

S. Kaswell



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

October 27, 1986

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PAUL A. VOLCKER  
CHAIRMAN

The Honorable John D. Dingell  
Chairman  
Committee on Energy and Commerce  
U. S. House of Representatives  
Room 2125  
Rayburn House Office Building  
Washington, D. C. 20515

Dear Chairman Dingell:

I am responding to your letter, dated September 15, 1986, concerning the proposal by Security Pacific Corporation to establish an over-the-counter trading system to facilitate trading by primary dealers and other institutions of options on U.S. government securities. You have requested that we answer several questions concerning this proposal. The staff has prepared an annex which contains the answers to these questions.

No application has been made by Security Pacific Corporation for Board approval and the Board has not reviewed Security Pacific Corporation's proposal. The Board has taken no position on it pending staff preparation of the matter for Board review.

Sincerely,

*Paul A. Volcker*

Enclosure

STAFF MEMORANDUM REGARDING CHAIRMAN DINGELL'S LETTER  
CONCERNING THE PROPOSAL BY SECURITY PACIFIC  
CORPORATION TO ESTABLISH AN OVER-THE-COUNTER  
TRADING SYSTEM

The following are responses to questions posed by  
Chairman Dingell:

Background

It is our understanding that, as the proposal is currently structured, Security Pacific ("SecPac") is establishing two de novo subsidiaries to operate the OTC system: Security Pacific Options Trading Corporation ("SPOT") and Security Pacific Options Services Corporation ("SPOSC"). Participants in the OTC system will be given the opportunity to disseminate bid and ask quotations on options on U.S. government securities to one another through SPOT's automated communications network linking video display terminals in the participants' respective offices. Participants seeking to accept a bid or ask quotation will communicate a readiness to enter into an options trade at a quoted price to SPOT. SPOT will then attempt to match buying and selling interests. SPOSC will act as a clearing agency in the settlement of options trades and the exercise of options.

It is our further understanding that firms that elect to participate in the OTC System will not enter into options transactions directly with one another, but instead will buy options from and sell options to GECC Options Corporation

("GOC"), a wholly owned subsidiary of General Electric Credit Corporation ("GECC"). Thus, simultaneously with the issuance of an option to a participant, GOC will enter into an offsetting options transaction with a second participant, running a "matched book" at all times. GOC will act as issuer of all options purchased by participants in the OTC System and GE Credit will guarantee the options obligations of GOC.

Finally, it is our understanding that Security Pacific National Bank ("Bank") will issue a standby letter of credit for the benefit of GOC in the amount of \$35 million payable in the event of a default by one or more OTC System participants on obligations owed to GOC. Each participant, as a condition of participating in the OTC System, will agree to become an account party on the letter of credit. In the aggregate, Bank's exposure is to be limited to \$35 million, and the stated amount of the letter of credit is, accordingly, to be reduced by any reimbursed payment made for the account of any participant.

QUESTION 1

Doesn't the Security Pacific proposal involve nonbanking activities in violation of the Glass-Steagall Act and Bank Holding Company Act? Explain fully.

RESPONSE

SecPac proposes to establish two de novo nonbanking subsidiaries, SPOT and SPOSC, to engage in brokerage and clearing agency activities, respectively. While the Banking

Act of 1933 (commonly known as the "Glass-Steagall Act") prohibits a commercial bank from engaging in or being affiliated with a firm engaged principally in certain securities activities, courts have concluded that a commercial bank or its affiliate may act as a securities broker. Although SPOT and SPOSC will be affiliates of Bank, a member bank, they assert they will not be engaged in securities activities prohibited by Section 20 of the Glass-Steagall Act, citing Securities Industry Association ("SIA") v. Board of Governors, 104 S.Ct. 3003 (1984), where the Supreme Court ruled that section 20 of the Glass-Steagall Act does not prohibit securities brokerage activities. Under SecPac's proposal, the options on U.S. government securities will be issued by GOC, which is not itself a bank and is not affiliated with Bank.

The activity of acting as a securities broker is permitted by Regulation Y, 12 C.F.R. § 225.25(b)(15). This was sustained by the Supreme Court in SIA v. Board of Governors. The activity of acting as a clearing agent is a traditional banking function and is permitted under Regulation Y, 12 C.F.R. § 225.25(b)(3).

#### QUESTION 2

Security Pacific has agreed to issue a letter of credit payable to GOC in an amount not to exceed \$35 million dollars in the event that one or more participants in its trading system default. What are the provisions of this letter of credit? By issuing the letter of credit, isn't Security Pacific still guaranteeing all option trades in its system up to \$35 million dollars? Is there anything to preclude Security Pacific from later increasing the amount of the letter of credit? Does this new mechanism, and the related GOC guarantee

arrangement, constitute an evasion of federal banking law, including the Bank Holding Company Act?

RESPONSE

It is our understanding that Bank has agreed to issue a letter of credit payable to OCC in an amount not to exceed \$35 million dollars in the event one or more participants in its trading system default. It is our further understanding that there is nothing to preclude SecPac from later increasing the amount of the letter of credit other than the lending limits applicable to national banks, 12 U.S.C. § 24. We also understand that the OCC is reviewing the letter of credit to determine whether it complies with laws and regulations applicable to national banks.

QUESTION 3

Have the Federal Reserve Board, Comptroller of the Currency and the FDIC approved this venture of Security Pacific? Has Security Pacific filed with any of the bank regulators any applications or requests for no-action letters? If so, please explain any actions taken by the regulator or its staff in response to these Security Pacific filings.

RESPONSE

It is our understanding that Bank has filed a request for a no-action letter with the OCC, but has not yet received a response. SecPac has not filed any applications or requests for no-action letters with the Board concerning this specific proposal. We are not aware of any filings by Bank or SecPac with the FDIC.

QUESTION 4

Security Pacific has stated that the brokerage and clearing functions for its options system will be performed by SPOSC and SPOT. SPOSC and SPOT are subsidiaries of the bank's holding company parent, SecPac. As bank holding company subsidiaries, aren't SPOSC and SPOT subject to FRB jurisdiction under the Bank Holding Company Act? Don't SPOSC and SPOT need prior FRB approval by a regional FRB bank, under Section 4(c)(8) of the Act before engaging in these activities? Has such approval already been granted and if so, when and why? If you have not received an application, please provide a copy of the application when filed. Is there any lawful procedure for SPOSC and SPOT to begin to engage in these activities without first receiving approval of this application? Has the FRB or its staff conferred with SecPac concerning its plans to comply with these requirements? If so, please explain the substance of these discussions.

RESPONSE

As subsidiaries of SecPac, a registered bank holding company, SPOSC and SPOT are subject to the Board's jurisdiction under the BEC Act. Under amendments to the Board's Regulation Y adopted in 1984 (12 C.F.R. § 225.23(b)), a bank holding company need not seek approval or file notice with the Board to engage through a de novo subsidiary in a Regulation Y listed activity if the Board has previously approved an application by the bank holding company to engage in that activity, so long as (i) the prior approval was not subject to a geographic limitation, and (ii) the proposed activity is to be conducted within the United States (unless prior approvals authorized nonbanking activities in a foreign country in which the new subsidiary proposes to have operations).

SecPac takes the position that the activities in which it proposes to engage, through its de novo nonbank subsidiaries SPOT and SPOSC, are within the activities of acting as a broker and as a clearing agent, which are on the list of permissible nonbanking activities contained in the Board's Regulation Y, 12 C.F.R. § 225.25(b)(15) and (3), respectively. SecPac has previously received prior approvals by the Board and the Federal Reserve Bank of San Francisco to engage in brokerage and clearing agency activities throughout the United States.

Board staff has consulted with the staff of the Securities and Exchange Commission ("SEC") and reviewed the decision by the SEC to issue a no-action letter to SecPac concerning its proposal to establish the OTC System. It is our understanding, based upon this consultation and review, that the SEC has concluded that the activities of SPOT are those of a broker and that the activities of SPOSC are those of a clearing agency. Based upon this view, the SEC has not required SecPac to register the OTC System as an exchange pursuant to the Securities Exchange Act of 1934.

The Board may require an application if it determines that the activities of SPOT and SPOSC are not contemplated within the scope of the System's prior approvals.

QUESTION 5

Under the Bank Holding Company Act, has the FRB ever approved an application of a bank holding company subsidiary to engage in the type of novel activities contemplated for SPOSC

and SPOT? Has the FRB ever disapproved a similar application? If so, what grounds were cited by FRB? Has the FRB ever disapproved a related application regarding options and futures brokerage or clearing activities? Again, if so, what grounds were cited by FRB?

RESPONSE

The Board has not approved this specific proposal by SecPac, nor has SecPac filed an application for Board approval. SecPac asserts that SPOT is engaged in brokerage activities and SPOSC is engaged in the activities of a clearing agency. Both of these activities are on the list of permissible activities contained in the Board's Regulation Y and have been approved in numerous applications. There is a question, however, whether the combination of these two permissible activities in SecPac's proposal would result in an activity that is beyond the scope of the System's prior approvals. This question will be considered by the Board when it reviews SecPac's proposal.

QUESTION 6

Existing FRB precedent strongly supports disapproval of any application Security Pacific Corporation might make under Section 4(c)(8) of the Bank Holding Company Act to engage in the proposed brokerage and clearing activities of SPOT and SPOSC, respectively. In granting other applications to perform brokerage and clearing functions for options, the FRB has recognized the potential adverse effects of these actions but approved the applications because the options trading would occur on SEC-regulated exchanges . . . . Since the Security Pacific options proposal deliberately deviates from the securities laws' regulatory framework for options, it would appear to follow that perceived potential adverse effects of the planned brokerage and clearing activities of SPOT and SPOSC would not be counter balanced by any appropriate regulation and could not be approved under existing precedent. Is my understanding of the FRB precedent and position accurate?



RESPONSE

In prior approvals concerning acting as broker on options on U. S. government securities, the Board has relied upon "the regulatory framework established pursuant to law by the SEC" as one mitigating factor in overcoming possible adverse effects. SecPac's proposal will also be subject to a degree of SEC regulation. GOC will be required to register the options and GE Credit Corporation will be required to register its guarantee of the options under the Securities Act of 1933. In addition, pursuant to the Government Securities Act of 1986, recently passed by both the House and the Senate, SPOT and SPOSC will be required to register with the SEC as a broker and a clearing agency, respectively, under the Securities Exchange Act of 1934.

Moreover, before the passage of the aforementioned legislation, the SEC imposed certain conditions in connection with its no-action letter. Specifically, the SEC has asked that SecPac provide the following to the SEC on a quarterly basis: (1) the number and identity of (a) participants in the system and (b) applicants who have been denied participation; (2) the volume of transactions through the system; (3) the number of options positions that are (a) closed out by offset, (b) exercised, and (c) allowed to expire; (4) the number of defaults on options contracts; (5) the number of, and cost to, SecPac (or its affiliates) of satisfying such defaults; and

(6) the number of, and estimated cost to, participants of any defaults not satisfied by SecPac GECC or GOC. In addition, the SEC has requested that SecPac provide its staff with current copies of any rules, regulations or similar documents as well as copies of any contracts participants must sign. The SEC also has requested that SecPac provide the SEC staff with thirty days' prior notice of any material changes in the operation of the OTC System that are contemplated in order for the SEC's staff to reevaluate its no-action position in light of such changes. In addition, the SEC's position is conditioned upon the agreement of SecPac, if it should elect to terminate or suspend its Treasury options program for financial, operational or other reasons, to continue to operate the program as long as any options issued under the program remain outstanding.

QUESTION 7

Do you believe that the establishment, promotion and operation of an options exchange is "closely related to banking" within the meaning of Section 4(c)(8) of the Bank Holding Company Act?

RESPONSE

The Board has never made the determination that the establishment, promotion and operation of an options exchange is "closely related to banking" within the meaning of section 4(c)(8) of the BHC Act. As discussed above, the SEC has concluded that the OTC System is not an exchange. The

*Not true*

Board will review SecPac's proposal to determine whether the activities to be performed by SPOT and SPOSC are within the scope of the System's previous approvals concerning SecPac's performance of securities brokerage and clearance activities.

October 20, 1986