

## FEDERAL RESERVE SYSTEM

Citigroup Inc.  
New York, New York

### Order Approving Notice to Engage in Activities Complementary to a Financial Activity

Citigroup Inc. (“Citigroup”), a financial holding company (“FHC”) within the meaning of the Bank Holding Company Act (“BHC Act”), has requested the Board’s approval under section 4 of the BHC Act (12 U.S.C. § 1843) and the Board’s Regulation Y (12 C.F.R. Part 225) to retain all the voting shares of Phibro, Inc., New York, New York (“Phibro”). Phibro engages in a variety of commodity-related activities, including trading in physical commodities, an activity that the Board has not previously approved under the BHC Act. Citigroup currently owns Phibro pursuant to the temporary grandfather authority provided by section 4(a)(2) of the BHC Act.<sup>1</sup>

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 Derivatives”). Under Regulation Y, a BHC may conduct Commodity Derivatives activities 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 physical commodities. Under these restrictions, a BHC may take and make delivery of physically settled derivatives involving commodities that a state

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<sup>1</sup> Citigroup’s grandfather rights expire on October 8, 2003. Citigroup originally acquired its interest in Phibro in October 1998 in connection with the merger between Travelers and Citicorp. See Travelers Group Inc., 84 Federal Reserve Bulletin 985 (1998).

member bank is permitted to own.<sup>2</sup> For all other types of physically settled derivatives,<sup>3</sup> a BHC must make reasonable efforts to avoid delivery on such derivatives or must take and make delivery only on an instantaneous, pass-through basis. Other than in the limited circumstances described above in connection with Commodity Derivatives, Regulation Y generally does not permit BHCs to take or make delivery of nonfinancial commodities.

The BHC Act, as amended by the Gramm-Leach-Bliley Act (“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.<sup>4</sup> The BHC Act permits a FHC to engage in a broad range of activities that are defined in the statute to be financial in nature.<sup>5</sup> Moreover, the BHC Act allows FHCs to engage in any activity that the Board determines, in consultation with the Secretary of the Treasury, to be financial in nature or incidental to a financial activity.<sup>6</sup>

In addition to these provisions, the BHC Act permits FHCs to engage in any activity that the Board (in its sole discretion) determines is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of

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

<sup>3</sup> These derivative contracts would include instruments based on, for example, energy-related and agricultural commodities.

<sup>4</sup> 12 U.S.C. § 1843(c)(8).

<sup>5</sup> The Board determined by regulation before November 12, 1999, that engaging as principal in Commodity Derivatives, subject to certain restrictions, was closely related to banking. Accordingly, engaging as principal in BHC-permissible Commodity Derivatives is a financial activity for purposes of the BHC Act. See 12 U.S.C. § 1843(k)(4)(F).

<sup>6</sup> 12 U.S.C. § 1843(k)(1)(A).

depository institutions or the financial system generally.<sup>7</sup> This authority is intended to allow the Board to permit FHCs to engage on a limited basis in an activity that appears to be commercial rather than financial in nature, but that is meaningfully connected to a financial activity such that it complements the financial activity.<sup>8</sup>

The only limitations on this complementary authority are that, in addition to finding a connection between the nonfinancial activity and a financial activity conducted by the FHC, the Board must determine that the nonfinancial activity does not pose unacceptable risks to the safety and soundness of the FHC, its subsidiary depository institutions, or the U.S. financial system. The safety and soundness requirement was added as part of a compromise in which Congress rejected requests to allow unrestricted affiliations between depository institutions and nonfinancial companies. Moreover, the BHC Act provides that any FHC seeking to engage in a complementary activity must obtain the Board's prior approval under section 4(j) of the BHC Act. In reviewing such a proposal, the BHC Act requires the Board to consider whether performance of the activity by the FHC can reasonably be expected to produce public benefits that outweigh possible adverse effects.<sup>9</sup>

As noted above, Citigroup has requested that the Board expand the authority of FHCs to purchase and sell commodities in the spot market and to take and make delivery of physical commodities to settle Commodity Derivatives ("Commodity Trading Activities"). Commodity Trading Activities substantially involve the commercial activities of physically owning and disposing of assets such

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<sup>7</sup> 12 U.S.C. § 1843(k)(1)(B).

<sup>8</sup> See 145 Cong. Rec. H11529 (daily ed. Nov. 4, 1999) (Statement of Chairman Leach) ("It is expected that complementary activities would not be significant relative to the overall financial activities of the organization.").

<sup>9</sup> 12 U.S.C. § 1843(j)(2)(A).

as oil, natural gas, agricultural products, and other nonfinancial commodities. Moreover, the risks associated with conducting these activities are commercial risks not traditionally incurred or managed to a material extent by banking organizations. Accordingly, the Board does not believe that Commodity Trading Activities may be construed at this time as incidental to a financial activity within the meaning of the GLB Act. The Board concludes, however, for the reasons set forth below, that there is a reasonable basis for construing these activities as complementary to a financial activity within the meaning of the GLB Act.

A number of considerations support a Board determination that Commodity Trading Activities are complementary to a financial activity. First, Commodity Trading Activities flow from the existing financial activities of FHCs. In particular, Commodity Trading Activities would provide FHCs with an alternative method of fulfilling their obligations under otherwise BHC-permissible Commodity Derivatives. For example, if warranted by market conditions, a FHC would be able to use Commodity Trading Activity authority to take a Commodity Derivative to physical settlement rather than terminating, assigning, offsetting, or otherwise cash-settling the contract.

The Board also notes that Citigroup contends that the existing restrictions of Regulation Y place FHCs at a significant bargaining disadvantage when operating in physically settled over-the-counter (“OTC”) derivatives markets. According to Citigroup, counterparties to FHCs in these markets are aware of the regulatory impediments that inhibit FHCs from taking derivative contracts to physical settlement. As a consequence, FHCs that participate in these markets can be forced to terminate or offset their derivative contracts on uneconomic terms. In Citigroup’s view, allowing FHCs to engage in Commodity Trading Activities would permit FHCs to compete in physically settled OTC derivatives markets more economically.

Moreover, authorizing Commodity Trading Activities would enhance the ability of FHCs to efficiently provide a full range of commodity-related services to their customers. Granting FHCs increased flexibility to buy and sell commodities in the spot market and to physically settle Commodity Derivatives likely would benefit customers by enabling FHCs to transact more efficiently with customers in a wider variety of commodity markets and transaction formats. Approving Commodity Trading Activities as a complementary activity also would enable FHCs to acquire more experience in the markets for physical commodities and thereby improve their understanding of commodity derivatives markets and the profitability of their existing BHC-permissible commodity derivatives businesses.

It is also important to note that a number of non-BHC participants in the commodity derivatives markets, including diversified financial companies, conduct Commodity Trading Activities in connection with their commodity derivatives business. These companies can, and regularly do, buy and sell commodities in the spot market and physically settle commodity derivative contracts. Permitting FHCs to engage in Commodity Trading Activities in connection with their commodity derivatives business would, therefore, enable FHCs to offer services that are provided by a number of other financial intermediaries.

Based on the foregoing and all other facts of record, the Board concludes that Commodity Trading Activities involving a particular commodity complement the financial activity of engaging regularly as principal in BHC-permissible Commodity Derivatives based on that commodity.<sup>10</sup>

As noted above, in order to authorize Citigroup to engage in Commodity Trading Activities as a complementary activity under the GLB Act, the Board also

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<sup>10</sup> For example, Commodity Trading Activities involving all types of crude oil would be complementary to engaging regularly as principal in BHC-permissible Commodity Derivatives based on Brent crude oil.

must determine that the activities do not pose a substantial risk to the safety or soundness of depository institutions or the U.S. financial system generally.<sup>11</sup> In addition, the Board must determine that the performance of Commodity Trading Activities by Citigroup “can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.”<sup>12</sup>

In order to limit the potential safety and soundness risks of Commodity Trading Activities, Citigroup has proposed to engage in only a limited amount of Commodity Trading Activities. As a condition of this order, the market value of commodities held by Citigroup as a result of Commodity Trading Activities must not exceed 5 percent of Citigroup’s consolidated tier 1 capital.<sup>13</sup> Citigroup also must notify the Federal Reserve Bank of New York if the market value of commodities held by Citigroup as a result of its Commodity Trading Activities exceeds 4 percent of its tier 1 capital.

In addition, Citigroup may take and make delivery only of physical commodities for which derivative contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission (“CFTC”) (unless specifically excluded by the Board) or which have been specifically approved by the

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<sup>11</sup> 12 U.S.C. § 1843(k)(1)(B).

<sup>12</sup> 12 U.S.C. § 1843(j).

<sup>13</sup> Citigroup would be required to include in this 5 percent limit the market value of any commodities held by Citigroup as a result of a failure of its reasonable efforts to avoid taking delivery under section 225.28(b)(8)(ii)(B) of Regulation Y. In the past, the market value of commodities held by BHCs as a result of an inability to avoid delivery on Commodity Derivatives has not been material.

Board.<sup>14</sup> This requirement is designed to prevent Citigroup from becoming involved in dealing in finished goods and other items, such as real estate, that lack the fungibility and liquidity of exchange-traded commodities.

Permitting Citigroup to engage in the limited amount and types of Commodity Trading Activities described above does not appear to pose a substantial risk to Citigroup, its subsidiary depository institutions, or the U.S. financial system generally. Through its existing authority to engage in Commodity Derivatives, Citigroup already may incur market risk associated with commodities. Permitting Citigroup to buy and sell commodities in the spot market or physically settle Commodity Derivatives would not appear to increase significantly the organization's potential exposure to commodity price risk.

Adding Commodity Trading Activities would, however, expose Citigroup to additional risks, including, but not limited to, storage risk, transportation risk, and legal and environmental risks. To minimize these risks, Citigroup would not be authorized to (i) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities; or (ii) process, refine, or otherwise alter commodities. In conducting its Commodity Trading Activities,

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<sup>14</sup> The particular commodity derivative contract that Citigroup takes to physical settlement need not be exchange-traded, but (in the absence of specific Board approval) futures or options on futures on the commodity underlying the derivative contract must have been approved for exchange trading by the CFTC.

The CFTC publishes annually a list of the CFTC-approved commodity contracts. See Commodity Futures Trading Commission, FY 2002 Annual Report to Congress 124. With respect to granularity, the Board intends this requirement to permit Commodity Trading Activities involving all types of a listed commodity. For example, Commodity Trading Activities involving any type of coal or coal derivative contract would be permitted, even though the CFTC list specifically approves only Central Appalachian coal.

Citigroup will be expected to use appropriate storage and transportation facilities owned and operated by third parties.<sup>15</sup>

Citigroup has indicated that it will mandate that commodity storage facilities used by Citigroup have all required governmental permits and provide to Citigroup a certificate to that effect. Citigroup has further stated that all commodity storage facilities will be inspected by or on behalf of Citigroup before use and that Citigroup will physically inspect any commodity in storage every six months.

In addition, Citigroup has indicated that it will adopt additional standards for Commodity Trading Activities that involve environmentally sensitive products, such as oil or natural gas. For example, Citigroup will require that the owner of every vessel that carries oil on behalf of Citigroup be a member of a protection and indemnity club and carry the maximum insurance for oil pollution available from the club. Citigroup also will require every such vessel to carry substantial amounts of additional oil pollution insurance from creditworthy insurance companies. Furthermore, Citigroup will place age limitations on vessels and will require vessels to be approved by a major international oil company and have appropriate oil spill response plans and equipment. Moreover, Citigroup will have a comprehensive backup plan in the event any vessel owner fails to respond adequately to an oil spill and will hire inspectors to monitor the loading and discharging of vessels.

Citigroup also has represented that it will have in place specific policies and procedures for the storage of oil. In addition to the general policies set forth above, Citigroup will require all oil storage facilities it uses to carry a significant

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<sup>15</sup> Approving Commodity Trading Activities as a complementary activity, subject to limits and conditions, would not in any way restrict the existing authority of Citigroup to deal in foreign exchange, precious metals, or any other bank-eligible commodity.

amount of oil pollution insurance from a creditworthy insurance company and to have appropriate spill response plans and equipment. Citigroup also will have a comprehensive backup plan in the event the storage facility owner fails to respond adequately to an oil spill.

Finally, Citigroup and its Commodity Trading Activities will remain subject to the general securities, commodities, and energy laws and the rules and regulations (including the antifraud and antimanipulation rules and regulations) of the Securities and Exchange Commission, the CFTC, and the Federal Energy Regulatory Commission.

The Board believes that Citigroup has the managerial expertise and internal control framework to manage the risks of taking and making delivery of physical commodities. In addition, Citigroup has the expertise and internal controls to integrate effectively the risk management of Commodity Trading Activities into Citigroup's overall risk management framework, including managing on a consolidated basis Citigroup's overall exposure arising from commodity-related activities.

Approval of the proposal likely would benefit Citigroup's customers by enhancing the ability of Citigroup to provide efficiently a full range of commodity-related services. Approving Commodity Trading Activities for Citigroup also would enable the company to improve its understanding of physical commodity and commodity derivatives markets and its ability to serve as an effective competitor in physical commodity and commodity derivatives markets.

For these reasons, and based on Citigroup's policies and procedures for monitoring and controlling the risks of Commodity Trading Activities, the Board concludes that consummation of the proposal does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and

can reasonably be expected to produce benefits to the public that outweigh any potential adverse effects.

Based on all the facts of record, including the representations and commitments made by Citigroup in connection with the notice, and subject to the terms and conditions set forth in this order, the Board has determined that the notice should be, and hereby is, approved. The Board's determination is subject to all the conditions set forth in Regulation Y, including those in section 225.7 (12 C.F.R. 225.7), and to the Board's authority to require modification or termination of the activities of a BHC or any of its subsidiaries as the Board finds necessary to ensure compliance with, or to prevent evasion of, the provisions and purposes of the BHC Act and the Board's regulations and orders issued thereunder. The Board's decision is specifically conditioned on compliance with all the commitments made in connection with the notice, including the commitments and conditions discussed in this order. The commitments and conditions relied on in reaching this decision shall be deemed to be conditions imposed in writing by the

Board in connection with its findings and decision and, as such, may be enforced in proceedings under applicable law.

By order of the Board of Governors,<sup>16</sup> effective October 2, 2003.

(signed)

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Robert deV. Frierson  
Deputy Secretary of the Board

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<sup>16</sup> Voting for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, and Bernanke. Absent and not voting: Governor Kohn.