



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

SCOTT G. ALVAREZ  
GENERAL COUNSEL

May 15, 2006

Isaac Lustgarten, Esq.  
McDermott Will & Emery LLP  
50 Rockefeller Plaza  
New York, New York 10020

Dear Mr. Lustgarten:

This responds to your request on behalf of [BANK HOLDING COMPANY (“BHC”)], a bank holding company that has elected to be a financial holding company within the meaning of the Bank Holding Company Act of 1956 (12 U.S.C. § 1841 *et seq.*) (“BHC Act”). You have inquired as to whether it would be permissible under the BHC Act and the Board’s Regulation Y (12 C.F.R. part 225) for [BHC] to engage in “commodity purchase and forward sale” (“CPFS”) transactions as a method of financing the commodity inventories of its customers.<sup>1</sup>

You have described two alternative structures for the CPFS transactions. In the first structure, [BHC] would purchase a commodity from its customer and simultaneously enter into a forward sale agreement under which

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<sup>1</sup> You have indicated that the commodities involved in these transactions would include agricultural commodities (such as corn, wheat, soybeans and other legumes, cotton, cocoa, coffee, sugar, various oilseeds and oils, and dairy products), live cattle, timber, and exchange-traded metals. [BHC]’s CPFS transactions would in all cases involve commodities (i) for which contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission, or (ii) which [BHC] can show, to Board staff’s satisfaction, have readily-available price quotes and are traded regularly in global commodity markets.

the customer would be obligated to repurchase the commodity from [BHC] at a predetermined price and on a predetermined future date. The second structure is similar to the first structure, except that it would involve a third party, either as the initial seller of the commodity to [BHC] or as the ultimate purchaser of the commodity from [BHC]. For example, under this second structure, [BHC] might purchase a commodity from a supplier identified by [BHC]'s customer and simultaneously execute a forward sale agreement under which [BHC]'s customer would be obligated to purchase the commodity from the bank at a predetermined price and on a predetermined future date. During the term of a CPFS transaction, [BHC] would hold title to the underlying commodity, would mark the commodity to market on a daily basis, and would call for additional margin if the market value of the commodity falls below a specific collateral threshold.

The BHC Act permits bank holding companies to engage in any activity that the Board had determined by regulation or order as of November 11, 1999, "to be so closely related to banking as to be a proper incident thereto."<sup>2</sup> The Board had determined by regulation issued prior to November 11, 1999, that "[m]aking, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit and accepting drafts) for the company's account or for the account of others" is an activity so closely related to banking as to be a proper incident thereto and, therefore, is a permissible activity for bank holding companies.<sup>3</sup> You argue that the proposed CPFS transactions are the functional equivalent of extensions of credit, and therefore permissible under this authority.

[BHC] would earn a fixed return on a CPFS transaction, just as it would on an ordinary secured loan, and its risk exposure would effectively be limited to counterparty credit risk. You have indicated that [BHC] would subject any prospective CPFS counterparty to the same credit review process used for loan applicants, and that [BHC]'s internal credit review personnel would also review outstanding CPFS arrangements. You have indicated that [BHC] would never enter into an agreement to purchase a commodity unless the bank simultaneously enters into an agreement to sell the commodity to a creditworthy counterparty on a fixed future date at a fixed price. You have indicated that the fixed future sale price would be equal to the initial purchase

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<sup>2</sup> 12 U.S.C. § 1843(c)(8).

<sup>3</sup> See 12 C.F.R. 225.28(b)(1).

price plus a fixed interest component (and thus would not vary based on movements in the price of the commodity). In other words, unless the ultimate purchaser defaults, [BHC] would be repaid its principal plus a fixed amount of interest at maturity of the transaction. Accordingly, unless the ultimate purchaser defaults, [BHC] would not bear any commodity price risk from a CPFS transaction – the price the bank would receive for the commodities on the maturity date of the transaction would be fixed on the date the bank enters into the transaction. If the ultimate purchaser were to default in its obligation to purchase the underlying commodity at the maturity of the CPFS transaction, [BHC] would have a claim against the ultimate purchaser to recover the equivalent of principal and interest and could sell the commodity into the market to mitigate credit losses in the same manner as the bank would liquidate any collateral supporting a loan in default. Any commodities acquired by [BHC] as a result of counterparty default would be held in accordance with the limits applicable to assets acquired by a bank holding company in the course of collecting a debt previously contracted.<sup>4</sup>

Moreover, you have represented that all non-price risks and costs of owning the commodity during the term of the CPFS transaction would be borne by the ultimate purchaser. For example, [BHC] would not be exposed to the storage risk of the commodity because the terms of the CPFS transaction would require the ultimate purchaser to purchase the commodity “as is, where is,” (in the absence of willful misconduct by [BHC]). The ultimate purchaser must also obtain insurance that covers the risks of damage, deterioration, and typically theft or fraud of the commodity, and [BHC] would be added as a named beneficiary to the insurance policy. During the term of the transaction, the ultimate purchaser (not [BHC]) would be responsible for paying the costs of storing and insuring the commodity. In all cases, although [BHC] would take title to the underlying commodity at the inception of a CPFS transaction, it would take title in the form of a warehouse receipt only; that is, the commodity would continue to be stored in a licensed warehouse owned and operated by an entity other than [BHC]. The commodity would not be moved physically as a result of the transaction.

You have stated that [BHC] acquires title to the underlying commodity in a CPFS transaction as an incident to the financing the bank provides to its customers and not for speculative purposes. You have

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<sup>4</sup> 12 C.F.R. 225.22(d)(1).

represented that [BHC] does not and will not hold itself out as making a market in the commodity. In addition, you have indicated that [BHC] does not and will not (i) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities; or (ii) process, refine, or otherwise alter commodities.

To support your view that the transaction is the functional equivalent of an extension of credit, you have indicated that [BHC] would account for a CPFS transaction as an “asset purchased under an agreement to resell” and would recognize profit and loss on a CPFS transaction on an accrual basis, in a manner similar to a traditional loan. You also have stated that the ultimate purchaser counterparty in a CPFS transaction would generally record the underlying commodity as an asset on its balance sheet, and would record its obligation to purchase the commodity as a short-term debt liability on its balance sheet, during the term of the transaction.

The Board has previously found a three-party commodity financing arrangement similar to [BHC]’s proposed three-party CPFS transactions to be an extension of credit permissible for bank holding companies under Regulation Y. In a 1973 order issued to Chemical New York Corporation (“Chemical”), the Board approved as a permissible lending activity for bank holding companies an arrangement under which Chemical would finance a utility’s coal purchases by purchasing from a third party, and taking title to, a quantity of coal on a monthly basis at the direction of the utility customer.<sup>5</sup> Chemical would store the coal on the premises of the utility under a lease arrangement with the utility. The utility would use the coal continuously throughout the following month and would pay Chemical monthly for the amount of coal used, at a price equal to Chemical’s acquisition cost for the coal plus a fixed amount of interest. The utility explicitly bore the risk of loss or damage to the coal during storage. If the utility defaulted, Chemical had the right to sell the coal to cover its losses and the right to sue the utility for any shortfall in the liquidation proceeds. As with the proposed CPFS transactions, the utility’s motive for the transaction was to obtain financing for its commodities inventory.

Based on the information you have provided and the Board’s precedents in this area, it is my opinion that the proposed CPFS transactions are

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<sup>5</sup> Chemical New York Corporation/CNA Nuclear Leasing, Inc., 59 Federal Reserve Bulletin 698 (1973).

within the scope of permissible lending activities for bank holding companies under section 225.28(b)(1) of Regulation Y. [BHC] should have in place policies and procedures to identify whether a CPFS transaction would create heightened legal or reputational risk to [BHC], and to manage any such risk. In particular, [BHC] should have policies and procedures to identify whether a particular CPFS transaction lacks economic substance or business purpose; may be designed by the counterparty for questionable accounting, regulatory, or tax purposes; or may be accounted for or disclosed by the counterparty in a way that is misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

This opinion is limited solely to the permissibility of the proposed CPFS activities described above under Regulation Y and does not address the permissibility of any other activities or authorize [BHC] to engage in any other activities in the United States. Any material change in the manner in which [BHC] conducts the proposed CPFS transactions could result in a different conclusion and should be reported promptly to Board staff. If you have any questions about this matter, please contact Mark E. Van Der Weide (202/452-2263) or Andrew S. Baer (202/452-2246) of the Board's Legal Division.

Sincerely,

*(signed)*

Scott G. Alvarez

cc: Federal Reserve Bank of New York  
New York State Banking Department