



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

October 14, 2008

Interpretive Letter #1102
November 2008
12 USC 84

Subject: Authority of National Banks to Join the National Securities Clearing Corporation Limited

Dear []:

This responds to your request on behalf of [] (“Bank”), that the Office of the Comptroller of the Currency (“OCC”) confirm that it is permissible for the Bank, via its Mumbai branch, to offer clearing and settlement¹ services in India, as a custodian clearing member (“CCM”) of the National Securities Clearing Corporation Limited (“NSCCL”). As a CCM, the branch must participate in the NSCCL’s settlement guarantee fund (“NSGF”), which NSCCL may use to cover the defaults of other members.

For the reasons discussed below, we believe the National Bank Act (“NBA”) permits the Bank’s Mumbai branch to become an NSCCL CCM and participate in the NSGF. We note that the Bank’s exposure to the NSCCL for the defaults of other members is subject to the lending limit in 12 U.S.C. § 84 (“Section 84”). Before the branch may become an NSCCL CCM, the Bank must notify its examiner-in-charge (“EIC”), in writing, of the proposed activities and must receive written notification of the EIC’s supervisory no-objection. The no-objection is based on the EIC’s evaluation of the adequacy of the Bank’s risk measurement and management systems and controls to enable the branch to in engage in custodian clearing activities on the NSCCL in a safe and sound manner, and the EIC’s evaluation of any other supervisory considerations

¹ Clearing and settlement involve a determination of trade obligations, which are discharged by the transfer of funds and delivery of securities (collectively hereinafter referred to as “clearing.”). NSCCL Bye laws, Chap. VI, § B.10; http://www.nseindia.com/content/nsccl/nsccl_eqclearing.htm

relevant to NSCCL membership.²

Background

NSCCL is a wholly owned subsidiary of the National Stock Exchange (“NSE”).³ NSCCL’s capital markets (“CM”) segment carries out the clearing of trades executed in the NSE’s CM segment.⁴ The CM segment provides a trading and clearing platform for securities such as equities, preference shares, exchange traded funds, and retail government securities.⁵ The Bank wishes to become a CCM of NSCCL’s CM segment.

NSCCL has three categories of clearing members: trading, professional, and custodian.⁶ CCMs are a special category of clearing members who are not trading members (“TMs”).⁷ CCMs clear trades executed by trading members (“TMs”) and their constituents.⁸ A TM may assign a trade to a CCM for clearing if the CCM confirms the trade to NSCCL. If the CCM confirms the trade, the NSCCL assigns the obligation to the CCM. If the CCM rejects the trade, the obligation is assigned back to the TM.⁹ CCMs that clear on NSCCL must be registered as custodians with the Securities and Exchange Board of India (“SEBI”).¹⁰

CCMs have a number of financial obligations to NSCCL, including the payment of initial and variation margin and contributions to the NSGF, which are available to cover member defaults.¹¹

² Under OCC Interpretive Letter No. 929 (Feb. 11, 2002) (“IL No. 929”), within 10 days of a national bank’s foreign branch becoming a member of a foreign exchange or clearinghouse, the bank must certify to its EIC that it has become a member, its loss exposure is limited as a legal and accounting matter to amounts below Section 84 limits, and it does not have open-ended liability for the obligations of the exchange or clearinghouse or its members. However, where a foreign exchange or clearinghouse does not limit a bank’s loss exposure to amounts below the Section 84 limits, a national bank must comply with the procedures in this letter.

³ NSE Fact Book (2008), at p. 14. The NSE is a Mumbai-based stock exchange. See <http://www.nseindia.com>

⁴ http://www.nseindia.com/content/nscl/nscl_clgandsett.htm.

⁵ See NSE Fact Book (2008), at p. 59.

⁶ NSCCL Regulations (CM Segment), Chap. 2, § 3.

⁷ NSE Fact Book (2008), at p. 22; Indian Securities Market: A Review, (2007), at pp. 156-7.

⁸ The term “constituent” means a client, customer or investor who deals with a TM. NSCCL Bye laws, Chapter I, § 1.6A.

⁹ http://www.nseindia.com/content/nscl/nscl_custodians.htm.

¹⁰ SEBI (Custodian of Securities) Regulations (1996), at <http://203.199.12.51/acts/act05a.html>.

¹¹ NSCCL Bye laws, Chap. XII, § 2.

NSCCL Bye laws and Regulations define acts that constitute member defaults and describe the actions the NSCCL will take once a member is in default. Events of default include, for example, a member's inability to fulfill clearing or settlement obligations or pay any sum due to the NSCCL.¹² In the event of a member default, the NSCCL will liquidate all losses resulting from the default, using a preset priority schedule.¹³ If funds are not sufficient to cover a member default, the NSCCL has the right to assess the remaining balance against all members in proportion to each member's contribution to the NSGF (*i.e.*, excess liability).¹⁴

The NSCCL has a comprehensive risk management system in place that protects against member defaults. The system monitors the track record and performance of its members and their deposits, undertakes on-line monitoring of members' positions and exposures,¹⁵ collects margin from members, and automatically deactivates members if they breach certain limits.¹⁶

The Bank represents that if the branch is permitted to become an NSCCL CCM member, it will analyze its potential liability to NSCCL on an ongoing basis.

Discussion

For the reasons discussed below, we conclude that it is permissible under the NBA for the Bank's Mumbai branch to become an NSCCL CCM. The Bank's exposure to the NSCCL for the defaults of other members may not exceed the limits in Section 84 or any lower limit set by the EIC.¹⁷ Before the Bank may become an NSCCL member, the Bank must notify its EIC, in

¹² NSCCL Bye laws, Chap. XI, § 1.

¹³ In the event of default, the NSCCL will liquidate all losses resulting from a member default, using the following priority schedule: the defaulting member's margin; the defaulting member's contribution, deposit or bank guaranty; any security deposit made by the defaulting member to an exchange whose dealings are cleared by NSCCL; proceeds recovered by auctioning or transferring the defaulting member's membership; fines, penalties, interest on delayed payment and/or interest/other income earned by investment or disinvestment of NSCCL; and, any NSCCL retained earnings and profits. NSCCL Bye laws, Chap. XII, § 7.

¹⁴ *Id.* If a loss charged *pro rata* to NSCCL members is later recovered, the net amount of the recovery shall be credited to the members against whom the loss was charged in proportion to the amount actually charged to them. NSCCL Bye laws, Chap. XII, § 11.

¹⁵ NSCCL has in place an on-line monitoring and surveillance system where member exposure is monitored on a real time basis. A system of alerts is built in so that a member and the NSCCL are alerted at pre-set levels (reaching 70%, 85%, 90% 95% and 100%) when members approach their allowable limits. The system enables NSCCL to further check the micro-details of member positions, if required, and take pro-active action. The on-line surveillance mechanism also generates various alerts/reports on any price/volume movement of securities not in line with past trends/patterns. Alerts are scrutinized and if necessary taken up for follow-up action. Open positions of securities are also analyzed. Print media rumors are also tracked and where they are price sensitive, companies are contacted for verification and responses are communicated to members and the public. Indian Securities Market: A Review (2007), at pp. 159-60.

¹⁶ *Id.*

¹⁷ Under Section 84's general lending limit, a national bank's loans and extensions of credit to one borrower are limited to 15 percent of the bank's capital and surplus. A loan is defined as an advance of funds based on an

writing, of the proposed activities and must receive written notification of the EIC's supervisory no-objection. The no-objection is based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems and controls to enable the Bank to engage in NSCCL CCM activities in a safe and sound manner, and the EIC's evaluation of any other supervisory considerations relevant to NSCCL membership.

National Bank Act

The NBA permits national banks and their branches to engage in custodian clearing activities, subject to safety and soundness limitations, as activities that are part of the business of banking because the activities are functionally equivalent to bank permissible credit and financial intermediation activities.¹⁸ The NBA also permits national banks to provide default fund contributions to clearinghouses as bank permissible guaranties, as activities incidental to these bank permissible activities.

Clearing is a form of extending credit, one of the main functions of banking institutions.¹⁹ A clearing agent substitutes its credit for that of its customers. A clearing agent is liable to a clearinghouse for performance on all submitted contracts, and assumes, with respect to the clearinghouse, the risk of other member defaults. The clearing function also is akin to two other traditional bank credit functions: providing bankers' acceptances and letters of credit.²⁰ The credit function provided by the bank in its clearing capacity is part of the business of banking, because a principal business of a bank is to extend credit.²¹

National bank clearing activities also are functionally consistent with the primary role of banks as financial intermediaries. The role of a bank is to act as an intermediary, facilitating the flow of money and credit among different parts of the economy.²² The role of a bank intermediary takes many forms: providing payments transmission services, borrowing from savers and lending to users, and participating in the capital markets, as here. As the recognized intermediaries

obligation of the borrower to repay or repayable from property pledged. Accordingly, consistent with prior precedent, all advances by the Bank to the NSCCL that arise from the default of NSCCL members (including subsequent defaults that may result if other NSCCL members are unable to meet their payment obligations under a default allocation assessment) cannot, as a matter of law, exceed in the aggregate 15 percent of the Bank's capital and surplus. OCC Interpretive Letter No. 1071 (Sept. 6, 2006) ("IL No. 1071"). The EIC may also set a lower limit on liability based on safety and soundness considerations, in which case, a bank cannot exceed the lower limit. *Id.*

¹⁸ See, e.g. OCC Interpretive Letter No. 1014 (Jan. 10, 2005) ("IL No. 1014"); IL No. 929, *supra.*; and OCC Interpretive Letter No. 494 (Dec. 29, 1989) ("IL No. 494").

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² See, e.g., OCC No-Objection Letter No. 90-1 (Feb. 16, 1990) and OCC No-Objection Letter No. 87-5 (July 20, 1977).

between other, non-bank participants in the financial markets and the payment systems, banks possess the expertise to make exchange of payments and securities between, and settle transactions for, parties and to manage their own intermediation position.²³

A long line of OCC precedents support the conclusion that the Bank's proposed custodian clearing services are within the legally authorized powers of national banks.²⁴ Moreover, the OCC has permitted national banks and their foreign branches to join clearinghouses and other entities that require members to cover a portion of the losses arising from the default of other members, as bank permissible guaranties, where the bank had a substantial interest in being a member and its liability was *de minimis* or limited, and did not exceed Section 84 or lower EIC limits.²⁵ Under 12 C.F.R. § 7.1017(a), a national bank is permitted to guarantee the obligations of another party if the bank has a substantial interest of its own in the transaction. This regulation provides, in part, that "[a] national bank may lend its credit, bind itself as a surety to indemnify another, or otherwise become a guarantor . . . if: (a) The bank has a substantial interest in the performance of the transaction involved."²⁶

Here, the Bank has a substantial interest in agreeing to cover a portion of the losses of defaulting NSCCL members because the obligation is an integral part of permissible custodian clearing activities. The Bank seeks NSCCL membership in order to clear trades executed in the CM segment of the NSE. The Bank, via the branch, must agree to cover a portion of the losses of defaulting NSCCL members as a condition of NSCCL membership. Thus, the Bank has a substantial interest in guaranteeing the potential losses of other NSCCL members as a condition to NSCCL membership. Under these circumstances, the Bank's obligation to cover a portion of the losses of defaulting NSCCL members is a bank permissible guaranty, subject to the limits described below.

²³ See OCC Interpretive Letter 892 (Sept. 8, 2000).

²⁴ See, e.g., OCC Interpretive Letter No. 1026 (Apr. 27, 2005) (national bank may engage in safekeeping of securities as custodian and engage in securities lending in connection with these services); OCC Interpretive Letter No. 1013 (Jan. 7, 2005) (national bank as custodian of gold bullion and cash); Operating Subsidiary Notice Application Control Number: 94-ML-08-0002 (Sept. 21, 1994) (national bank clearing membership in the Singapore International Monetary Exchange); OCC Interpretive Letter No. 494, *supra*. (national bank and operating subsidiary as exchange clearing members); OCC Interpretive Letter No. 422 (Apr. 11, 1988) (national bank and operating subsidiary clearing and exchange memberships); OCC Interpretive Letter 384 (May 18, 1987) (same); OCC Interpretive Letter No. 380 (Dec. 29, 1986); (execution, clearance, and exchange membership); OCC Interpretive Letter No. 372 (Nov. 7, 1986) (same).

²⁵ See, e.g., IL No. 1071, *supra*; IL No. 1014, *supra*; and IL No. 929, *supra*.

²⁶ 12 C.F.R. § 7.1017(a). A nexus between a bank permissible transaction and a guaranty may provide the "substantial interest" for the bank. See, e.g., IL No. 929, *supra*. (bank's provision of a default fund contribution/guaranty was incidental to the business of bank's clearing and execution activities and satisfied substantial interest needed for issuance of a guaranty) and OCC Interpretive Letter No. 376 (Oct. 25, 1986) (national bank's guarantee of third party securities borrowers' conduct was incidental to the bank's securities lending program and constituted a sufficient substantial interest).

OCC precedent clearly establishes that national banks and their foreign branches may contribute to funds and programs to guarantee the potential losses of others, in order to engage in bank permissible activities, where the bank's potential liability for the defaults of others is limited. For example, the OCC found it permissible for a national bank foreign branch to contribute to the default fund of the London Clearinghouse in order to clear bank permissible derivative contracts where the liability for other member defaults was limited.²⁷ In IL No. 929, clearinghouse members were required to contribute to a default fund to cover losses caused by any defaulting member. In the event of a member default, the clearinghouse could seek additional contributions to the default fund by non-defaulting members. The non-defaulting members had the option of contributing the additional funds or resigning their membership. Thus, there was a theoretical cap on a non-defaulting member's liability for the default of other members – the member's original default fund contribution due to the option of resignation. The OCC found that the branch's participation in the clearinghouse was permissible because the bank's liability was limited and the bank had a substantial interest in contributing to the default fund so that it could engage in bank permissible clearing activities.

The OCC also confirmed the permissibility of national banks contributing to the loss allocation system of the Government Securities Division of the Fixed Income Clearing Corporation as a condition to clearinghouse membership, where liability for the losses of other members was limited.²⁸ Clearinghouse members were required to maintain clearing fund deposits in an account to be used by the clearinghouse to cover losses in the event of a member default. Any losses remaining after applying the deposit could be allocated to non-defaulting members. In that event, a non-defaulting member could either pay the amount of the loss or terminate its membership. If a netting member terminated its membership, its loss allocation liability was limited to its clearing fund deposit. As a result, a member national bank could limit its liability to its initial required fund deposit. Thus, the OCC determined that a member's obligation to cover the losses of defaulting members was limited and that the bank had a substantial interest in providing the guaranty in order to engage in bank authorized clearing activities.

The OCC permitted a national bank to assume potential liability as a participant in a group self-insurance program that provided worker's compensation insurance to members of the group.²⁹ Under the program, members were required to contribute insurance premiums to establish a reserve fund that would be used to pay claims against any member of the group. In the event the reserve funds were insufficient to cover member obligations, each member would be liable for an additional assessment in cover the shortage. The OCC concluded that the program was permissible for the bank because it included enough safeguards that any liability under its guaranty for other member shortages was *de minimis* and the bank had a substantial interest in contributing to the fund to obtain worker's compensation coverage for the bank.³⁰

²⁷ IL No. 929, *supra*.

²⁸ IL No. 1014, *supra*.

²⁹ OCC Interpretive Letter No. 1022 (Feb. 15, 2005).

³⁰ The OCC found the decision in *Merchants v. Wehrmann*, 202 U.S. 295 (1906) ("*Wehrmann*") inapplicable to the proposed activities because existing safeguards were expected to limit the bank's liabilities under the group self-

Recently, the OCC permitted a national bank to become a member of independent systems operators (“ISOs”) to execute bank permissible electricity derivative transactions.³¹ As a condition to membership, the bank was to participate in a program that subjected members to potential unlimited liability for any losses allocated to members arising from member defaults. The ISOs had systems in place to mitigate the risk of additional assessments and the bank’s exposure was subject to the limits of Section 84.³² The OCC determined that the bank had a substantial interest in covering such potential losses as an integral part of ISO membership and the liability exposure was sufficiently limited where the ISO had risk of loss mitigants in place and the bank established risk management systems and controls to estimate and maintain its potential liabilities within Section 84 limits or lower limits imposed by the EIC.³³

Here, there are a number of safeguards and controls in place to limit the Bank’s liability from other NSCCL member defaults. As noted above, NSCCL has systems in place to mitigate the risk of additional assessments. NSCCL is constantly upgrading its risk management systems to prevent defaults. NSCCL’s risk management system monitors the track record and performance of its members and their deposits, undertakes on-line monitoring of member positions and exposure in the market, collects margins from members, and automatically disables members if they breach certain limits. Further, the Bank represents that it will assess its potential liability to the NSCCL on an ongoing basis. As described below, the Bank, as an NSCCL CCM, would be expected to have in place adequate risk management systems and controls to estimate and limit its potential liability. The Bank’s advances to NSCCL arising from default of NSCCL members may not exceed Section 84 limits or any lower limits set by the EIC. The Bank’s risk management systems and controls for monitoring this liability will assist the Bank in complying with applicable limits.

Based on all the foregoing, and subject to the safety and soundness considerations described below, we conclude that the Bank may join NSCCL.

Safety and Soundness Considerations

The Bank must have adequate risk measurement and management systems and controls in place to engage in NSCCL CCM clearing activities on a safe and sound basis. Specifically, the Bank

insurance program to *de minimis* amounts. In *Wehrmann*, the Supreme Court held that a national bank was not authorized to participate as a general partner in a partnership that was engaged in activities the Supreme Court found impermissible for national banks and that exposed the bank to potentially unlimited liabilities from those partnership activities.

³¹ IL No. 1071, *supra*.

³² The arrangement was also subject to any additional limits imposed by the bank’s EIC.

³³ The bank was required to notify its EIC, in writing, of each proposed ISO membership and receive prior EIC written supervisory no-objection, based on the EIC’s evaluation of the adequacy of the bank’s risk measurement and management systems and controls to enable the bank to engage in the proposed activities on a safe and sound basis, and the EIC’s evaluation of any other supervisory considerations relevant to the particular proposal.

may not participate as a member of the NSCCL until it receives an EIC written supervisory no-objection letter, based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems to enable the Bank to engage in the activities on a safe and sound basis, and the EIC's evaluation of any other supervisory conditions relevant to the proposal. Moreover, the EIC may determine, for reasons of safety and soundness, that the Bank's exposure to the NSFG should be at a lower threshold. If at any time the Bank's analysis indicates that its potential liability to the NSCCL from defaults of other members would result in advances that exceed Section 84 or lower EIC limits, the Bank must adjust its activities so that its estimated potential exposure falls below the limits.

To join the NSCCL and participate in the NSFG on a safe and sound basis, the Bank must:

- Conduct a formal written assessment of credit risk measurement and management practices of the NSCCL. At a minimum, this risk assessment should determine:
 - Potential liability to the Bank from membership in the NSCCL.
 - The degree of reliance the Bank can place on NSCCL risk management practices to minimize or mitigate liability from other member obligations to the NSCCL.
- Obtain accurate and timely management information from the NSCCL to assess and monitor, based on the Bank's activity and the relevant laws, rules and regulations, potential liability to NSCCL. As part of this process, the Bank should keep abreast of the changes in membership rules and in member activity, on a periodic basis to assess how its contingent risk exposure is changing.
- Develop contingency strategies to mitigate risk to NSCCL and establish risk triggers and an approval process for executing contingency risk mitigation strategies. The contingency risk mitigation strategies should include internal limits when the Bank must adjust its activities to avoid exceeding limits on advances of funds to the NSCCL arising from the defaults of other members. The contingency risk mitigation strategies also should include notification to the Bank's EIC if at any time the cumulative payments under its contingent obligation to the NSCCL approach these limits.
- The Bank should also establish a risk monitoring program to ensure these supervisory conditions are adhered to on an ongoing basis.

Conclusion

We conclude that it is permissible under the NBA for the Bank's foreign branch to engage in custodial clearing activities as an NSCCL CCM. The Bank's exposure to the NSCCL for the defaults of other members may not exceed Section 84 or any lower limits set by the EIC. Before the Bank may become an NSCCL member, the Bank must notify its EIC, in writing, of the proposed activities and must receive written notification of the EIC's supervisory no-objection. The no-objection is based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems and controls to enable the Bank to engage in CCM activities on the NSCCL in a safe and sound manner, and the EIC's evaluation of any other

supervisory considerations relevant to NSCCL membership. Our conclusions are specifically based on the Bank's representations and written submissions describing the facts and circumstances of the subject transactions. Any change in the facts or circumstances could result in different conclusions. If you have any questions concerning this letter, please contact Tena M. Alexander, Senior Counsel, Securities and Corporate Practices Division, at (202) 874-4625.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel