commodity price index swaps], are incidental to the express power of national banks to receive deposits, make loans, and to the business of banking." *Id.* at 71,749.

126. The OCC defined a "notional principal contract" as a financial instrument "under which one party, in exchange for a specified consideration, makes payments to the counterparty at designated intervals." *Id.* at 71,748. The amount of such payment is calculated by reference to the value of a specified asset, such as a particular index. According to the OCC, the only difference between equity swaps and other types of swaps, long recognized as permissible for banks, was the basis for calculating periodic payments by the parties, which did not alter the nature of the contract. See *id.* at 71,749–50.

127. *Id.* at 71,749. As the OCC explained,

The [swap] contracts require a bank to pay money to a party depending on the rise

Reiterating the argument developed in prior interpretations with respect to commodity swaps, the OCC reasoned that, because an equity swap involved an exchange of payments between the bank and its counterparty and did not connote actual ownership of the underlying securities, so the only risk to which the bank was directly exposed was the risk of default by the counterparty and the crux of the proposed equity swap program was taking and managing credit risk—an essential banking activity.¹²⁸ The key function of standing between, and lending its credit to, customers on both sides of the economic exchange, also made equity swaps “incidental to the business of banking as a form of funds intermediation.”¹²⁹ Without elaborating on the concept, the OCC underscored that, in an equity swap, much like in a commodity swap, the bank acted as a financial intermediary between its customers seeking to manage their financial exposure to the underlying assets, regardless of what those assets were.

Nevertheless, the nature of the underlying asset in equity swaps and equity index swaps presented a very specific and significant legal hurdle, because the National Bank Act explicitly banned national banks from buying and holding equity stock for their own accounts.¹³⁰ To address the Glass-Steagall prohibition, the OCC again cited its prior decisions, including the MII Deposit Decision and the Matched Swaps Letter, to support a proposition that national banks may engage in financial transactions where they are not allowed to own the underlying assets, if such financial transactions are otherwise permissible under the National Bank Act. The OCC concluded, “Since national banks are exercising . . . statutory powers related to deposit taking, lending and funds intermediation when engaging in equity derivative swap activities, the prohibitions of Glass-Steagall are inapplicable.”¹³¹

In the same interpretation, the OCC permitted warehousing and

and fall in the price of a particular equity or commodity or equity index. Like a deposit that bears interest, the customer's receipt of swap payments constitutes the receipt of income for the hypothetical use of customer monies. Like debtors on bank loans, parties to swap contracts are also required to provide money to the bank based upon agreed fluctuations in the price of the relevant equity or index.

Id. at 71,749–50.

128. The OCC emphasized that equity swap transactions were distinguishable from the actual ownership of the underlying equity securities on several grounds: (i) parties to an equity swap did not acquire voting or management rights; (ii) swap counterparties' rights to receive dividend payments under an equity swap depended on the terms of the swap contract; (iii) a swap counterparty could not dispose of the underlying securities; and (iv) swap counterparties were exposed primarily to the counterparty credit risk and only secondarily to the market risks of holding the underlying equity stock. *See id.* at 71,749.

129. *Id.* at 71,750.

130. 12 U.S.C. § 24(Seventh) (2006).

131. OCC Interpretive Letter No. 652, *supra* note 124, at 71,750.

hedging equity swaps on a portfolio basis, similar to commodity swaps, by entering into cash-settled exchange-traded or OTC derivatives transactions, including futures contracts and options.¹³² Importantly, however, OCC Interpretive Letter No. 652 did not permit national banks to hedge their equity swaps by buying and selling the underlying stock. Beyond that, the key limitation imposed by the OCC on the national banks' equity swap activities was the requirement that equity swaps were not to be entered into "for speculative purposes" and that all equity swap activities were conducted in accordance with the principles of bank safety and soundness.¹³³

3. LIMITATIONS OF THE OCC'S "FUNCTIONAL EQUIVALENCY" APPROACH

As the preceding discussion shows, by the mid-1990s, the OCC had used the functional equivalency analysis to allow national banks to engage in a wide variety of cash-settled commodity and equity swaps, both on a perfectly matched and on a portfolio-hedged basis. A closer look at the OCC's interpretations reveals several trends in its reasoning. The basic principle of the OCC's statutory interpretation technique in these decisions was to represent the proposed activity in a highly generalized and abstract way, as a series of generic actions or a combination of fundamental risks, which could then be found functionally equivalent to actions and risks more immediately involved in banks' activities expressly authorized and enumerated in the powers clause. Once a particular form of derivative instrument was determined to be functionally equivalent to an express statutory power of banks, such as lending or deposit-taking, the OCC was able to forego referencing any expressly authorized bank powers and use such newly approved activity as the benchmark for functional equivalency analysis of the next derivative instrument brought for its approval.

This regulatory technique of bootstrapping bank-permissible activities, which the OCC actively used in the context of various nonderivative activities of national banks, potentially allows the agency to string along an unlimited number of bank-permissible activities. For that same reason, however, bootstrapping raises serious questions about its legal validity and is potentially vulnerable to challenges in court. Thus, in 2000, the D.C. Circuit explicitly rejected the OCC's authorization of the sale of crop insurance as a functional equivalent or a logical outgrowth of credit-related or other forms of insurance sales expressly authorized

132. *Id.* at 71,748.

133. At a minimum, this "safety and soundness" requirement meant that the bank must observe the guidelines set forth in BC-277. *Id.* at 71,751.

by the statute.¹³⁴ The court stated that authorizing activities on this basis would allow national banks “to constantly expand their field of operations on an incremental basis without congressional action,” so that “[t]here would be no logical stopping point.”¹³⁵

In order to be able to use functional equivalency as the basis for determining that a particular derivative transaction is a bank permissible activity, it was critically important for the OCC to emphasize the central role of credit risk in any such transactions and to dismiss, or significantly downplay, the importance of market risk or other forms of risk associated either with the underlying assets or the form of the transaction. Thus, the OCC repeatedly argued that, in any given commodity or equity swap contract, the bank was directly exposed solely to its counterparties’ credit risk. Since evaluating a borrower’s creditworthiness was banks’ core competency, the OCC argued, entering into commodity or equity swaps, regardless of the exact method of hedging of the bank’s exposure, did not pose any new, unfamiliar risks to the bank other than the traditional credit risk involved in corporate lending.¹³⁶ This argument, however, failed to take into account the full complexity of risks associated with commodity and equity derivatives. Despite the fundamental similarities in credit assessments of a counterparty to a swap and a corporate borrower in a traditional lending transaction, a bank acting as a principal in commodity- and equity-based derivative contracts faces significantly greater potential exposure to the risk of market price fluctuations, both with respect to the underlying asset and the derivative instrument itself.¹³⁷

134. See *Indep. Ins. Agents of Am., Inc. v. Hawke*, 211 F.3d 638, 645–46 (D.C. Cir. 2000).

135. *Id.* at 645.

136. The OCC also deliberately de-emphasized potential credit risk arising out of commodity swaps by arguing that the bank’s counterparties on both sides—the users and producers of the underlying commodities—were obligated to make payments only in situations when the movement in the market prices of the underlying commodity was in their favor and when they were “in the best financial position” to make such payments. This argument disregards the fact that, at least as a theoretical matter, in such situations the counterparty may also have a strong economic incentive to default on its payment obligations under the swap with the bank. Although, as a practical matter, this type of default may not be a frequent occurrence, particularly if the bank has ongoing customer relationships with its counterparties, the omission in the argument is notable. Another questionable assumption here is that the bank’s counterparties are always commercial hedgers rather than speculators.

137. For example, the fact that even in a perfectly matched swap the bank acting as a principal incurs legally independent payment obligations to two separate counterparties, the user and the producer of the underlying commodity, exposes the bank to commodity price risk in a more direct fashion than in any traditional lending relationship. If the counterparty to one side of a matched swap transaction defaults on its payment obligations, the bank would still be obligated to make a payment to the other, non-defaulting counterparty, and the amount of the bank’s payment obligation would depend on the movement in the price of the underlying commodity or commodity index. The level of inherent market risk is even higher in unmatched derivative transactions, in which there is a higher probability that the bank’s exposure under the derivative

Less than three years after issuing OCC Interpretive Letter No. 652, the OCC published a dedicated handbook for its bank examiners that focused specifically, and in great detail, on risk management of financial derivatives by commercial banks.¹³⁸ The *1997 Derivatives Handbook* lists nine separate categories of risk for purposes of supervising bank derivatives activities, including strategic, reputation, price, foreign exchange, liquidity, interest rate, credit, transaction, and compliance risk.¹³⁹ Although the OCC emphasized that, as a general matter, risks associated with financial derivatives were not entirely new or exotic, it also explicitly recognized that the complexity and potential severity of such risks depended on a variety of factors, including the price sensitivity or liquidity of a particular derivative instrument, as well as the degree of market price volatility of the underlying asset.¹⁴⁰ The nature and scope of a particular bank's derivatives activities also directly affect the risk profile of such bank's derivatives business. According to the *Handbook*, banks acting as dealers in derivatives markets face significantly greater risks than banks acting only as end-users and, therefore, must establish more comprehensive systems of derivatives risk management.¹⁴¹

It is notable that the *1997 Derivatives Handbook* stressed the potentially higher exposure to market, or price, risk under commodity- and equity-based derivatives, as compared to interest rate of currency derivatives:

Like equity derivatives, commodity derivatives usually expose an institution to higher levels of price risk than other financial derivatives, because of the price volatility associated with uncertainties about supply and demand and the concentration of market participants in the underlying cash markets. Because of these characteristics, the commodity derivative markets are generally much less liquid

contracts would not be fully hedged at all times. High volume of commodity and equity derivative business conducted by a dealer bank may further magnify market risk involved in these transactions.

138. COMPTROLLER OF THE CURRENCY, RISK MANAGEMENT OF FINANCIAL DERIVATIVES: COMPTROLLER'S HANDBOOK (1997) [hereinafter the *1997 Derivatives Handbook*].

139. See *id.* at 2.

140. For instance, with respect to market risk, the OCC emphasizes that "[p]rice sensitivity is generally greater for instruments with leverage, longer maturities, or option features." *Id.* at 18. In a deep, liquid market, a position may be liquidated in a short period of time, which decreases market risk associated with a particular instrument. In the absence of a liquid market, liquidating a position may generally take much longer, which increases a bank's exposure to market risk. See *id.*

141. The OCC defines "dealer" as a "bank that markets derivatives products to customers," *id.* at 3; and classifies all dealer-banks as either a Tier I dealer, which acts as a market-maker and provides quotes on derivatives products to other dealers and market professionals, or a Tier II dealer, which does not act as a market-maker and typically does not actively develop new derivative products, *id.* at 3-4.

than the interest rate and foreign exchange markets (where there are a large number of market participants), and fluctuations in market liquidity often accompany price volatility.¹⁴²

In addition, the OCC also recognized that the market risk sensitivity of any particular derivative contract was magnified by the effect of leverage, particularly where the payments under the contract were determined based on some multiple of the performance of the underlying asset.¹⁴³ Moreover, the OCC's later pronouncements explicitly stated that the credit risk posed by derivatives significantly differed from the credit risk inherent in traditional lending activities, "due to the more uncertain nature of the potential credit exposure" under derivatives contracts.¹⁴⁴

These far more nuanced observations about the risk profile of commodity and equity derivatives stand in sharp contrast to the OCC's reasoning in the Matched Swaps Letter, the Unmatched Swaps Letter, the Swap Warehousing Letter, and the OCC Interpretive Letter No. 652, which reduced the risk potential of such instruments to purely traditional credit risk. Perhaps, part of an explanation is the OCC's understandable lack of sophistication and limited understanding of these new financial instruments in the early stages of development of derivatives markets. An alternative explanation may be that, in its interpretive letters, the OCC deliberately simplified the issue in order to achieve the desired result and find proposed activities part of the "business of banking," despite what it already knew about potential risks involved in derivatives transactions. In the *1997 Derivatives Handbook*, intended for the OCC's internal consumption, the agency's purpose was to alert bank examiners to the variety and complexity of risks associated with derivatives activities. By contrast, the interpretive letters were explicitly written with certain external audiences in mind—the courts or the lawmakers, in case these decisions were ever challenged on legal or policy grounds—and the OCC's primary purpose was to advocate a position rather than present a thorough analysis of the issue.

142. *Id.* at 19–20.

143. *Id.* at 21.

144. 2007 OCC's Q. REP. ON BANK TRADING & DERIVATIVES ACTIVITIES, FOURTH QUARTER, 1, 3. According to the OCC,

With a funded loan, the amount at risk is the amount advanced to the borrower. The credit risk is unilateral; the bank faces the credit exposure of the borrower. However, in most derivatives transactions, such as swaps (which make up the bulk of bank derivatives contracts), the credit exposure is bilateral. Each party to the contract may (and, if the contract has a long enough tenor, probably will) have a current credit exposure to the other party at various points in time over the contract's life. Moreover, because the credit exposure is a function of movements in market rates, banks do not know, and can only estimate, how much the value of the derivative contract might be at various points of time in the future.

Id.

Another device the OCC used to construct its functional equivalency argument was to present a bank's role in the proposed derivatives activity as that of a simple participant in an exchange of payments. Once stripped of all transactional details and reduced merely to receiving and making payments from or to third parties, a commodity or equity swap became easily analogized to any other traditional bank activity involving exchange of money, or "funds intermediation."¹⁴⁵ Bringing lending, deposit-taking, and commodity and equity swaps to their lowest common denominator allowed the OCC to disregard any potentially significant differences among these activities and set the stage for finding commodity and equity swaps to be permissible as a functional equivalent of expressly authorized loans and deposits.

Thus, in its interpretive pronouncements on permissibility of commodity and equity swaps, the OCC began formulating the concept of financial intermediation as essentially a process of "making and receiving payments" on behalf of the bank's customers. As discussed below, the OCC later built on this concept to transcend the boundaries of a pure functional equivalency analysis and expand the definition of the "business of banking" from within.

Ultimately, however, the OCC encountered the same type of difficulties with the functional equivalency approach as it did with the original "look-through" method. On the one hand, wherever functional analysis could be used, it provided a solid ground for finding an activity permissible under the bank powers clause. Analogizing a derivative transaction to traditional lending or deposit-taking by stressing the direction of payments or the importance of counterparty credit risk, the OCC brought such transaction within the bank powers clause. By shifting the analytical focus entirely away from the nature of the underlying asset, this method allowed the OCC to overcome the inherent limitations of its original "look-through" approach and authorize banks to engage in derivative transactions linked to a wide variety of bank-ineligible assets.

On the other hand, the functional equivalency approach became increasingly constraining as bank derivatives activities became more complex. Thus, the OCC's interpretations allowing commodity and equity swaps did not permit national banks to make or accept physical delivery of the underlying commodities or equity securities. Furthermore, national banks were not allowed to buy or sell such underlying commodities or equities for the purposes of hedging their exposure

145. Arguably, the transfer of money between a drug dealer and street drug sellers would also fall under this extremely broad definition of "intermediating funds." Fortunately, the OCC has never had to face this interpretive dilemma because criminal statutes make this particular form of "financial intermediation" illegal and, thus, impermissible for banks.

under the swaps. To address these aspects of commercial banks' growing equity and commodity derivatives businesses, the OCC had to step outside the boundaries of the functional equivalency analysis.

III. THE "BUSINESS OF BANKING" AS FINANCIAL INTERMEDIATION: EVOLUTION OF THE OCC'S "ELASTIC DEFINITION" APPROACH

The most radical and far-reaching interpretive method actively utilized by the OCC to broaden bank derivatives powers was to expand the definition of the "business of banking" to encompass virtually any modern form of financial intermediation, broadly understood as a financial activity for customers' account involving exchanges of payments and assumption or transfer of financial risk. Beginning in the mid-1990s, the OCC used this line of reasoning to allow national banks to engage in physical hedging of commodity and equity derivatives, enter into certain types of equity options and forwards, trade derivatives linked to electricity prices, gas emission allowances, and real estate and natural catastrophe risk indices, and even become regional electricity marketers.

This Part traces the evolution of this "elastic definition" approach to the statutory concept of the "business of banking" and argues that, by interpreting the bank powers clause in such an extremely expansive manner, the OCC has deliberately gone beyond the bounds of reasonableness envisioned in VALIC. As a result of the OCC's interpretive efforts, the statutory concept of the "business of banking" has effectively ceased to function as a potentially limiting device with respect to commercial banks' activities and risk profile. To the contrary, the infinitely elastic concept of the "business of banking" that emerged from the OCC's recent interpretations authorizing bank derivatives transactions serves as a powerful enabling mechanism for the potentially unfettered expansion of banks' business activities.

A. *Further Expansion of Bank Permissible Derivatives Activities*

In the wake of the Supreme Court's decision in VALIC, the OCC began to push the boundaries of bank-permissible derivatives activities far beyond the reach of "functional equivalency." In the process of expanding the limits of its true and tried interpretive methods, the OCC gradually developed a new definition of the "business of banking" as pure financial intermediation, in all of its evolving forms.

1. PHYSICAL HEDGING OF COMMODITY AND EQUITY DERIVATIVES

The first area in which the OCC started gradually relaxing statutory restrictions on banks' nonbanking activities related to banks' ability to

make and accept physical delivery of equity stock or commodities as part of their business of trading and dealing in derivatives.

Despite the fact that, in the Matched Swaps Letter, the OCC specifically noted that proposed commodity derivatives were not intended for speculation on commodity prices because they did not allow for physical delivery of the underlying commodities, the agency later authorized physical hedging of banks' permissible commodity derivative activities.¹⁴⁶ Thus, in 1993, the OCC authorized national banks to hedge their previously permitted commodity-linked derivatives transactions by entering into physically settled commodity contracts and, in connection with such contracts, making or taking physical delivery of the underlying commodities, transferring documents of title, and engaging in other related activities.¹⁴⁷ In connection with the physical delivery of commodities, the OCC determined that it would also be permissible for a bank to engage in such activities as storing, transporting, obtaining, or disposing of such commodities.¹⁴⁸

The OCC reaffirmed this conclusion in its Interpretive Letter No. 684, issued shortly after the Supreme Court decided the *VALIC* case in 1995. Citing *VALIC*, as well as Interpretive Letter No. 632 and Interpretive Letter No. 494, the OCC stressed that "[m]any activities that are not included in the enumerated powers, including acting as a financial intermediary through commodity-linked transactions, are also inherent parts of the business of banking."¹⁴⁹

In Interpretive Letter No. 684, the OCC applied the three prongs of the Williams/Jacobsen test.¹⁵⁰ First, the OCC held that physical hedging was a "logical outgrowth" of bank-permissible unmatched commodity-based derivatives transactions, even if banks were not allowed to purchase the underlying nonfinancial commodities for investment purposes. Second, the OCC concluded that allowing banks to take and make physical delivery of the underlying commodities would benefit their customers. Thus, banks' ability to achieve more accurate and economical hedges would allow them to pass cost savings to their customers, allowing banks to lower their prices. Bank customers would also benefit from an increase in competition resulting from adding banks to the group of financial intermediaries able to take or make physical delivery of commodities underlying derivatives transactions. Finally, the OCC

146. See, e.g., OCC Interpretive Letter No. 896 (Aug. 21, 2000); OCC Interpretive Letter No. 684, *supra* note 59; OCC Interpretive Letter No. 632, [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,516 (June 30, 1993).

147. OCC Interpretive Letter No. 632, *supra* note 146, at 71,634-35.

148. *Id.* at 71,638.

149. OCC Interpretive Letter No. 684, *supra* note 59.

150. See *supra* notes 53-58 and accompanying text.

argued that physical delivery in commodity transactions did not pose any new or increased risks but, on the contrary, reduced the banks' risks by providing more precise hedges.¹⁵¹

However, due to the fact that physical delivery of commodities also involves additional risks in connection with the storage, transportation, and insurance of the commodities, the OCC imposed several conditions on the banks' physical hedging activities.¹⁵² In addition, the OCC included an explicit safety and soundness safeguard by requiring every individual bank to obtain the written authorization of the OCC's supervisory staff before actually commencing its physical hedging activities.¹⁵³

Physical delivery of equity securities to settle or hedge equity derivative transactions posed an even greater set of potential problems for banks because of the express prohibition under the Glass-Steagall Act on banks holding or purchasing equity stock. Nevertheless, in July 2000, the OCC authorized three national banks to purchase and hold equity securities, which banks are generally prohibited from holding under the federal banking laws, in order to hedge such banks' exposure under otherwise permissible customer-driven equity derivatives transactions.¹⁵⁴

151. See OCC Interpretive Letter No. 684, *supra* note 59. Curiously, however, the OCC conveniently ignored this heightened basis risk when it approved portfolio hedging and cross-hedging of commodity swaps in the Unmatched Swaps Letter and the Swap Warehousing Letter. Similarly, when authorizing banks to hedge their exposure under unmatched commodity swaps through commodity futures and options, the OCC did not discuss any potential liquidity issues in the markets for commodity-linked financial instruments. Here, faced with a bank's request for physical hedging, the OCC recited the applicant-bank's argument that access to physical commodity markets would reduce its basis risk "by providing a degree of liquidity that may exceed the liquidity offered by the futures markets or the cash-settled markets." OCC Interpretive Letter No. 632, *supra* note 146, at 71,636.

152. OCC Interpretive Letter No. 684, *supra* note 59. These conditions included the requirements that (i) any physical hedging activity was used only to supplement the existing hedging methods where such transactions provide a more accurate hedge; (ii) actual physical settlements constituted only in a nominal percentage of hedging transactions; (iii) all physical hedging transactions had to be customer-driven and could not be used as a means of speculating on commodity price movements; and (iv) banks conducted all such activities in a safe and sound manner and adopted and maintained proper internal risk management systems, consistent with the prudential guidelines in the key OCC document addressing the safety and soundness of derivatives: BC-277. See *id.*

153. *Id.* The OCC's supervisory review and approval prior to a bank's commencement of its derivatives program is typically administered through the bank's Examiner In Charge (EIC) issuing a no-objection ruling.

154. U.S. GAO, EQUITY HEDGING: OCC NEEDS TO ESTABLISH POLICY ON PUBLISHING INTERPRETIVE DECISIONS 5 (2001); see also OCC Interpretive Letter No. 935, at 1 (May 14, 2002) ("The OCC has determined that it is legally permissible for a national bank to purchase and hold equity securities that banks do not generally have authority to purchase to hedge customer-driven, bank permissible equity derivative transactions."); OCC Interpretive Letter No. 892, at 1 (Sept. 13, 2000) ("[T]he OCC determined, in the case of three national banks, that the banks could take

The OCC's approval of physical hedging of banks' equity derivatives transactions, which the OCC chose not to publish and distributed only among its select officials,¹⁵⁵ quickly became the center of a political controversy when Congressman James A. Leach, outraged by what he had perceived as a violation of the Glass-Steagall Act's prohibition on bank purchases of equity for their own account, demanded an explanation from the OCC. In response to Congressman Leach's request, the then-Comptroller John Hawke issued Interpretive Letter No. 892, in which he offered a detailed account of his agency's position on the issue of permissibility of bank equity derivatives and related hedging activities.

Citing the OCC's own "longstanding" precedent, the Comptroller's letter concluded that hedging risks arising from permissible equity derivatives activities was an integral part of permissible financial intermediation activities of banks and, thus, a part of the "business of banking."¹⁵⁶ In addition, according to the Comptroller, equity hedging was "incidental" to the "business of banking," because hedging permissible equity derivatives through holding the underlying securities was "convenient and useful" to banks conducting permissible equity derivatives transactions.¹⁵⁷ The OCC's reasoning was based entirely on the fact that physical holdings of equity would increase the banks' profitability and efficiency by reducing the costs of hedging their equity derivatives transactions.¹⁵⁸

positions in equity securities solely to hedge bank permissible equity derivative transactions originated by customers for their valid and independent business purposes.").

155. The original memorandum setting forth the OCC's rationale for authorizing the banks' equity hedging programs, prepared on July 13, 2000, was distributed solely to Deputy Comptrollers for Large Bank Supervision. See U.S. GAO, *supra* note 154, at 10.

156. OCC Interpretive Letter No. 892, *supra* note 154, at 7-9.

157. *Id.* at 2, 4. Prior to the OCC's approval of physical hedging of banks' equity derivatives, dealer-banks hedged their exposure by entering into perfectly matched offsetting transactions with their nonbank affiliates, which then bought or sold the underlying equity shares to achieve the desired hedge position. See *id.* at 2-3.

158. According to the Comptroller,

The equity hedges enable the banks to protect against loss in banking transactions in the most efficient manner and therefore are convenient and useful to the banks' equity derivative business. Here, the banks represented that physically hedging equity derivative transactions within the banks, rather than through affiliates, will enable them to retain additional revenues from equity derivative activities and enjoy substantial cost savings. Furthermore, when the mirror transactions are eliminated, the revenues and profits generated by the equity derivative transactions and the physical hedges will accrue to the benefit of the banks. Permitting the banks to use equities to hedge risks arising from permissible equity derivative transactions thus will enable the banks to operate more efficiently, compete more effectively with entities that engage in similar optimal hedges, offer customers the least costly and most attractive products and services, and operate profitably.

Id. at 9.

Characteristically, the sixteen-page-long letter did not contain any substantive discussion of long-term consequences of, or potential risks associated with, allowing banks to buy and sell equity as part of their derivatives hedging programs.¹⁵⁹ Instead, the OCC's approval was subject to several conditions, including a commitment by the banks not to hold equity securities for speculative purposes and to limit their total holdings of securities under the hedging program to five percent of a class of stock of any issuer.¹⁶⁰ In addition, the OCC reiterated its usual requirement that, before any bank establishes an equity hedging program, it must obtain specific approval from the OCC Examiner In Charge, based on its review of the bank's internal risk management system.

Upon Congressman Leach's request, the U.S. General Accounting Office (GAO)¹⁶¹ reviewed the OCC's decision process with respect to national banks' equity hedging activities and published a report in August of 2001.¹⁶² Largely reiterating the OCC's reasoning, the GAO's report agreed with its conclusion as to the permissibility of equity hedging as an activity incidental to otherwise permissible equity derivatives activities of national banks but criticized the agency's lack of a clearly articulated policy on publishing its interpretive decisions.¹⁶³ However, the *GAO Equity Hedging Report* did not scrutinize the fundamental assumptions built into the OCC's interpretation and unquestioningly relied on the same Williams/Jacobsen test to conclude that the OCC's decision was a reasonable interpretation of the bank powers clause.¹⁶⁴

The GAO's concurrence solidified the OCC's reign as the agency whose decisions on the scope of banks' derivatives powers remained

159. The bulk of the Comptroller's letter contained an intricate and detailed argument as to why the precise language of section 16 of the Glass-Steagall Act did not prohibit purchases and sales of equity for hedging purposes. Essentially, the OCC's argument was that section 16 did not prohibit bank equity ownership to the extent such ownership was *otherwise authorized* as incidental to, or part of, the "business of banking." *Id.* at 10–15.

160. *Id.* at 1–2. The bank must establish to the OCC's satisfaction that, among other things, it will hold equity securities solely to hedge risks from permissible derivative activities and not for speculative purposes, it generally will not take anticipatory or maintain residual positions in the securities, and it will not acquire more than five percent of a class of securities of any single issuer for hedging purposes. *Id.* at 1. Importantly, the five percent concentration limit does not have a statutory basis and the OCC may, therefore, increase that threshold in its full discretion.

161. The GAO was later renamed and is currently known as the Government Accountability Office.

162. U.S. GAO, *supra* note 154.

163. The GAO generally seemed unconvinced that the reason for the OCC's secretive behavior (such as distributing the original authorization strictly to a narrow circle of OCC's legal and supervisory personnel) was not simply its fear of negative reaction on the part of legislators and other bank regulators. Importantly, the GAO recommended that the OCC start publishing all interpretations of § 24(Seventh). See U.S. GAO, *supra* note 154, at 12–14, 20–22.

164. See *id.* at 32–35.

largely beyond the reach of lawmakers' criticism. Subsequently, the OCC further expanded national banks' ability to purchase and hold a wide range of bank-ineligible securities for purposes of hedging permissible equity derivatives transactions. Thus, in July 2006, the OCC confirmed that it was permissible for national banks to hedge bank-permissible derivative transactions by buying and selling below-investment grade debt instruments.¹⁶⁵ In October 2007, the OCC authorized national banks to hedge bank-permissible derivatives transactions by purchasing and holding, among other things, equity interests in limited partnerships, limited liability companies, closed and open-end mutual funds, exchange traded funds, and real estate investment funds.¹⁶⁶

The specific inclusion of limited partnership and LLC interests in this list of equity securities means that national banks may purchase and hold interests in hedge funds and private equity funds for purposes of hedging their exposure under other bank-permissible derivative transactions—a valuable right for banks seeking to offer their customers derivative instruments linked to the performance of hedge funds.¹⁶⁷ However, the OCC's interpretation did not engage in any discussion of the potential differences between risks inherent in either synthetic or direct investment in hedge funds, on the one hand, and risks associated with investing in traditional corporate stock, on the other.¹⁶⁸

2. BEYOND “FUNCTIONAL EQUIVALENCY”

In a series of interpretive letters issued between 2002 and 2008, the OCC broadened the powers of national banks to engage in a wide variety of cash-settled, customer-driven equity and commodity derivative transactions—swaps, options, forwards, etc.—and hedge the risks arising from such transactions.¹⁶⁹ These permissible activities included

165. See OCC Interpretive Letter No. 1064, at 3 (July 13, 2006).

166. See OCC Interpretive Letter No. 1090, at 1–3 (Oct. 25, 2007). The applicant-bank, which already had a well-established equity derivatives business and hedged its exposure with other equity derivatives or physical holdings of equity on the basis of the OCC's prior interpretations and supervisory authorizations, was seeking a confirmation that those prior authorizations continued to apply to physical hedges involving all these types of equity interests. *Id.* at 7.

167. Beginning in 2004 and 2005, various hedge fund-linked derivatives—highly complex, individually tailored, and generally illiquid instruments—became increasingly popular among sophisticated investors. Hedging these nonstandard and hard-to-value instruments is both critically important and difficult to achieve synthetically. Thus, one could argue that legal availability of direct hedging, in effect, enabled, and even encouraged, commercial banks to enter that potentially lucrative but high-risk market.

168. The OCC specifically noted that the applicant-bank's request did not include any type of interest in a hedge fund or investments in real estate. OCC Interpretive Letter No. 1090, *supra* note 166, at 3 n.14. Nevertheless, that fact alone does not seem like a satisfactory reason to avoid this important issue.

169. See, e.g., OCC Interpretive Letter No. 1081 (May 15, 2007); OCC Interpretive Letter No.

cash-settled, perfectly matched derivatives instruments involving exchanges of payments based on the price of electricity,¹⁷⁰ and cash-settled equity options and forward contracts (as opposed to the previously authorized equity swaps).¹⁷¹ In each case, the OCC conditioned its authorization on the fact that the relevant derivatives activities were part of the bank's customer-driven,¹⁷² "non-proprietary financial intermediation business" and that the bank "ha[d] in place an appropriate risk measurement and management process for its derivatives and hedging activities."¹⁷³

What makes these interpretations particularly notable is that they contain the OCC's new, revisionist view of its own prior decisions regarding permissibility of commodity and equity derivatives activities. In these interpretive letters, the OCC pointed specifically to the Matched Swaps Letter and the Unmatched Swaps Letter as examples of pre-*VALIC* reasoning, in which the emphasis was placed mainly on characterizing commodity and equity derivatives as functional equivalents of lending and deposit-taking powers expressly authorized under § 24(Seventh). The OCC emphasized that, since the issuance of those early interpretations, it had concluded that "swaps and funds intermediation activities [we]re part of the business of banking" and did not need to be analogized to any expressly enumerated statutory powers.¹⁷⁴

On this basis, the OCC concluded that, through prior decisions, it had already authorized national banks to "engage in customer-driven, non-proprietary derivatives transactions involving exchanges of payments as part of a financial intermediation business."¹⁷⁵ The OCC then used the familiar functional equivalency argument, stating that cash-settled equity options and forwards and electricity-linked derivatives were functionally equivalent to the previously authorized equity and commodity swaps as activities fundamentally involving exchanges of payments based on changes in the value of equities.¹⁷⁶

1079 (Apr. 19, 2007); OCC Interpretive Letter No. 949 (Sept. 19, 2002); OCC Interpretive Letter No. 937 (June 27, 2002).

170. See OCC Interpretive Letter No. 937, *supra* note 169, at 1 & n.1.

171. See OCC Interpretive Letter No. 949, *supra* note 169, at 1.

172. The OCC defined "customer-driven" as a transaction entered into for a customer's "valid and independent business purposes." OCC Interpretive Letter No. 892, *supra* note 154, at 1.

173. OCC Interpretive Letter No. 949, *supra* note 169, at 1.

174. *Id.* at 3 n.4; see also OCC Interpretive Letter No. 937, *supra* note 169, at 10–11 (reconsidering the primary basis for prior authorizations of commodity-linked swaps); OCC Interpretive Letter No. 892, *supra* note 154, at 7 n.19 (reconsidering the basis for authorizing equity-based swaps in OCC Interpretive Letter No. 652 that characterized swaps as an activity functionally equivalent to lending and deposit-taking).

175. OCC Interpretive Letter No. 949, *supra* note 169, at 2.

176. *Id.* at 3. For example, in OCC Interpretive Letter No. 937, the OCC stressed,

Electricity derivative transactions are a natural extension of the Bank's existing

Thus, the OCC retroactively expanded the scope of its own prior decisions regarding permissibility of derivative transactions under the bank powers clause. In approving banks' initial forays into the derivatives business, the OCC focused on specific characteristics of swaps and relied primarily on deconstructing a swap as a financial instrument combining the elements of lending and deposit-taking. It was this *form-specific* reasoning that served as the basis for the OCC's subsequent expansion of bank derivatives activities. By retroactively revising its prior decisions to encompass a significantly broader universe of derivative instruments, the OCC has created an illusion of a stronger precedential basis for its new, expansive concept of the "business of banking" as financial intermediation involving exchanges of payments.

This extremely broad formulation did not call for an analysis of the nature of the activity in question and the overall risks involved in permitting banks as a group to conduct such activities. Instead, the OCC conditioned the permissibility of these newly approved equity and electricity-linked derivatives activities for each specific bank on that bank's ability to conduct them in a "safe and sound" manner.¹⁷⁷ To the extent the OCC's new version of its own interpretive position contained any general limitations on banks' commodity and equity derivatives activities, such limitations pertained only to banks' potential ability to enter into derivatives trades that were proprietary, speculative, or settled by physical delivery of the underlying assets. Perhaps more importantly,

energy derivative products, e.g., petroleum, natural gas, and other hydrocarbon derivative products. Electricity swaps, forwards and options are the operational, structural, and functional equivalents of commodity derivative transactions the OCC has previously determined are permissible for national banks.

OCC Interpretive Letter No. 937, *supra* note 169, at 7. The OCC advanced a similar argument in OCC Interpretive Letter No. 949:

Cash-settled equity options and forwards may be permissible for national banks under the same rationale provided in the OCC precedent addressing equity and equity index swaps. Similar to equity swaps, cash-settled equity options and forwards are privately negotiated contracts between parties that enable customers to manage financial risks relating to price fluctuations in equities and market uncertainties. Similar to swaps, those option and forward products fundamentally involve exchanges of payments based on the change in the value of equities. In fact, comparable payment obligations may be created using equity swaps, options and forwards.

OCC Interpretive Letter No. 949, *supra* note 169, at 3 (footnote omitted).

177. See BC-277, *supra* note 70. In what became a standard condition on authorizations of bank derivatives activities, the OCC stated that, before a particular bank could enter into cash-settled equity options or forwards, it had to obtain a supervisory approval from the OCC, based on the examining staff's review of the bank's risk management and internal control system, which, at a minimum, must comply with the OCC guidelines for financial derivative activities (setting forth certain requirements for the senior management oversight of derivative activities of the bank, market risk management, credit and liquidity risk management, capital adequacy, and other internal controls). *Id.*

however, these formally announced limitations seem to have very little practical effect on banks' ability to expand their derivatives activities. The OCC's treatment of the requirement of cash settlement exemplifies this trend.

3. PHYSICALLY SETTLED COMMODITY DERIVATIVES

Gradually, the OCC began relaxing the requirement that bank-permissible commodity derivatives be settled in cash and allowing banks to accept transitory title transfers to the underlying commodities, including electricity, coal, and various metals.

Thus, in 2003, the OCC further expanded banks' powers to conduct electricity-linked derivatives business by permitting transitory title transfers to electricity, whereby the bank "takes title to electricity in a 'chain of title' and relinquishes title instantaneously," to settle and hedge its existing electricity derivatives transactions.¹⁷⁸ In April 2006, the OCC determined that it was permissible for national banks to engage in customer-driven coal derivatives transactions that settled in cash or by transitory title transfer and were hedged on a portfolio basis with derivatives or spot market transactions, which also settled in cash or by transitory title transfer.¹⁷⁹ The OCC also allowed cross-hedging of the bank's coal derivatives transactions, with the same ability to take transitory title transfer to commodities underlying the hedging transactions.¹⁸⁰ A few months later, the OCC allowed national banks to conduct customer-driven derivatives transactions based on the price of metals,¹⁸¹ which settled in cash or by transitory transfer of title and which were hedged on a portfolio basis with exchange-traded and OTC derivatives transac-

178. OCC Interpretive Letter No. 962, at 2 (Apr. 21, 2003). This interpretation was issued in response to a request by Bank of America and made subject to the standard safety and soundness conditions requiring supervisory review of the bank's risk management capabilities. *Id.* at 5. In April 2005, the OCC authorized JPMorgan Chase Bank to conduct, subject to the OCC's supervisory approval, a similar electricity derivatives program involving both cash-settled transactions and transactions settled through transitory title transfer. *See* OCC Interpretive Letter No. 1025, at 1 (Apr. 6, 2005).

179. *See* OCC Interpretive Letter No. 1060, at 1 (Apr. 26, 2006). The OCC issued Interpretive Letter No. 1060 in response to another request by JPMorgan Chase Bank, which had previously received authority to conduct cash-settled, perfectly matched commodity derivatives business, including transactions based on the price of coal and related indices.

180. *Id.* at 2. The OCC stated that, for cross-hedging purposes, the bank could use only derivative contracts on the commodities, which the OCC approved for hedging in OCC Interpretive Letter No. 1039 (Sept. 13, 2005), "or other relevant OCC precedent," and which were "approved for hedging by transitory title transfer in OCC precedent." OCC Interpretive Letter No. 1060, *supra* note 179, at 2.

181. *See* OCC Interpretive Letter No. 1073, at 1 (Oct. 19, 2006). The term "metals" in OCC Interpretive Letter No. 1073 included all metals other than those that national banks already had the express authority to buy as "exchange, coin and bullion" under § 24(Seventh). *Id.* at 1 n.2.

tions that settled in cash or by transitory transfer of title.¹⁸²

The OCC's decisions rest on three interrelated lines of argument. First, the OCC argued that the proposed transactions were "a natural extension" of the applicant banks' "existing financial intermediation activities."¹⁸³ According to the OCC, changing the reference asset did not alter the nature of the risks or the nature of the activity, which was a mere financial intermediation. Citing OCC Interpretive Letter No. 1025, the OCC concluded, "In conducting transitory title transfers in connection with a permissible derivatives business, banks act as financial intermediaries, ultimately exchanging payments between counterparties managing financial risks or otherwise meeting financial needs."¹⁸⁴

The second line of the OCC's argument held that the proposed transactions would increase banks' profitability and competitiveness by allowing banks to offer their customers (such as mining companies or power generators) a broader range of products, to expand their customer base, and to broaden the markets in which they can participate. This expansion may, in turn, diversify and reduce risks arising from its existing commodity and energy derivatives business. Finally, the OCC emphasized that portfolio hedging and transitory title transfer would increase banks' hedging options and their ability to control risks more effectively.¹⁸⁵

182. OCC Interpretive Letter No. 1073 was issued in response to an application by Bank of America and its London branch. Bank of America had already received permission from the OCC to conduct cash-settled, perfectly matched derivatives based on the price of aluminum, nickel, lead, zinc, and tin, pursuant to OCC Interpretive Letter No. 1039. See OCC Interpretive Letter No. 1039, *supra* note 180, at 1-2. More generally, it was an active and significant participant in commodity derivatives markets and conducted transitory title transfer transactions in its electricity-linked derivatives business. The bank's customers included "producers and consumers of metals, utilities, hedge funds, and merchant/trading companies." OCC Interpretive Letter No. 1073, *supra* note 181, at 2 n.8.

183. OCC Interpretive Letter No. 1060, *supra* note 179, at 6. In this interpretation, the OCC maintained that the applicant, JPMorgan Chase Bank, already had authority to enter into electricity-based derivatives transactions that settled by transitory title transfer and to hedge derivatives contracts based on the price of crude oil, natural gas, and electricity on a portfolio basis. *Id.* at 1. Thus, it had the experience with managing the risks of both portfolio hedging (by dynamically adjusting the hedges, as new transactions were added to the portfolio) and transitory title transfers.

184. *Id.* at 6.

185. The OCC argued that portfolio hedging, which allowed the bank to recognize naturally offsetting positions in its portfolio and to hedge only a residual risk position, reduced the bank's transaction costs and operational risks associated with multiple transactions and was therefore a more convenient and cost-effective method of hedging than perfectly matched transactions. Although in perfectly matched transactions, the bank retained only the counterparty credit risk, "portfolio-hedging may expose the Bank to market and basis risk (i.e., the risk that the price fluctuations of the hedging instruments will not exactly match price fluctuations of the underlying transactions)[;] however, these risks will be subject to risk management limits." *Id.* at 3. Basis risk, which tends to become more pronounced during the lifetime of a transaction, makes accurate hedging particularly important. The OCC concluded that, because cash-settled instruments may

The OCC's determination of legal permissibility of the proposed transactions was subject to the usual condition of safety and soundness, as detailed in the *1997 Derivatives Handbook* and BC-277.¹⁸⁶ However, recognizing that these particular transactions may be trading dangerously close to energy and commodity trading, a commercial activity impermissible for banks, the OCC imposed certain additional risk management requirements.¹⁸⁷ The OCC required that the bank's risk management processes must include an independent compliance monitoring program to ensure compliance with the specific commitments made by the bank with respect to the derivatives activities, including a commitment to conduct its proposed commodity derivatives business only as a customer-driven financial intermediation and non-proprietary trading business.¹⁸⁸

4. BROADENING THE SCOPE OF PERMISSIBLE REFERENCE ASSETS

The new notion of the "business of banking" as unlimited financial intermediation gave the OCC a broader leeway to authorize banks to offer their customers new types of derivatives instruments replicating financial exposure to a potentially infinite variety of assets.

In 2007, the OCC concluded that national banks may engage in customer-driven, perfectly matched, cash-settled derivatives transactions

provide less than the most accurate hedges, "the ability to engage in transitory title transfers involving coal will enable the Bank to more accurately and precisely hedge its proposed coal derivative transactions and substantially reduce its basis risk in portfolio-hedged coal derivative transactions. *Id.*

186. The OCC reiterated that an effective system of risk management would include "board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function that oversees and ensures the appropriateness of the risk management process." *Id.* at 7. Banks' risk control processes should encompass compliance with the applicable accounting and bank reporting requirements. *Id.*

187. For example, the OCC required that the program also be effective in preventing "manipulative practices of any kind" and, among other things, included a "well-defined exception approval and reporting procedures." *Id.* at 8.

188. For instance, Bank of America explicitly stated that the proposed metal derivative transactions would be conducted in a manner consistent with the policies, procedures, and controls it applied to its existing commodity derivatives business and that it would:

- (i) not engage in metal derivative transactions other than cash-settled transactions and those that settle by transitory title transfer, (ii) not run a proprietary book in metal derivatives (except insofar as that book is created to accommodate customer-driven transactions or as part of the Bank's portfolio hedging strategy), (iii) limit trading in the proposed metal derivatives exclusively to hedge residual open positions arising from customer transactions, (iv) not take physical positions in metals, and (v) conduct its metal derivative business in a safe and sound manner and consistent with prudent risk management practices prescribed [*sic*] the *OCC Handbook: Risk Management of Financial Derivatives* and Banking Circular 277.

OCC Interpretive Letter No. 1073, *supra* note 181, at 5 (footnote omitted).

on inflation indices,¹⁸⁹ property indices,¹⁹⁰ and “risk indices associated with designated types of natural events and catastrophes.”¹⁹¹ Thus, in OCC Interpretive Letter No. 1079, the OCC authorized the applicant bank to offer swaps, caps, floors, and swaptions based on inflation indices to corporate and institutional clients seeking to hedge their inflation exposure under various contractual obligations or by virtue of providing goods and services.¹⁹² In OCC Interpretive Letter No. 1081, the OCC allowed a national bank to offer cash-settled property index swaps, forwards, and options to investment funds, pension funds, property investors, corporations, financial institutions, high net worth individuals, and affiliates of the bank.¹⁹³ Finally, in OCC Interpretive Letter No. 1101,

189. See OCC Interpretive Letter No. 1079, *supra* note 169, at 1. The inflation derivatives referenced in this interpretation were linked to U.S. consumer price index (CPI), various CPI sub-indices, and the producer price index (PPI), regularly published by the U.S. Bureau of Labor Statistics (BLS). As the OCC explained, each of the PPI and the CPI is a large “family of indices that measure the average change over time in the prices” of goods and services in the economy—PPIs measure the changes in prices received by domestic producers of goods and services, while CPIs measure the changes in prices paid by consumers of such goods and services. *Id.* at 2 n.4. “The BLS reports PPIs and CPIs every month for virtually every sector of the U.S. economy.” *Id.*

190. See OCC Interpretive Letter No. 1081, *supra* note 169, at 1. These property indices included major U.S. and UK commercial and residential property indices, such as the Investment Property Databank (IPD) UK Annual Index, tracking commercial property values in the UK, and the House Price Indices (HPI), tracking values of single-family homes in the U.S. See *id.* at 2. In October 2007, the OCC further expanded the range of bank-permissible property index linked derivative transactions to include customer-driven, perfectly matched, cash-settled swaps, forwards, and options on certain additional property indices. See OCC Interpretive Letter No. 1089 (Oct. 15, 2007).

191. OCC Interpretive Letter No. 1101, at 1 (July 7, 2008). The reference indices for the swaps permitted under OCC Interpretive Letter No. 1101 included Property Claim Services Indices based on the estimated economic consequences of specific natural catastrophe events and used in industry-loss based transactions, Eqecat indices tracking changes in the physical characteristics of natural catastrophes in specific locations over defined periods of time, and parametric indices reflecting measurements of the physical characteristics of specified natural catastrophe events. See *id.* at 3.

192. OCC Interpretive Letter No. 1079, *supra* note 169, at 2. Representative examples of such transactions cited in the letter included a real estate property manager receiving rent payments linked to inflation indices and seeking to swap them for fixed rate payments sufficient to service his fixed rate debt obligation on the property, an insurance company offering customers insurance products with benefits linked to inflation and seeking to mitigate its risk by receiving inflation-linked payments from the bank in exchange for fixed-rate payments, and a pension fund seeking to protect itself from potential increases in its liabilities as a result of inflation rising above a certain level. *Id.* Under the bank’s proposal, its affiliate specializing in inflation-linked financial products was to be its counterparty for all perfectly matched hedging transactions. *Id.* The OCC noted that this arrangement shifted the market risk to the bank’s affiliate, which would also assume all transactional and operational risk associated with these transactions. *Id.* The bank would manage legal, compliance, and counterparty credit risk by executing all transactions under the standard industry documentation and applying its standard counterparty credit approval and monitoring process. *Id.*

193. According to the application, the bank’s customer base for property index derivatives would not include retail investors. OCC Interpretive Letter No. 1081, *supra* note 169, at 2. As the letter explained, property index derivatives were attractive to banks’ customers as a means of

the OCC confirmed that it was permissible for national banks to engage in customer-driven, perfectly matched, cash-settled derivatives on indices referencing “large-scale natural catastrophe events,”¹⁹⁴ where the parties’ payment obligations existed regardless of the parties’ actual exposure to the underlying risk.¹⁹⁵

In all three cases, the OCC based its approval on the argument that the proposed programs fell within the parameters of bank-permissible financial intermediation business.¹⁹⁶ The OCC argued that the proposed derivative transactions linked to inflation, real property, or catastrophe risk indices, as well as the related hedging activities, involved exchanges of payments with the bank acting as a financial intermediary between customers, which was a traditional and permissible banking function. As the OCC asserted, “The proposed transactions will not result in any substantive change in the type or nature of financial intermediation activities provided by the Bank, but only in its underlying basis (i.e., inflation indices).”¹⁹⁷ The OCC emphasized that, in each case, the proposed index

managing financial risks associated with investment in real estate or gaining synthetic exposure to real estate market without dealing in physical property. *Id.*

194. OCC Interpretive Letter No. 1101, *supra* note 191, at 2. OCC Interpretive Letter No. 1101 specifically addressed swaps but made clear that other types of natural catastrophe derivatives may also be permissible under the same interpretation. *See id.* at 7–8.

195. These catastrophe risk swaps are fundamentally similar to so-called “naked” credit default swaps: They essentially function as a speculative purchase or sale of insurance without an “insurable interest.” Credit default swaps were widely criticized as instruments enabling excessive speculation in asset-backed securities that eventually triggered the current global financial crisis. *See, e.g.,* George Soros, *The Game Changer*, FT.COM, Jan. 29, 2009, <http://www.ft.com/cms/s/0/09b68a14-eda7-11dd-bd60-0000779fd2ac.html>.

196. The OCC cited OCC Interpretive Letter No. 1065 (July 24, 2006), Interpretive Letter No. 1039, and the MII Deposit Decision to support this general proposition. According to the OCC,

Banks have long served as financial intermediaries between customers, most traditionally by taking deposits and making loans, to facilitate the flow of funds in the economy and meet various customer financial needs. National bank derivative activities may extend beyond traditional deposit taking and lending, but these activities are, at their essence, modern forms of financial intermediation. Through intermediated exchanges of payments, banks facilitate the flow of funds within our economy and serve important financial risk management and other financial needs of bank customers.

OCC Interpretive Letter No. 1081, *supra* note 169, at 5.

197. OCC Interpretive Letter No. 1079, *supra* note 169, at 6; *see also* OCC Interpretive Letter No. 1081, *supra* note 169, at 6 (“The proposed transactions will not result in any substantive change in the type or nature of financial intermediation activities provided by the Bank, but only in its underlying basis (i.e., property indices).”). In authorizing inflation index-based derivatives in OCC Interpretive Letter No. 1079, the OCC also utilized the familiar “look-through” approach and argued that national banks, which already conducted activities in inflation-linked products, could therefore engage in derivative transactions referencing such bank-permissible instruments. OCC Interpretive Letter No. 1079, *supra* note 169, at 5–6. For this proposition, the OCC cited the MII Deposit Decision and OCC Interpretive Letters No. 1039 and 1065. The OCC stressed that the proposed transactions would be “in furtherance of the Bank’s already authorized ability to engage in inflation-linked products, such as investment securities, certificates of deposit, and

derivatives program would enable the applicant bank to be more profitable and competitive, to expand its customer base, and to take advantage of its strong credit ratings and existing financial intermediation expertise.¹⁹⁸

However, once again, the OCC's decisions contained no substantive discussion of how the exposure to new types of risks associated with these new types of underlying assets increased potential risk to the safety and soundness of individual banking institutions or the banking sector as a whole. Focusing almost exclusively on potential increases in banks' profitability and competitive strength, the agency's interpretations failed to mention the other side of the inevitable trade-off: increasing U.S. banks' vulnerability to such distant shocks as sudden changes in the value of non-U.S. real estate or natural disasters in remote corners of the planet undergoing a major climate change.¹⁹⁹

B. "*Business of Banking*" or "*Business of Commerce*"?

One of the critical, and largely overlooked, implications of the OCC's recent expansion of bank-permissible derivatives and related hedging activities is the corrosive effect of such expansion on the principle of separation of banking and commerce underlying the entire system of U.S. bank regulation.

1. COMMODITY DERIVATIVES: FINANCIAL INTERMEDIATION OR TRADE INTERMEDIATION?

In September 2005, in response to a request by JPMorgan Chase Bank (Chase), the OCC issued an interpretation permitting national banks to engage in customer-driven, perfectly matched, cash-settled derivatives transactions on a long list of various commodities and related

derivatives on these instruments." *Id.* at 3. An example of such authorized activities was banks' power to deal in, underwrite, and purchase and sell for their own accounts Treasury-Inflation Protected Securities (TIPS) issued by the Department of the Treasury and backed by the full faith and credit of the U.S. government. *Id.*; accord 12 C.F.R. §§ 1.2(j)(2), 1.3(a) (2008).

198. See, e.g., OCC Interpretive Letter No. 1081, *supra* note 169, at 4. According to the OCC, offering these new types of derivatives transactions would be a "natural extension" of the bank's existing perfectly matched, customer-driven derivatives business, as it would allow the bank to meet existing customer demand for managing, e.g., real property exposure "in substantially the same manner" as it was done with respect to its existing equity and commodity derivatives. *Id.*

199. For example, the insurance industry is currently struggling with the challenges of pricing and managing natural catastrophe risk in the face of global climate change. See, e.g., Michael G. Faure, *Insurability of Damage Caused by Climate Change: A Commentary*, 155 U. PA. L. REV. 1875 (2007); Howard C. Kunreuther & Erwann O. Michel-Kerjan, *Climate Change, Insurability of Large-Scale Disasters, and the Emerging Liability Challenge*, 155 U. PA. L. REV. 1795 (2007). Thus, it seems reasonable to conclude that commercial banks' increased involvement in this highly volatile and uncertain market merits far more attention and thoughtful analysis on the part of the regulators than what the OCC had given it in OCC Interpretive Letter No. 1101.

indices.²⁰⁰ OCC Interpretive Letter No. 1039 was very broad in its scope and did not limit permissible derivatives transactions to swaps or any other particular form of financial instruments.²⁰¹

Under Chase's proposed program, the bank was to hedge its derivatives transactions with its customers by entering into offsetting mirror transactions with its affiliate, a subsidiary of the bank's parent company, engaged in commodity trading and commodity derivatives business and not rated by any credit rating agency. Both the bank and its affiliate could initiate and negotiate transactions with unaffiliated parties (which had to be pre-approved by the bank), but it was the bank that always acted as a counterparty in each transaction with such third parties.²⁰²

In granting its approval, the OCC relied heavily on the Matched Swaps Letter, which allowed banks to enter into perfectly matched, cash-settled commodity price index swaps.²⁰³ The OCC noted that the only differences between swaps approved in 1987 and the proposed program under consideration were the use of an affiliate for the offsetting transaction and the expansion of the list of commodities and commodity price indices that may be used as reference assets. According to the OCC, based on Chase's presentation of facts, these differences did not "alter the nature of the proposed activities as financial intermediation."²⁰⁴ The OCC stressed that, because the transactions approved in the

200. OCC Interpretive Letter No. 1039, *supra* note 180. The list of commodities and indices approved as potential reference assets underlying these derivatives transactions included crude oil, natural gas, heating oil, natural gasoline, gasoline, unleaded gas, gasoil, diesel, jet fuel, jet kerosene, residual fuel oil, naphtha, ethane, propane, butane, isobutene, crack spreads, lightends, liquefied petroleum gases, natural gas liquids, distillates, oil products, coal, emissions allowances, benzene, dairy, cattle, wheat, corn, soybeans, soybean meal, soybean oil, cocoa, coffee, cotton, orange juice, sugar, paper, rubber, steel, aluminum, zinc, lead, nickel, tin, cobalt, iridium, rhodium, freight, high density polyethylene (plastic), ethanol, methanol, newsprint, paper (linerboard), pulp (kraft), and recovered paper (old newsprint).

Id. at 1–2.

201. Despite the broad language of OCC Interpretive Letter No. 1039, the OCC continued to receive requests from banks to approve their customer-driven, perfectly matched, cash-settled derivatives transactions linked to various categories of reference commodities that were not explicitly listed in Interpretive Letter No. 1039. *See, e.g.*, OCC Interpretive Letter No. 1065, *supra* note 196 (numerous things); OCC Interpretive Letter No. 1063 (June 1, 2006) (hogs, lumber, corrugated cardboard, polystyrene); OCC Interpretive Letter No. 1059 (Apr. 13, 2006) (polypropylene, old corrugated cardboard); OCC Interpretive Letter No. 1056 (Mar. 29, 2006) (frozen concentrate orange juice).

202. OCC Interpretive Letter No. 1039, *supra* note 180, at 2. The offsetting transactions between the bank and its affiliate would be made on market terms and documented under standard industry documentation. The bank would also provide operational and administrative services to the affiliate.

203. *See* Matched Swaps Letter, *supra* note 72, at 76,640.

204. However, the OCC disregarded the fact that the Matched Swaps Letter authorized only commodity and commodity price index *swaps*, as opposed to derivatives transactions generally. In that particular interpretation, the OCC's argument rested partly on the functional equivalence

Matched Swaps Letter and the transactions proposed by the applicant bank were perfectly matched, the only risk assumed by the bank was its credit risk with respect to the counterparties.²⁰⁵ Citing OCC Interpretive Letter No. 937, the OCC claimed that it has

already determined national banks may engage in derivative transactions on any commodity where the use of the commodity will not result in any substantive change to the type or nature of the financial intermediation activity but only in its underlying basis (i.e., the particular commodity or related index used as the reference asset).²⁰⁶

Thus, the OCC concluded that the bank could act as a financial intermediary in customer-driven, perfectly matched, cash-settled derivatives transactions on the listed commodities and related indices, subject only to the usual condition that the OCC (acting through the bank's EIC) was satisfied with its risk management systems and controls.

Despite the routine reasoning and unassuming tone of the decision, the full regulatory implications of the OCC's Interpretive Letter No. 1039 can only be understood in the broader context of the commodity and energy trading and derivative business conducted by JPMorgan Chase & Co. (JPMC), the ultimate parent company of Chase and a bank holding company (BHC) within the meaning of the BHC Act.²⁰⁷

As a general matter, BHCs are permitted, with the Federal Reserve's approval, to engage as principals in a wide range of exchange-listed or OTC derivative transactions, based on financial and nonfinancial assets, provided that, among other things, the contracts either require cash settlement or allow for prior offset, and the bank holding company either makes every effort to avoid physical delivery or effects delivery by instantaneous transfer of title to a third party, without taking

between proposed perfectly matched commodity swaps and perfectly matched interest rate swaps, which were widely used by banks at the time and viewed as part of traditional "funds intermediation." In OCC Interpretive Letter No. 1039, the OCC did not address any potential differences that stemmed from this expansion in the types of derivative transactions beyond swaps.

205. OCC Interpretive Letter No. 1039, *supra* note 180, at 3. Such a simplified view of a swap as a mere exchange of payments equivalent to interest on deposits and loans and posing solely traditional credit risk to the bank-dealer may have been justified in 1987, in the beginning of the derivatives revolution, when banking regulators were less educated about derivatives in general. However, relying on the Matched Swaps Letter's reasoning can hardly be justified in 2005, well after the real dangers inherent in the use and misuse of derivatives became apparent in a number of high profile cases, including bankruptcy of California's Orange County, rescue of Long-Term Capital Management hedge fund, and the spectacular failure of Enron. As these cases demonstrated, the mere fact that a swap requires exchange of payments between two counterparties does not define its potential risk profile.

206. *Id.* at 4.

207. JPMC is also a financial holding company (FHC), which allows it to conduct a broader range of activities "financial in nature," as defined in the BHC Act and the Federal Reserve's Regulation Y. See 12 U.S.C. §§ 1841(p), 1843(l) (2006).

physical possession of the underlying commodity.²⁰⁸ This limitation on physically settled commodity derivatives serves to preserve the separation of banking and commerce embodied in the BHC Act.

Importantly, however, the Federal Reserve has the power to allow a BHC that qualifies as a financial holding company (FHC)²⁰⁹ to engage in any commercial activity that is determined by a Federal Reserve's order to be "complementary" to a financial activity and not jeopardize safety and soundness of the FHC, its subsidiary depository institutions or the U.S. banking system as a whole.²¹⁰ "Complementary" activities are explicitly nonfinancial commercial activities that are "meaningfully connected to a financial activity such that it complements the financial activity."²¹¹ Pursuant to this authority, in November 2005, the Federal Reserve issued an order allowing JPMC to purchase and sell physical commodities (including oil, natural gas, electricity, and agricultural products) in the spot market to hedge its otherwise permissible commodity derivative activities, and to take or make delivery of such physical commodities to settle such transactions.²¹²

As a result of the Federal Reserve's order granting such "complementary" powers to JPMC, almost simultaneously with the OCC's approval of Chase's expanded commodity derivatives activities, JPMC was permitted to build an active commodity trading business through its nonbank subsidiaries, which could enter into commodity derivatives transactions with Chase and take advantage of the latter's high credit ratings, large balance sheet, and potential access to cheaper funds and the public safety net. In this situation, the fact that bank derivatives

208. 12 C.F.R. § 225.28(b)(8)(ii)(B)–(C) (2008). These provisions apply to transactions involving bank-impermissible underlying assets. As is the case with banks, BHCs are generally allowed to make or receive physical delivery of the assets in which they can trade directly (e.g., currency, government securities, certain investment-grade corporate debt securities, gold, and other precious metals).

209. Under the BHC Act, as amended by the GLB Act, to qualify as an FHC, a BHC must, among other things, certify that all of its deposit-taking subsidiaries are well-capitalized (i.e., maintain certain capital adequacy ratios) and well-managed (i.e., received at least a satisfactory rating at its most recent examination). See 12 U.S.C. § 1843(l)(1).

210. *Id.* § 1843(k)(1)(B).

211. UBS AG, 90 Fed. Res. Bull. 215, 216 (2004).

212. See JPMorgan Chase & Co., 92 Fed. Res. Bull. C57, C57–C58 (2005). To prevent potential risks to the FHCs' safety and soundness, the Federal Reserve imposed several conditions on these newly approved commodity trading activities, including (i) limiting the aggregate market value of commodities held in connection with the approved activities to five percent of the FHC's consolidated Tier 1 capital (which includes common and preferred stock of the FHC and certain types of deeply subordinated debt); (ii) allowing physical delivery only with respect to commodities for which derivative contracts have been approved by the Commodity Futures Trading Commission (CFTC) for trading on futures exchanges or which are specifically approved by the Federal Reserve; and (iii) requiring that the FHCs use appropriate storage and transportation facilities owned and operated by third parties. See *id.* at C58.

transactions authorized in OCC Interpretive Letter No. 1039 were “perfectly matched”—a significant factor in the OCC’s reasoning—appears largely meaningless as a method of reducing the bank’s risk.

This type of regulatory arbitrage contributes to further erosion of the separation of banking and commerce in practice. In effect, JPMC was authorized to enter a line of business indisputably commercial in nature—trading and dealing in commodities. Given the realities of today’s markets, the fact that commodity derivatives constitute an integral part of JPMC’s commodity trading business does not automatically transform it into a financial intermediation business. Moreover, when viewed not in isolation but as a key element in JPMC’s commodity trading strategy, Chase’s own commodity derivatives activities cannot be easily characterized as a traditional form of purely “financial” intermediation and, thus, part of the usual business of banking.

2. ELECTRIC POWER MARKETING

In September 2006, the OCC determined that it was legally permissible for a national bank to become a member of several regional Independent Systems Operations (ISOs) and Regional Transmission Organizations (RTOs)—nonprofit organizations regulated by the Federal Energy Regulatory Commission (FERC), which coordinate, control, and monitor the operation of the electric power system in a certain geographic area and run organized spot and forward markets for electricity and related products.²¹³ This interpretation was issued in response to a request by Bank of America, which had previously received permission from the OCC to conduct electricity-linked derivatives and hedge transactions that settle in cash or by transitory title transfer.²¹⁴

The OCC based its reasoning on a well-established general proposition that national banks were permitted to engage in certain customer-driven commodity derivatives transactions and offsetting hedging transactions as part of the business of banking.²¹⁵ The OCC relied on Bank of

213. See OCC Interpretive Letter No. 1071 (Sept. 6, 2006). ISOs and RTOs also act as clearing organizations for transactions in electricity markets.

214. See OCC Interpretive Letter No. 1025, *supra* note 178, at 1. Bank of America also obtained an order from the FERC granting it authority to act as a power marketer, which is required in order to conduct transitory title transfers in electricity markets. OCC Interpretive Letter No. 1071, *supra* note 214, at 3 n.7.

215. Citing OCC Interpretive Letters No. 1025, 962, and 937, the OCC restated the familiar view of commodity derivatives:

These derivative transactions are financial arrangements involving exchanges of payments, with the bank acting as a financial intermediary between customers, a traditional and permissible banking function. . . . These derivative transactions assist bank customers in managing financial risks or meeting other financial needs. For example, commodity derivative transactions can offer users and producers of a

America's representation that an active membership in several regional ISOs and RTOs was necessary in order for it to execute bank-permissible electricity-linked derivatives and hedging transactions, settled in cash or by transitory title transfer, in certain geographic markets.²¹⁶ On this basis, the agency concluded that such membership "clearly is convenient and useful to the Bank's financial intermediation business in electricity and therefore incidental to the business of banking."²¹⁷

The OCC's main concern with respect to a national bank's membership in power marketing and clearing organizations was with the potential effect on the bank of the mutualization of risk and resulting unlimited liability typically associated with exchange and clearinghouse memberships. As a member of an ISO/RTO, Bank of America could be required to advance funds to cover a portion of the losses caused by another member's default, which creates a guaranty-like obligation. Under the U.S. banking laws and regulations, a national bank is generally permitted to guarantee obligations of a third party only if the bank itself has a "substantial interest" in the transaction.²¹⁸ After a long discussion and citing numerous precedents where national banks were permitted to become members of securities and commodity exchanges, the OCC concluded that the bank's obligations as an ISO/RTO member constituted a permissible guaranty, because such obligations were an integral part of an ISO/RTO membership, which was itself incidental to the bank's electricity derivatives business.²¹⁹ As usual, the OCC conditioned

commodity protection against increases and decreases in the price of the commodity.

OCC Interpretive Letter No. 1071, *supra* note 214, at 2.

216. As Bank of America represented in its application, membership in ISOs/RTOs was required for it as a FERC-authorized power marketer to participate in physically settled and ISO-administered markets and was the most effective way for executing cash-settled electricity derivatives (due to the liquidity support provided by the ISOs and RTOs). *Id.* at 7-8.

217. The OCC explained that, in determining whether an activity was "convenient" or "useful," it considered

whether the activity facilitate[d] the operations of the bank as a banking enterprise, enhance[d] the efficiency or quality of the content or delivery of banking services or products, optimize[d] the use and value of a bank's facilities and competencies, or enable[d] a bank to avoid economic waste in its banking franchise.

Id. at 8 (citing OCC Interpretive Letter No. 845 (Oct. 20, 1998)).

218. See 12 C.F.R. § 7.1017 (2008).

219. The OCC also cited several risk mitigating factors (such as the ISO/RTO rules on creditworthiness standards for their members, collateral and netting requirements, credit monitoring and analysis, shortened settlement periods, etc.), which served as safeguards limiting the risk of Bank of America's liability as a result of defaults by other ISO/RTO members. In addition, the OCC asserted that the bank's exposure would be limited because its advances of funds to the ISOs/RTOs were subject to the general lending limits under the OCC regulations. See OCC Interpretive Letter No. 1071, *supra* note 214, at 10-11. Under 12 U.S.C. § 84(a)(1) and 12 C.F.R. § 32.3(a), a national bank's extensions of credit to any single borrower are generally limited to fifteen percent of the bank's capital and surplus. See 12 U.S.C. § 84(a)(1) (2006); 12

its approval of Bank of America's proposal on the OCC's supervisory approval of its risk management systems and controls, especially with respect to the bank's contingent risk exposure and specific risk mitigation strategies, including appropriate limits on advances to ISOs and RTOs.²²⁰

Thus, the OCC's current interpretation of the "business of banking" as including, among many other forms of "financial intermediation," a wide variety of electricity-linked derivatives activities paved a way for national banks to enter directly the undeniably commercial business of electric power marketing. It is not widely known that U.S. commercial banks can—and some of the largest ones already do—act in that capacity. Perhaps more importantly, the OCC's decision potentially set a precedent for allowing U.S. commercial banks to expand into other physical energy and commodity market segments.

C. *Assessing the "Elastic Definition" Approach*

Under the OCC's "elastic definition" approach to statutory interpretation, the concept of the "business of banking" in § 24(Seventh) of the National Bank Act is presently defined very broadly to encompass all forms of modern "financial intermediation," which is, in turn, defined by the OCC in highly abstract terms as essentially any bank activity involving an exchange of payments with, or between, third parties.

In developing this highly expansive interpretation of the bank powers clause, the OCC actively utilized the Williams/Jacobsen test for the "business of banking."²²¹ The OCC typically based its argument on the proposition that each newly proposed bank derivatives transaction was a "logical outgrowth" of a previously authorized bank activity and was "convenient or useful" to banks and their customers. As a detailed analysis of the OCC's interpretations shows, the OCC emphasized that proposed derivatives activities, or the related hedging transactions, potentially increased banks' profitability and competitiveness and provided bank customers with a wider choice of financial risk management solutions. Notably, the OCC's interpretive letters did not contain a meaningful discussion of potential risks of the proposed activities, nor did they address any public policy interests that might dictate a more cautious approach to expanding bank-permissible derivatives activities.

Furthermore, a closer look at the conditions and limitations on per-

C.F.R. § 32.3(a) (2008). The OCC argued that an advance of funds to an ISO/RTO was an "extension of credit" subject to this limitation. See OCC Interpretive Letter No. 1071, *supra* note 214, at 11.

220. OCC Interpretive Letter No. 1071, *supra* note 214, at 11–12.

221. See *supra* notes 53–58 and accompanying text.

missible derivatives activities imposed by the OCC casts serious doubt on their practical scope and effectiveness. For instance, two of the key conditions originally attached to the OCC's approval of equity options and forwards and various commodity-linked derivatives were the requirements of cash settlement and perfect matching. Gradually, both of these requirements were significantly relaxed and, in some cases, removed entirely. Currently, most types of commodity derivatives can be settled either by physical delivery of the underlying asset or by transitory title transfer. Both commodity and equity derivatives can be hedged by buying and selling physical assets.

An important remaining limitation on many bank permissible equity and commodity derivatives transactions is a requirement that all such transactions are "customer-driven" and not "speculative." As interpreted by the OCC, a transaction is "customer-driven" if it is entered into for a customer's "valid and independent business purpose."²²² This is a very liberal requirement that does not necessarily mean that customers must initiate or "drive" a transaction by seeking a specific derivatives product. This definition allows banks to create and actively market new derivatives products to prospective customers who might derive financial benefit from using or investing in such products. To the extent the term "customer-driven" has any meaning, it means simply that banks do not enter into a transaction solely for the purposes of making a proprietary investment.

Similarly, the prohibition on "speculative" transactions in corporate equity or nonfinancial commodities has a far more limited meaning in practice. This condition is very similar to the "customer-driven" requirement. Essentially, it requires only that the bank transact with third parties seeking to manage their own financial risks or achieve their own financial goals (which may very well be speculative in nature) so that the bank's primary goal in each such transaction is to earn fees by providing risk management services to its customers rather than to invest in the underlying asset in hopes of profiting from favorable movements in its price. However, it does not limit banks' ability to pocket the profits from such favorable movements (and, conversely, incur losses from unfavorable price movements), in addition to the fee income derived from the bank's counterparties. Thus, the OCC's prohibition on "speculative" transactions, despite its seemingly resolute tone, has little, if any, practical effect on the level of a bank's actual risk exposure under a derivative contract. More generally, the prohibition on entering into derivatives or hedging contracts "for speculative purposes" is inherently questionable because of the fundamental difficulty of effectively sepa-

222. OCC Interpretive Letter No. 892, *supra* note 154, at 1.

rating permissible and impermissible activities based on their "purpose."²²³

As a practical matter, the only real limitation on the expansion of bank permissible derivatives activities is the OCC's standard requirement of a prior supervisory approval of each individual bank's proposed derivatives program, based on the review by the bank's Examiner In Charge (or other OCC supervisory staff) of the bank's internal risk management systems and controls.²²⁴ On its face, this requirement is aimed at preserving the safety and soundness of the banking system, while at the same time allowing for a greater degree of regulatory and supervisory flexibility and pragmatism.²²⁵ However, a critically important question in this respect is the extent of the OCC's practical ability to assess the effectiveness of banks' internal risk management systems, particularly in light of the increasingly dynamic and complex nature of the largest dealer-banks' derivatives business.²²⁶ For instance, a large bank may have meticulously written comprehensive procedures for internal approvals and monitoring of derivatives transactions and exposure, which a team of resident bank examiners may equally meticulously and comprehensively review. And yet, there can be no guarantee that the bank is, in fact, effective in measuring and managing its true risk exposure. Even a highly experienced bank examiner would not be able to evaluate the effectiveness of the bank's procedures in controlling and containing its risks without developing an intimate understanding of the bank's derivatives activities and the true nature and scope of the risks they pose. Unfortunately, as the recent global financial crisis has so aptly demonstrated, even the top managers at the world's largest financial institutions frequently fail to understand and properly evaluate the true nature and scope of their own institutions' risk exposure under derivatives and other complex financial transactions. It is hardly realistic to expect bank examiners to fare any better in this respect.²²⁷

223. See, e.g., Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 775-76 (1999).

224. Under the OCC's a large-bank supervision program, each of the largest national banks has a dedicated team of resident examiners who, under the command of the Examiner in Charge, provide a continuous risk-based supervisory review of the bank's operations. See generally COMPTROLLER OF THE CURRENCY, *LARGE BANK SUPERVISION: COMPTROLLER'S HANDBOOK* (2001), available at <http://www.occ.treas.gov/handbook/lbs.pdf> (discussing the large-bank supervision program).

225. But see *infra* notes 238-41 and accompanying text.

226. The global financial crisis, which started in the U.S. subprime mortgage and loan securitization markets, calls for an even greater degree of healthy skepticism with regard to the ability of the OCC's supervisory staff to uncover and effectively address potentially problematic banking practices.

227. In addition to the unavoidable disparities in the technical expertise and institutional resources, there are other aspects of potential power asymmetry (including, e.g., differences in

Finally, the fact that the OCC's official guidelines on risk management of derivatives instruments have not been updated since 1997, which constitutes an entire era in the development of derivatives markets, casts further doubts on the agency staff's ability to serve as effective "gatekeepers" in this area.

IV. REGULATORY IMPLICATIONS OF THE OCC'S DEFINITION OF THE "BUSINESS OF BANKING"

Despite its seemingly narrow doctrinal focus, the OCC's current approach to what constitutes the "business of banking" within the meaning of the bank powers clause of the National Bank Act has regulatory implications reaching far beyond the technicalities of statutory interpretation and even the permissibility of derivatives activities of national banks. The OCC's highly expansive notion of the "business of banking" as modern financial intermediation and dealing in financial risk, in all of its constantly evolving forms, raises significant questions from the perspective of broader regulatory reform in the financial services sector.

A. FROM A LIMITING DEVICE TO AN ENABLING MECHANISM

This Article tells a story of one federal agency's attempts to interpret an ambiguously phrased clause in the nineteenth-century federal statute in the face of the changing needs and practices of the regulated industry. As a general matter, the increasingly fast pace of technological progress and globalization make regulators' task of adapting obsolete laws to the realities of the modern times particularly daunting. Not surprisingly, many industry observers and academic experts have praised the OCC's ability to achieve this elusive goal by loosening the statutory constraints on the banking industry's business through regulatory action.²²⁸

However, it is important to judge the OCC's success—or failure—as a regulator on its ability to find a proper balance between modernizing the regulatory framework for the sake of financial innovation, on the

socioeconomic status) between a large bank's managers and derivatives experts, on the one hand, and the examination team, on the other, which may significantly impair the examiners' ability to challenge effectively the managers' judgment.

228. See, e.g., James R. Smoot, *Bank Operating Subsidiaries: Free at Last or More of the Same?*, 46 DEPAUL L. REV. 651, 740 (1997) (viewing the OCC's expansive approach to bank permissible activities as a positive example of an effective "incremental reform" and a lawful exercise of its regulatory authority). In a seminal article on statutory obsolescence, Professor Donald C. Langevoort expressed similar sentiment with respect to the "revisionist" approach of federal courts to interpreting obsolete banking statutes to account for the "transitional" character of the banking industry in the 1980s. See Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 674, 732 (1987).

one hand, and maintaining a strong commitment to the fundamental statutory and policy objectives underlying that framework, on the other. It is the argument of this Article that, by pushing the limits of the bank powers clause, the OCC has significantly compromised the latter component of its charge.

On the most fundamental level, the OCC's interpretive "revolution" serves to undermine the integrity of the existing system of U.S. bank regulation and supervision. Through a seemingly mundane and rather obscure process of issuing legal interpretations, the OCC has removed most of the existing statutory restrictions on banks' activities, as a practical matter. By elasticizing the definition of the "business of banking," the OCC has effectively rendered this statutory concept meaningless as a potentially limiting device and transformed it into a powerful enabling mechanism. As a result of the OCC's aggressive interpretation of the bank powers clause, the U.S. commercial banks, while formally prohibited from investing in commercial enterprises and conducting commercial and financial activities, now have a powerful source of legal authority to circumvent these prohibitions in practice.

The expansion of bank permissible derivatives activities is an important factor contributing to the de facto erosion of the separation between banking and commerce, the cornerstone principle built into the U.S. system of bank regulation.²²⁹ An extremely broad notion of the "business of banking" developed in the context of bank derivatives activities provides an effective tool for the OCC in its efforts to expand bank permissible activities and investments in other, potentially more controversial, areas.²³⁰ Applying the OCC's reasoning, it is virtually impossible to envision a commercial activity that banks would not be able to pursue, either as a form of modern financial intermediation and, thus, part of the "business of banking" or as an activity "incidental" to it.

For example, why not allow a national bank to own an actual coal mine, an oil field, or a power plant? Owning the source of a commodity would certainly be "convenient and useful" to a national bank in conducting its commodity derivatives business by enhancing the bank's

229. See *supra* note 22 and accompanying text.

230. One of the most publicly controversial decisions in recent years was the OCC's authorization of expanding national banks' powers in commercial real estate. See OCC Interpretive Letter No. 1044, at 1-2 (Dec. 5, 2005) (allowing PNC to build and own a hotel and condominiums); OCC Interpretive Letter No. 1045, at 1 (Dec. 5, 2005) (allowing Bank of America to build and own a luxury hotel); OCC Interpretive Letter No. 1048, at 1 (Dec. 21 2005) (allowing Union Bank of California to acquire a seventy percent ownership stake in a windmill farm). Although, in these cases, the OCC focused mainly on interpretation of specific provisions of federal banking law dealing with banks' real estate powers rather than the bank powers clause in § 24(Seventh), the agency's general expansive view of the business of banking provided a broader doctrinal basis for these decisions.

ability to make physical delivery of the commodity in question. In addition to the assured and inexpensive access to the physical commodity, such ownership would also provide the bank with access to invaluable market information, which is critical to the more efficient pricing and valuation of the bank's commodity derivatives. Thus, ownership of a coal mine, oil field, or power plant is a "logical outgrowth" of the bank's permissible commodity derivatives activities: It would greatly increase the bank's efficiency, profitability, and competitive position and allow it to expand its client base. Therefore, subject to the supervisory review of the bank's risk management system, and as long as the bank makes certain commitments (such as hiring reliable third parties to operate the coal mine, oil field, or power plant, obtaining proper insurance, and disposing of its ownership interest if and when it ceases the related commodity derivatives business), owning these assets should be a bank-permissible activity. There is nothing in the OCC precedent that would foreclose this conclusion.²³¹

Furthermore, through derivatives transactions, commercial banks can easily achieve synthetic exposure to performance of commercial entities without investing in these entities' stock. Such synthetic investment may create the same types of conflict of interest and risk exposure as direct equity ownership prohibited under the Glass-Steagall Act. In fact, the use of derivative instruments allows banks to take on much higher levels of risk than direct investment in corporate stock or physical commodities. Derivative instruments allow counterparties a virtually unlimited degree of flexibility in structuring each individual transaction, with respect to the composition of the underlying assets, methods of calculating payment obligations, and other terms, each of which may easily multiply both potential losses and potential gains under the instrument. In addition, commercial banks are now allowed to buy and sell corporate stock and physical commodities, despite statutory prohibitions on such activities, as part of their permissible derivatives business and related hedging transactions.²³²

The broader effects of the OCC's expansive interpretive approach to permissibility of bank derivatives activities are strikingly visible when considered in tandem with the significant expansion of commodity trading activities of nonbank affiliates of banks under the BHC Act. As discussed above, the Federal Reserve has recently allowed several FHCs to

231. In fact, under the OCC's current approach, operating a general travel agency may be the only commercial activity remaining outside national banks' reach, only because it has been singled out as a classic example of an impermissible activity by the courts. See *NationsBank of N.C. v. Variable Annuity Life Ins. Co. (VALIC)*, 513 U.S. 251, 258 n.2 (1995); *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 438 (1st Cir. 1972).

232. See *supra* Part III.

purchase and sell physical commodities (including oil, natural gas, electricity, and agricultural products) in the spot market to hedge their otherwise permissible commodity derivative activities, and to take or make delivery of such physical commodities to settle such transactions.²³³ As a result of the Federal Reserve's orders granting such "complementary" powers to individual FHCs and the OCC's interpretive letters concluding that commodity derivatives transactions constitute part of the "business of banking," several large U.S. financial holding companies are currently permitted to conduct an active commodity trading business through nonbank subsidiaries, which can enter into commodity derivatives transactions with their commercial bank affiliates and take advantage of the affiliated banks' higher credit ratings, large balance sheets, and access to cheaper funds and the public safety net.²³⁴ In effect, large U.S. financial conglomerates are now generally permitted to build an active business of trading and dealing in energy, metals, and other nonfinancial commodities, as long as such activities are "meaningfully connected" to derivatives activities conducted by the commercial banks or nonbank entities within their ownership structure. While much of the public outcry and political battles over the future of the separation of banking and commerce surrounded Wal-Mart's recent failed attempts to enter the banking market,²³⁵ Bank of America, JPMC, and Citigroup have been quietly and effectively dismantling the same statutory wall from the other side.

The recent conversion of Goldman Sachs and Morgan Stanley, both of which are major players in the physical markets for energy and commodities, into FHCs potentially elevates this issue to a new level of sig-

233. See, e.g., JPMorgan Chase & Co., 92 Fed. Res. Bull. C57, C58 (2005); Citigroup, Inc., 89 Fed. Res. Bull. 508, 509 (2003).

234. The latest financial crisis made it abundantly clear that these unique advantages of commercial banks are increasingly important in the world of complex finance. Thus, one of the key reasons for several large nonbanking institutions' recent decisions to become BHCs and convert their deposit-taking subsidiaries into commercial banks was the need to have access to the more stable and cheaper source of funding through retail deposits, as well as permanent access to the Federal Reserve's liquidity support mechanisms. See, e.g., Press Release, Goldman Sachs, Goldman Sachs To Become The Fourth Largest Bank Holding Company (Sept. 21, 2008), available at <http://www2.goldmansachs.com/our-firm/press/press-releases/archived/2008/bank-holding-co.html>; Press Release, Morgan Stanley, Morgan Stanley Granted Federal Bank Holding Company Status by U.S. Federal Reserve Board of Governors (Sept. 21, 2008), available at <http://www.morganstanley.com/about/press/articles/6933.html>.

235. In July 2005, Wal-Mart Stores, Inc. applied to the Utah banking authorities and the FDIC for a license to open an industrial bank, a Utah-chartered depository institution that is not considered a "bank" for the purposes of the BHC Act. This attempt of a retail giant to enter into financial services caused a high-profile political controversy. In March of 2007, Wal-Mart withdrew its application. See Press Release, Wal-Mart Stores, Inc., Wal-Mart Withdraws ILC Charter Application (Mar. 16, 2007), available at <http://walmartstores.com/FactsNews/NewsRoom/6349.aspx>.

nificance. Under the BHC Act, both companies have up to five years within which either to divest of any business activities not permissible to FHCs or to bring them in conformity with the requirements of the BHC Act.²³⁶ However, given the federal regulators' presently heightened concern with economic viability of large U.S. financial institutions, it would not be surprising if both entities were allowed to retain most, if not all, of their lucrative commodities and energy operations and investments not currently permissible for FHCs. In that case, it is highly likely that all other large FHCs competing with Goldman Sachs and Morgan Stanley would be allowed to expand the range of their activities in the same areas. An obscure and largely unpublicized process of gradual transformation of the nation's largest banking institutions into powerful commodity and energy traders of the Enron variety (except with access to retail deposit funds) would then be complete.²³⁷

To the extent that the existing statutory and regulatory restrictions on bank permissible investments and activities are designed to safeguard commercial banks' safety and soundness and ensure impartiality of their credit allocation decisions, the growing ability of large banking organizations to circumvent such restrictions, through expansion of their derivatives and related commercial activities, raises a number of serious questions. Does it make sense to continue denying national banks the power to purchase and hold for their own account common stock of a commercial entity, whereas the same banks are free to enter in derivative contracts referencing the same common stock and exposing themselves to the same, or potentially far greater, risks? Conversely, should commercial banks be allowed to trade and deal in derivatives and, if so, under what conditions? Who should have the power to make these decisions and what is the appropriate process through which these and other similar decisions should be made?

While answering these questions is beyond the scope of this Article, it is important to point out that the OCC's aggressively expansive approach to the bank powers clause effectively precluded these crucially important issues from getting the public attention they deserve. Finding an indirect method of circumventing statutory activity restrictions removed the strongest incentive for the banking industry to lobby Congress for statutory reforms that would bring the U.S. banking laws and regulations in line with the evolving market practices. By allowing banks to grow their derivatives businesses and extend their reach into

236. See 12 U.S.C. § 1843(e) (2006).

237. The growing role of banking organizations in global commodity and energy trade is a fascinating phenomenon, which, to date, has not received much attention from legal scholars. However, an in-depth analysis of this issue is a separate research project that is beyond the scope of this Article.

securities and commercial activities prohibited under federal banking laws, the OCC staved off a broader substantive discussion of the fundamental changes in the risk profile of the banking industry and the necessary adjustments in the existing methods of protecting safety and soundness of the financial system and ensuring fair flow of credit throughout the economy.

As a result, it is left solely to the OCC to analyze thoroughly these issues and to identify the full range of potential risks posed by derivatives activities of commercial banks. While it is possible that the OCC engages in such internal deliberations before authorizing each newly proposed bank derivative product, its published interpretive letters conspicuously lack any substantive discussion of potential drawbacks of allowing banks to get into various derivative markets and come across more as advocacy than an objective and measured analysis. The OCC's position that all forms of financial intermediation, and the concomitant dealing in all kinds of financial risk, are permissible as part of the "business of banking" within the meaning of the National Bank Act fails to take into account important public policy considerations built into the current system of banking regulation in the U.S.²³⁸ One such critical consideration is the continuing existence of the federal deposit insurance scheme, which makes it necessary to evaluate any expansion of bank-permissible derivatives activities from the perspective of potential hazards to depositors and the federal deposit insurance funds. Although the OCC routinely conditions the authorization of each specific bank's derivatives program on a supervisory assessment of its internal risk management system, the main emphasis in its interpretations is consistently on the profitability of derivatives activities for commercial banks and the importance of expanding their client base and enhancing their competitiveness vis-à-vis other providers of financial services.²³⁹

In the absence of any principled limitations built into the current definition of the "business of banking," the only real constraint on the expansion of bank-permissible activities is administrative self-restraint and the OCC's sense of caution in judging whether further expansion in bank activities presents potential safety and soundness concerns. How-

238. As Professor Symons put it,

Nonbanking powers have been granted to banks in the past and in certain instances should be granted in the future as well. But prior to granting banks powers not within the principled definition of the business of banking, there should be adequate consideration of the impact the granting of such powers could have on the role that banks historically have played in our society.

Symons, *supra* note 33, at 718.

239. This trend has been particularly strong in the post-VALIC era, with the advent of the OCC's new official test for what constitutes a bank-permissible activity. *See supra* notes 58-59 and accompanying text.

ever, the OCC's recent interpretations dealing with bank derivatives activities demonstrate a rather troublesome pattern in this respect.

From the point of view of regulatory process, the OCC's decision-making in this area is very nontransparent and individualized. As discussed above, the OCC started publishing all of its legal interpretations of § 24(Seventh) only after the GAO made a strong recommendation to that effect in its review of the OCC's secretive verbal authorization of physical hedging of equity derivatives.²⁴⁰ Examination of the agency's published interpretations shows that the OCC's interpretive process aims primarily at achieving a positive outcome for the banks seeking an expansion of their derivatives powers. Perhaps more importantly, the OCC does not publish interpretations stating what types of derivatives activities are not permissible for national banks as clearly falling outside the statutory boundaries.²⁴¹ So far, the OCC has opted against adopting official regulations outlining the parameters of permissible derivatives activities of commercial banks, ostensibly, due to the difficulty of keeping such regulations up to date. Regardless of the merits of this argument, a decision not to issue regulations allowed the OCC to avoid complying with the mandatory rule-making procedures under the Administrative Procedure Act, including the requirement of public notice and comment.²⁴²

Moreover, in the absence of an established "derivatives" industry that might view commercial banks' expansion into the derivatives market as a competitive threat, the legal validity of the OCC's decisions expanding bank derivatives powers has not been challenged in court or otherwise brought into the public view. Global derivatives market developed alongside, and largely as a direct result of, commercial banks' growing derivatives trading and dealing business. In that sense, large U.S. banks themselves were the key players in the derivatives industry. A more challenging task, however, is explaining the absence of courtroom battles between commercial banks and investment banks dealing in derivatives. Part of an explanation for such friendly co-existence in the derivatives dealer market between these traditional rivals may be the important role large commercial banks, with their sizeable balance sheets, cheap cost of funds, and high credit ratings, came to play in developing and growing global OTC derivatives markets. In the highly complex and interconnected world of OTC derivatives, all the major dealers have significant exposure to one another, so that the failure (or

240. See U.S. GAO, *supra* note 154, at 20–22.

241. Anecdotal evidence suggests that the OCC did, in fact, reject a number of proposals by banks seeking to offer certain derivatives products that the OCC was uneasy about, but the entire process was handled through purely informal discussions.

242. See Administrative Procedure Act § 1, 5 U.S.C. § 553 (2006).

forced withdrawal from the market) of any single large dealer would be a potential threat to the entire market.²⁴³ Another factor explaining the absence of legal challenges to the OCC's decisions on the part of investment banks may also be their reluctance to argue in court that certain derivatives were to be treated as transactions in "securities" impermissible for commercial banks. Such characterization could have potentially adverse regulatory consequences for the investment banks' own derivatives activities by subjecting these largely unregulated activities to the whole panoply of securities laws and regulations.²⁴⁴

Regardless of its underlying causes, the absence of external pressure from "natural" private-market competitors was a critically important factor that allowed the amazing metamorphosis of the statutory concept of the "business of banking" to take place quietly, in the shadows of obscure and tedious administrative action.

B. *Systemic Risk Considerations*

A close look at the OCC's interpretive process reveals significant lapses in that agency's ability to address and monitor potential systemic risks posed by the U.S. banking organizations' complex derivatives businesses.

As this Article shows, by the mid-2000s, the OCC successfully reinvented the statutory concept of the "business of banking" as a catch-all category broad enough to expand bank-permissible activities subject only to the agency's own judgment and sense of administrative restraint. By doing so, the OCC has effectively shifted the issue of whether or not a certain type of activity, including any derivatives activity, is permissible for commercial banks under the National Bank Act, away from the area of substantive policy-making and into the sphere of individualized supervisory assessment. The OCC's current default policy is that any activity that can be characterized either as financial intermediation or as an activity "convenient or useful" to financial intermediation is potentially permissible under the bank powers clause, so that the only real decision takes place at the point of authorizing a particular bank's com-

243. The cascading effect on global financial system of the failure of Lehman Brothers, a U.S. investment bank that was a major dealer and counterparty in OTC derivatives markets, serves to exemplify the potential magnitude of such a threat. *See Was Lehman Loss All That Bad?*, NYTIMES.COM, Oct. 22, 2008, <http://www.nytimes.com/2008/10/22/business/economy/22views.html> (describing how the fall of Lehman Brothers in September 2008 turned a financial tremor into a tsunami).

244. These are only some of the many factors that may help to explain the absence of legal battles for control of derivatives market between commercial banks and other groups of financial institutions. However, a detailed analysis of this intriguing dynamic is beyond the scope of this Article.

mencement of such activity. Under this approach, the supervisory review of banks' internal risk management systems serves as the principal basis for granting individual banks the power to engage in a wide variety of financial, and even nonfinancial, commercial activities.

The OCC's interpretive letters present this shift in the decision-making process as serving the goal of protecting banks' safety and soundness. However, an equally strong (if not stronger) argument is that individual entity-wide risk analysis fundamentally impedes the OCC's ability to evaluate the safety and soundness of the banking system as a whole. Evaluation of enterprise-level risk management is an insufficient basis for developing a broad grasp of system-wide vulnerabilities in the highly complex and closely interconnected financial markets. From that perspective, the supervision-based approach to expansion of bank-permissible activities is inherently ineffective in detecting and measuring systemic risk, which is of particular concern in the area of financial derivatives.

The OCC's focus on the supervisory review of banks' internal risk management reflects the general fascination, since the 1990s, with the concept of enterprise-wide risk management as the principal tool for maintaining system-wide financial stability. In essence, this "risk management" philosophy denies the validity of setting limits on private actors' risk-taking and ties the levels of acceptable financial risk to the institutions' internal capabilities to hedge such risks.²⁴⁵ However, as the most recent global financial crisis demonstrated, such an unbridled faith in the magical powers of "risk management" is based on a fundamentally faulty and overly optimistic assumption that individual financial institutions can effectively measure and manage complex financial risks.²⁴⁶ This sobering post-crisis lesson casts further doubt on the OCC's nearly exclusive reliance on the supervisory assessment of individual banks' ability to "manage" risks associated with various new derivatives instruments as the appropriate mechanism for guarding against systemic failures.

CONCLUSION

The latest financial crisis forcefully underscored the fact that, in

245. For examples of this approach to systemic risk issues, see COUNTERPARTY RISK MGMT. POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (2005), available at http://www.isda.org/demosite/educat/pdf/CRMPGII_7-22-05_FINAL_v6_wcover.pdf; PRESIDENT'S WORKING GROUP ON FIN. MKTS., PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL (2007), available at http://www.treasury.gov/press/releases/reports/hp272_principles.pdf.

246. See Alan Greenspan, Op-Ed., *We Will Never Have a Perfect Model of Risk*, FIN. TIMES (London), Mar. 17, 2008, at 9.

two-and-a-half decades of unprecedented financial innovation leading to it, financial risk became the most important asset class rather than a mere attribute of traditional financial assets. Derivatives and other complex financial instruments were at the heart of this paradigmatic change. Through their active participation in these markets, global financial conglomerates, including large U.S. commercial banks, have effectively become creators of, dealers, traders, and investors in pure financial risk, regardless of its specific form or source.

Examination of the OCC's written authorizations of bank derivatives activities provides valuable insight into the dynamics of this fundamental transformation. The OCC's interpretation of the "business of banking" as unlimited financial intermediation, which includes active derivatives trading and dealing, allowed banks to provide an ever-growing variety of financial risk management services to a broad range of clients, from industrial hedgers of commodity price risks to speculators in real estate or emission allowances. In effect, the OCC enabled the largest U.S. banks to hold themselves out as being in the business of buying and selling financial risk of any kind, and in any combination, to any financially sophisticated third party. It is hardly surprising, therefore, that some of the largest U.S. banking organizations nearly crumbled under the weight of mispriced and misunderstood risk on their books.

Defining the modern "business of banking" as general financial intermediation has fundamental implications for the continuing effectiveness of the existing system of bank regulation and supervision, originally designed to address the far more circumscribed risks inherent in the traditional business model of a commercial bank as a deposit-taking and lending institution. While modern banks continue to perform their unique intermediation functions in the financial system, which make them "special" and provide justification for tight regulatory oversight,²⁴⁷ the rapidly growing and highly complex derivatives business of large U.S. commercial banks is significantly altering the overall risk profile of the banking industry.²⁴⁸ This shift in the business of banks requires a

247. See, e.g., Corrigan, *Are Banks Special?*, *supra* note 14. For an insightful discussion of the continuing importance of commercial banks' traditional deposit-taking and lending functions, see Jonathan R. Macey, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691 (2000).

248. According to the Vice Chairman of the Board of Governors of the Federal Reserve System Donald L. Kohn,

The changing business of the largest commercial banks means that threats to financial stability do not necessarily come from traditional sources such as a deposit run or a deterioration in a bank's portfolio of business loans. The largest banks' capital markets businesses have given rise to new threats to financial stability. These threats stem from banks' securitization activity, from the complexity of banks'

serious and critical reassessment of the key *substantive* principles and assumptions built into our bank regulatory system. Thus, to the extent large U.S. commercial banks are acting as wholesale dealers in financial risk, whose core competency is structuring, pricing, and trading complex financial instruments in institutional markets, it becomes essential to design an appropriate system of regulation and supervision to address the risks unique to this new form of financial intermediation. One of the critical questions in this respect is whether this type of business should get the benefit of having access to federally insured retail deposits and other channels of federal subsidies available to traditional banks. More broadly, the fact that these institutions are increasingly becoming “too big to fail”—or, arguably, “too big to save” in times of a major crisis—requires serious rethinking of how to contain moral hazards inherent in their sprawling business activities.

Another important lesson the story of the quiet metamorphosis of the “business of banking” offers to policymakers concerns the central role of the *administrative process* in shaping substantive legal and regulatory outcomes.²⁴⁹ Any credible proposal to modernize financial services regulation in the United States has to address the fundamental problem of aligning institutional incentives with the broader public interest and creating procedural safeguards against skewed or imprudent agency decision-making. Whether there is a single super-regulator or several regulatory “peaks” in the financial sector, the key challenge, both in practice and in theory, will be to find the right balance between regulatory flexibility and independence, on the one hand, and agency accountability and transparency, on the other.

These are only a few of the fundamental issues Congress will have to address as part of a comprehensive legislative reform necessary in order to bring the U.S. legal and regulatory structure in line with the fundamental changes in the business and risk profile of today’s financial institutions. As this Article sought to demonstrate, a deeper understanding of what these fundamental changes mean and how they came about is an indispensable element of this process.

capital markets activity, and from the services that banks provide to the asset-management industry, including hedge funds. And risks that are more traditional to banking, such as liquidity risk and concentration risk, have appeared in new forms.

Donald L. Kohn, Vice Chairman, Fed. Reserve Sys., *The Changing Business of Banking: Implications for Financial Stability and Lessons from Recent Market Turmoil* (Apr. 17, 2008), available at <http://www.federalreserve.gov/newsevents/speech/kohn20080417a.htm>.

249. For a comprehensive treatment of this general topic, see Steven P. Croley, *Public Interested Regulation*, 28 FLA. ST. U. L. REV. 7, 28–54 (2000); and Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 86–105 (1998).