

**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 14, 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, NW., Washington, DC 20551, or mailed electronically to [regs.comments@federalreserve.gov](mailto: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, NW. Members of the public may inspect comments in Room MP-500 of the Martin Building between 9 a.m. and 5 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").<sup>1</sup>

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.<sup>2</sup> For all other types of physically settled commodity derivatives,<sup>3</sup> 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).<sup>4</sup>

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 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

<sup>1</sup> 12 CFR 225.28(b)(8)(ii)(B).

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

<sup>4</sup> 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.