



FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

March 14, 2002

Notice 02-13

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

**Equity Securities to Hedge Customer-Driven
Equity Derivative Transactions**

DETAILS

The Board of Governors of the Federal Reserve System has announced that it would not apply section 9 of the Federal Reserve Act to prohibit a state member bank from acquiring equity securities to hedge its customer-driven equity derivative transactions entered into by the bank with any unaffiliated third party if such purchases are made in accordance with the conditions and restrictions applicable to national banks.

Any state member bank that seeks to acquire equity securities to hedge its equity derivative transactions must receive the prior approval of the Board's Director of Banking Supervision and Regulation. In addition, a state member bank may engage in equity hedging activities only to the extent permitted by state law, and the bank must comply with any applicable state notice or approval requirements.

MORE INFORMATION

For more information, please contact Gayle Teague, (214) 922-6151, in the Banking Supervision Department. Paper copies of this notice or previous Federal Reserve Bank notices can be printed from our web site at <http://www.dallasfed.org/banking/notices/index.html>.

A copy of the Board's statement follows.

Board Statement Concerning the Acquisition of Stock by State Member Banks to Hedge Equity Derivative Transactions

The Board has considered the issue of whether a state member bank may acquire equity securities in order to hedge the bank's exposure arising from one or more equity derivative transactions lawfully entered into by the bank with a third party. Section 9 of the Federal Reserve Act (12 U.S.C. § 335) provides that state member banks are subject to the same limitations and conditions on the purchase, sale, underwriting, and holding of investment securities and stock that apply to national banks under 12 U.S.C. § 24(Seventh).

The Office of the Comptroller of the Currency ("OCC") has reaffirmed that section 24(Seventh) generally prohibits national banks from acquiring equity securities.¹ The OCC also recently determined that a national bank, subject to certain conditions and OCC review and approval, may acquire equity securities solely for the purpose of hedging the bank's exposure arising from customer-driven equity derivative transactions lawfully entered into by the bank.² The General Accounting Office has reviewed and concurred with this decision.³

In light of these decisions and other relevant facts, the Board will not apply section 9 of the Federal Reserve Act so as to prohibit a state member bank from purchasing equity securities to hedge the risks arising from equity derivative transactions⁴ entered into by the bank with an unaffiliated third party, provided such purchases are made in accordance with the same conditions and restrictions applicable to national banks and the state member bank receives the Board's prior approval as described below.

¹ See OCC Interpretive Ltr. No. 892 (Sept. 13, 2000).

² Id.

³ See "Equity Hedging: OCC Needs to Establish Policy on Publishing Interpretive Decisions," GAO-01-945 (Aug. 2001).

⁴ An "equity derivative transaction" is a contract that provides for the bank to pay or receive an amount that is based, at least in part, on the price or total return of an individual equity security, a group of equity securities, or an index of equity securities. Examples of an equity derivative transaction include equity swaps, equity index swaps, equity index deposits, and equity-linked loans.

These conditions and restrictions provide that, among other things, a state member bank may acquire an equity security solely for purposes of hedging the bank's exposure arising from one or more equity derivative transactions entered into by the bank with, and at the request of, an unaffiliated third party. A state member bank may not acquire equity securities for speculative or investment purposes.

A state member bank also may not acquire through its equity hedging activities more than 5 percent of the stock of any issuer. Federal law also prohibits a state member bank from underwriting or dealing in any equity security. See 12 U.S.C. §§ 24(Seventh), 335. Accordingly, a state member bank may not hold itself out to the public as willing to purchase or sell any equity security or act as a market-maker in any security by continuously quoting "bid" and "ask" prices for the security.

A state member bank also must receive the approval of the Director of Board's Division of Banking Supervision and Regulation prior to acquiring any equity security for hedging purposes. A request for approval should fully describe the proposed scope of the bank's equity hedging and related equity derivative activities. In addition, any request should describe the policies, procedures, internal controls and limits that the bank will use to monitor and control the risks associated with the bank's equity derivative and equity hedging activities and to ensure compliance with the limitations applicable to the bank's equity hedging activities. In determining whether to approve a request to engage in equity hedging activities, the Director will consider the financial and managerial resources of the banking organization, including the organization's risk-management policies, procedures and systems, and other factors that the Director determines to be relevant. The Director may place any conditions on an approval that the Director determines are necessary or appropriate to ensure that the bank's equity hedging activities are conducted in accordance with applicable law, including this statement, and do not pose an undue risk to the bank or the deposit insurance funds.

A state member bank also must have the authority under applicable state law to enter into equity derivative transactions and to purchase equity securities in order to hedge the risks arising from such transactions. In addition, a state member bank must comply with any applicable state notice or approval requirements to engage in equity hedging activities.

The Board expects to monitor a state member bank that receives approval to engage in equity hedging activities to ensure that the bank acquires equity securities only for purposes of hedging the risks arising from the bank's equity derivative transactions and does not violate the prohibition contained in section 24(Seventh) on a member bank acquiring stock for speculative or investment purposes. In addition, the Board will monitor the equity hedging activities of state member banks to ensure that they are conducted in a safe and sound manner.

Any questions concerning this statement should be directed to Michael G. Martinson, Associate Director (202-452-3640), or James Embersit, Assistant Director (202-452-5249), of the Board's Division of Banking Supervision and Regulation, or to Scott G. Alvarez, Associate General Counsel (202-452-3583), or Kieran J. Fallon, Senior Counsel (202-452-5270), of the Board's Legal Division.

Dated: February 21, 2002