

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-1146]

Bank Holding Companies and Change in Bank Control

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule with request for public comments.

SUMMARY: The Board of Governors of the Federal Reserve System is proposing an amendment to Regulation Y that would permit bank holding companies to take and make delivery of title to commodities underlying derivative contracts on an instantaneous, pass-through basis.

DATES: Comments on the proposed rule must be received not later than April 21, 2003.

ADDRESSES: Comments should refer to Docket No. R-1146, and should be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551, or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson also may be delivered between 8:45 a.m. and 5:15 p.m. to the Board's mail facility in the West Courtyard of the Eccles Building, located on 21st Street between Constitution Avenue and C Street, N.W. Members of the public may inspect comments in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. on weekdays pursuant to § 261.12, except as provided in § 261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

FOR FURTHER INFORMATION CONTACT: Scott G. Alvarez, Associate General Counsel (202/452-3583), Mark E. Van Der Weide, Counsel (202/452-2263), or Andrew S. Baer, Counsel (202/452-2246), Legal Division. For users of Telecommunications Device for the Deaf (TDD) only, contact 202/263-4869.

SUPPLEMENTARY INFORMATION:

Background

The Board's Regulation Y currently authorizes bank holding companies ("BHCs") to engage as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on a rate, price, financial asset, nonfinancial asset, or group of assets (other than a bank-ineligible security) ("Commodity Contracts"). A BHC's authority to enter into Commodity Contracts is subject to certain restrictions that are designed to limit the BHC's activity to trading and investing in financial instruments rather than dealing directly in commodities. In particular, Regulation Y provides that a BHC may enter into a Commodity Contract only if (i) the commodity underlying the contract is eligible for investment by a state member bank; or (ii) the contract requires cash settlement; or (iii) the contract allows for assignment, termination, or offset prior to delivery or

expiration (the “Contractual Offset Requirement”), and the BHC makes every reasonable effort to avoid taking or making delivery of the underlying commodity (the “Delivery Avoidance Requirement”).¹

The effect of these restrictions is to allow a BHC to engage as principal in derivative contracts involving any type of commodity (other than bank-ineligible securities) but to limit the authority of a BHC to physically settle derivative contracts. Under these restrictions, a BHC may take or make delivery on derivative contracts based on commodities that a state member bank is permitted to own.² For all other types of physically settled commodity derivatives,³ a BHC must make reasonable efforts to avoid delivery, and the contract must have assignment, termination, or offset provisions.

The Bank Holding Company Act (“BHC Act”), as amended by the Gramm-Leach-Bliley Act (Pub. L. No. 106-102, 113 Stat. 1338 (1999)) (“GLB Act”), permits a BHC to engage in activities that the Board had determined were closely related to banking, by regulation or order, prior to November 12, 1999. A BHC must conduct these activities in accordance with the terms and conditions contained in such regulations and orders, unless modified by the Board.

Citigroup Inc., New York, New York (“Citigroup”), and UBS AG, Zurich, Switzerland (“UBS”), have asked the Board to modify the restrictions in Regulation Y to allow BHCs to enter into derivative contracts that typically result in taking and making delivery of title to, but not physical possession of, commodities on an instantaneous, pass-through basis (regardless of whether the contracts contain specific assignment, termination, or offset provisions).⁴

In response to these requests, the Board has determined to seek public comment on the proposed rule described below.

Proposed Rule

As noted, Citigroup and UBS have urged the Board to permit BHCs to enter into Commodity Contracts that are settled by the BHC receiving and transferring title to the underlying commodity instantaneously, by operation of contract, and without taking physical possession of the commodity. Citigroup and UBS also have urged the Board to remove its

¹ 12 CFR 225.28(b)(8)(ii)(B).

² State member banks may own, for example, investment grade corporate debt securities, U.S. government and municipal securities, foreign exchange, and certain precious metals.

³ These would include derivative contracts based on, for example, energy-related commodities and agricultural commodities.

⁴ Citigroup and UBS also have asked the Board to allow financial holding companies to take and make physical delivery of a limited amount of commodities as an activity that is incidental or complementary to engaging as principal in BHC-permissible Commodity Contracts. The Board continues to review these broader requests.

regulatory requirement that BHCs only enter into Commodity Contracts that require cash settlement or specifically provide for assignment, termination, or offset prior to delivery.

These requests arise in large part because, in certain over-the-counter forward markets (U.S. energy markets, for example), the physically settled derivative contracts traded by market participants do not specifically provide for assignment, termination, or offset prior to delivery and, thus, do not conform to the Contractual Offset Requirement of Regulation Y. Moreover, participants in these markets generally settle the derivative contracts by temporarily taking and making delivery of title to the underlying commodities and, thus, do not comply with the Delivery Avoidance Requirement of Regulation Y.

Financial intermediary participants in these markets generally enter into back-to-back derivative contracts with third parties that effectively offset each other. That is, financial intermediaries in these markets that enter into a contract to buy, for example, a certain number of barrels of oil from a certain counterparty in a certain future month generally also will enter into another contract, prior to the expiration of the original contract, to sell the same number of barrels of oil to another counterparty in the same future month on substantially identical delivery terms. These market practices typically result in the creation of a chain of contractual relationships that begins with a commodity producer, passes through a number of intermediaries who have entered into matched contracts both to buy and sell the same commodity at the same future time, and ends with a purchaser that intends to take physical delivery of the commodity. On the maturity date of the derivative contracts, the producer will be responsible for making physical delivery and the ultimate buyer will be responsible for accepting physical delivery, while each intermediate participant in the chain will be deemed, by operation of contract, to have instantaneously received and transferred legal title to the commodity.

The Board adopted the restrictions in Regulation Y on the types of Commodity Contracts that a BHC may enter into as principal to reduce the potential that BHCs would become involved in and bear the risks of physical possession, transport, storage, delivery, and sale of bank-ineligible commodities. The restrictions ensure that the commodity derivatives business of a BHC is largely limited to acting as a financial intermediary that facilitates transactions for customers who use or produce commodities or are otherwise exposed to commodity price risk as part of their regular business.

Citigroup and UBS contend that a BHC that takes title to a commodity on an instantaneous, pass-through basis takes no risk that is greater than or different in kind from the risk that it has as a holder of a commodity derivative contract that meets the current requirements of Regulation Y. Instantaneous receipt and transfer of title to (but not physical possession of) commodities does not appear to involve the usual activities relating to, or risks attendant on, commodity ownership. Instead, such transactions involve the routine operations functions of passing notices, documents, and payments -- functions that BHCs regularly perform in their role as financial intermediaries in other markets. Moreover, although BHCs that receive and transfer title to commodities on an instantaneous, pass-through basis face default risks, they are not significantly different than the default risks associated with cash-settled derivative contracts or derivative contracts that include the assignment, termination, or offset provisions required by Regulation Y.

In this light, the Board proposes to modify Regulation Y by changing the Delivery Avoidance Requirement to allow BHCs to take or make delivery of title to commodities underlying commodity derivative transactions on an instantaneous, pass-through basis.

In addition, the Board proposes to modify Regulation Y by changing the Contractual Offset Requirement to permit BHCs to participate in physically settled derivative markets where the standard industry documentation does not allow for assignment, termination, or offset. In particular, the proposal would allow BHCs to enter into Commodity Contracts that do not require cash settlement or specifically provide for assignment, termination, or offset prior to delivery so long as the contracts involve commodities for which futures contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission (“CFTC”) (and the BHC complies with the revised Delivery Avoidance Requirement). Limiting this relief from the Contractual Offset Requirement to derivative contracts based on commodities approved for exchange trading (which are more likely to have reasonably liquid markets) is intended to provide some assurance that a BHC’s reasonable efforts to avoid delivery would be successful. This requirement would, therefore, serve the same purpose as the current Contractual Offset Requirement, which facilitates the financial settlement of Commodity Contracts by requiring BHCs to have contractual rights to avoid taking or making delivery of the underlying commodities.

The proposed modifications of the derivatives provisions in Regulation Y would apply to all BHCs. Although the GLB Act prohibited the Board from adding to the list of activities permissible for all BHCs after November 11, 1999, the Act preserved the Board’s authority to modify the terms and conditions that applied to such activities before that date.⁵ The Board had authorized BHCs to engage as principal in commodity derivative transactions prior to November 11, 1999. The proposed rule would represent a relaxation of the current limitations that apply to a BHC’s commodity derivative activities under Regulation Y and would not create a new permissible activity for BHCs.

The Board invites comment on all aspects of the proposed rule and particularly seeks comment on whether the proposed modifications to Regulation Y would expand the ability of BHCs to participate in commodity derivative markets without exposing them to significant additional risks.

Plain Language

Section 722 of the GLB Act requires the Board to use “plain language” in all proposed and final rules published after January 1, 2000. In light of this requirement, the Board has sought to present the proposed rule in a simple and straightforward manner. The Board invites comment on whether the Board could take additional steps to make the proposed rule easier to understand.

⁵ See 12 U.S.C. 1843(c)(8).

Regulatory Flexibility Act

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the Board must publish an initial regulatory flexibility analysis with this proposed rule. The proposed rule, if adopted, would expand the scope of permissible commodity derivatives activities for a bank holding company. A description of the reasons for the Board's decision to issue the proposed rule and a statement of the objectives of, and legal basis for, the proposed rule are contained in the supplementary material provided above.

The proposed rule would apply to bank holding companies regardless of their size and should enhance the ability of all bank holding companies, including small ones, to compete with other providers of financial services in the United States and to respond to changes in the marketplace in which banking organizations compete. The Board specifically seeks comment on the likely burden the proposed rule would have on bank holding companies, especially small bank holding companies.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed the proposed rule under authority delegated to the Board by the Office of Management and Budget. The proposed rule contains no collections of information pursuant to the Paperwork Reduction Act.

List of Subjects in 12 CFR Part 225

Administrative practice and procedures, Banks, Banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

Authority and Issuance

For the reasons set forth in the preamble, the Board proposes to amend 12 CFR part 225 as follows:

PART 225 -- BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1843(k), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. Section 225.28 would be amended by revising paragraph (b)(8)(ii)(B) to read as follows:

§ 225.28 List of permissible nonbanking activities

* * * * *

(b) * * *

(8) * * *

(ii) * * *

(B) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security,⁶ if:

(1) A state member bank is authorized to invest in the asset underlying the contract;

(2) The contract requires cash settlement;

(3) The contract allows for assignment, termination, or offset prior to delivery or expiration, and the company--

(i) makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or

(ii) engages in the instantaneous receipt and transfer of title to the underlying asset, by operation of contract and without taking or making physical delivery of the underlying asset; or

(4) The contract is based on an asset for which futures contracts or options on futures contracts have been approved for trading on a U.S. contract market by the Commodity Futures Trading Commission, and the company--

(i) makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or

(ii) engages in the instantaneous receipt and transfer of title to the underlying asset, by operation of contract and without taking or making physical delivery of the underlying asset.

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By order of the Board of Governors of the Federal Reserve System, March 10, 2003.

Jennifer J. Johnson (signed)

Jennifer J. Johnson,

Secretary of the Board

⁶ A bank-ineligible security is any security that a state member bank is not permitted to underwrite or deal in under 12 U.S.C. 24 and 335.