

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 believes 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 the BHC 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 currently required by Regulation Y.<sup>5</sup>

The final rule's modifications to Regulation Y will enable BHCs that participate in commodity derivatives markets to provide their customers with

a more comprehensive range of financial intermediation and risk management services. In addition, the final rule should enhance the ability of BHCs to compete effectively with non-BHC participants in the commodity derivatives markets (who currently are able to engage in physically settled derivative transactions with customers). Moreover, by expanding the types of derivative transactions in which BHCs may engage, the final rule should augment the capacity of BHCs to understand commodity markets and to diversify the market, credit, and other risks involved in derivatives trading.

In addition, the Board does not believe that the final rule will materially increase the conflicts of interest faced by BHCs that participate in the commodity derivatives markets or result in any other material adverse effects. Although the final rule will enable derivatives affiliates of BHCs to use a wider variety of transaction formats, the rule will not expand the types of commodities that may serve as the basis for derivative transactions engaged in by BHCs. Importantly, banking organizations are subject to a number of Federal banking laws designed to prevent conflicts of interest, including sections 23A and 23B of the Federal Reserve Act and section 106 of the Bank Holding Company Act Amendments of 1970.<sup>6</sup> Moreover, banking organizations that engage in derivatives activities, including the commodity derivatives activities newly authorized by the final rule, would remain subject to the general securities, commodities, and energy laws and the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission ("CFTC"), and the Federal Energy Regulatory Commission.<sup>7</sup>

For these reasons, the Board's final rule modifies 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. A BHC takes and makes delivery of title to a commodity on an instantaneous, pass-through basis for purposes of the final rule only if the BHC takes delivery of title to the commodity from a seller and immediately thereafter makes delivery

of title to the commodity to a buyer. Accordingly, the revised Delivery Avoidance Requirement would not provide authority for a BHC to take physical delivery of commodities for use or investment or to make physical delivery of commodities out of the inventory of the BHC. In other words, the BHC must not be the original seller of the commodity in the initial position in the delivery chain or the ultimate buyer of the commodity in the last position in the delivery chain.

The Board's final rule also modifies 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 rule 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 CFTC (and the BHC complies with the revised Delivery Avoidance Requirement).<sup>8</sup>

A number of commenters expressed specific support for this modification of the Contractual Offset Requirement. Because derivative contracts based on commodities approved for exchange trading are more likely to have reasonably liquid markets than derivatives based on non-approved commodities, this modified requirement should continue to provide some assurance that BHCs would be able to avoid physical delivery of commodities underlying derivative contracts. 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.<sup>9</sup>

<sup>8</sup> The CFTC publishes annually a list of the CFTC-approved commodity contracts. See Commodity Futures Trading Commission, *FY 2001 Annual Report to Congress* 126. With respect to granularity, the Board intends this requirement to include all types of a listed commodity. For example, any type of coal or coal derivative contract would satisfy this requirement, even though the CFTC list specifically approves only Central Appalachian coal.

<sup>9</sup> One commenter asked whether the rule would authorize BHCs to engage in activities incidental to engaging in the derivative transaction types newly authorized by the rule, such as entering into service arrangements with operators of pipelines, power grids, and similar facilities. A BHC may engage in any incidental activities that are necessary to allow the BHC to engage in the derivative transaction

<sup>5</sup> Although one commenter expressed concern that the rule would facilitate excessive risk taking by BHCs, the commenter provided no evidence in support of this position. For the reasons discussed above, the Board does not believe that the rule will expose BHCs to different types or heightened levels of risk.

<sup>6</sup> See 12 U.S.C. 371c, 371c-1, 1972.

<sup>7</sup> Although one commenter asserted that the rule would result in increased conflicts of interest for BHCs, the Board is not aware of, and the commenter has not presented, any evidence in support of this position. For the reasons discussed above, the Board does not believe that the rule will materially increase the conflicts of interest faced by BHCs that trade commodity derivatives.