FEDERAL RESERVE SYSTEM

UBS AG
Zurich, Switzerland

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

UBS AG ("UBS"), a foreign bank that is treated as a financial holding company ("FHC") for purposes 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 UBSW Energy LLC, Stamford, Connecticut ("UBS Energy"), and to continue to engage in physical commodity trading in the United States. UBS currently conducts physical commodity trading in the United States pursuant to temporary grandfather authority provided by the BHC Act and Regulation Y.[1]

Regulation Y currently authorizes bank holding companies ("BHCs") to engage as principal in derivative contracts based on financial and nonfinancial assets ("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 nonfinancial commodities. Under these restrictions, a BHC generally is not allowed to take or make delivery of nonfinancial commodities underlying Commodity Derivatives. In addition, BHCs generally are not permitted to purchase or sell nonfinancial commodities in the spot market.

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[1] UBS's grandfather rights expire on February 8, 2004. UBS conducts its U.S. energy trading business through UBSW Energy and UBS's London branch.

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.[2] 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.[3] 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.[4]

In addition, 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 depository institutions or the financial system generally.[5] 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.[6] The BHC Act provides that any FHC seeking to engage in a

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[2] 12 U.S.C. § 1843(c)(8).

[3] 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. <u>See</u> 12 U.S.C. § 1843(k)(4)(F).

[4] 12 U.S.C. § 1843(k)(1)(A).

[5] 12 U.S.C. § 1843(k)(1)(B).

[6] <u>See</u> 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.").

complementary activity must obtain the Board's prior approval under section 4(j) of the BHC Act.[7]

UBS has requested that the Board permit it to purchase and sell physical commodities in the spot market and to take and make delivery of physical commodities to settle Commodity Derivatives ("Commodity Trading Activities"). The Board previously has determined 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.[8] UBS regularly engages as principal in BHC-permissible Commodity Derivatives based on a variety of commodities, including natural gas and electricity. Based on the foregoing and all other facts of record, the Board believes that Commodity Trading Activities are complementary to the Commodity Derivatives activities of UBS.

In order to authorize UBS to engage in Commodity Trading Activities as a complementary activity under the GLB Act, the Board also 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.[9] In addition, the Board must determine that the performance of Commodity Trading Activities by UBS "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible

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[7] 12 U.S.C. § 1843(j).

[8] See Citigroup Inc., 89 Federal Reserve Bulletin 508 (2003). 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.

[9] 12 U.S.C. § 1843(k)(1)(B).

adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices."[10]

Approval of the proposal likely would benefit UBS's customers by enhancing the ability of the bank to provide efficiently a full range of commodity-related services. Approving Commodity Trading Activities for UBS 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.

UBS has established and maintains policies for monitoring, measuring, and controlling the credit, market, settlement, reputational, legal, and operational risks involved in its Commodity Trading Activities. These policies address key areas such as counterparty credit risk, value-at-risk methodology and internal limits with respect to commodity trading, new business and new product approvals, and identification of transactions that require higher levels of internal approval. The policies also describe critical internal control elements, such as reporting lines, and the frequency and scope of internal audit of Commodity Trading Activities.

The Board believes that UBS has integrated the risk management of Commodity Trading Activities into the bank's overall risk management framework. Based on the above and all the facts of record, the Board believes that UBS has the managerial expertise and internal control framework to manage adequately the risks of taking and making delivery of physical commodities as proposed.

In order to limit the potential safety and soundness risks of Commodity Trading Activities, as a condition of this order, the market value of

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[10] 12 U.S.C. § 1843(j).

commodities held by UBS as a result of Commodity Trading Activities must not exceed 5 percent of UBS's consolidated tier 1 capital (as calculated under its home country standard).[11] UBS also must notify the Federal Reserve Bank of New York if the market value of commodities held by UBS as a result of its Commodity Trading Activities exceeds 4 percent of its tier 1 capital.

In addition, UBS may take and make delivery only of physical commodities for which derivative contracts have been authorized 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 Board.[12] This requirement is designed to prevent UBS 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.

To minimize the exposure of UBS to additional risks, including storage risk, transportation risk, and legal and environmental risks, UBS may not (i) own, operate, or invest in facilities for the extraction, transportation, storage, or

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[11] UBS would be required to include in this 5 percent limit the market value of any commodities held by UBS 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.

[12] The particular commodity derivative contract that UBS 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 authorized for exchange trading by the CFTC.

The CFTC publishes annually a list of the CFTC-authorized 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 has authorized only Central Appalachian coal.

distribution of commodities; or (ii) process, refine, or otherwise alter commodities. In conducting its Commodity Trading Activities, UBS will be expected to use appropriate storage and transportation facilities owned and operated by third parties.[13]

UBS and its Commodity Trading Activities also remain subject to the general securities, commodities, and energy laws and the rules and regulations (including the anti-fraud and anti-manipulation rules and regulations) of the Securities and Exchange Commission, the CFTC, and the Federal Energy Regulatory Commission.

Permitting UBS to engage in the limited amount and types of Commodity Trading Activities described above, on the terms described in this order, would not appear to pose a substantial risk to UBS, depository institutions, or the U.S. financial system generally. Through its existing authority to engage in Commodity Derivatives, UBS already may incur the price risk associated with commodities. Permitting UBS 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.

For these reasons, and based on UBS'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.

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[13] Approving Commodity Trading Activities as a complementary activity, subject to limits and conditions, would not in any way restrict the existing authority of UBS to deal in foreign exchange, precious metals, or any other bank-eligible commodity.

Based on all the facts of record, including the representations and commitments made by UBS 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,[14] effective January 27, 2004.

(signed)

Robert deV. Frierson
Deputy Secretary of the Board

[14] Voting for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.