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Financial Institutions Group Newsletter

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Federal Reserve Issues Proposal to Relax Limitations on Derivatives Activities of Bank Holding Companies

On March 11, 2003, the Federal Reserve Board ("Board") issued a proposed rule that would facilitate the ability of bank holding companies ("BHCs") to engage in non-financial derivative transactions, particularly those involving energy and agricultural commodities. Specifically, the Board proposal—which is open for public comment until April 21, 2003—would amend Regulation Y to broaden the circumstances under which BHCs may engage as principal in derivatives contracts; the amendment would permit BHCs to take delivery of title to commodities underlying derivative contracts on an instantaneous, pass-through basis.

Background

Since 1997, the Board's Regulation Y has authorized BHCs to invest as principal in derivatives contracts based on both financial and non-financial commodities.¹ Such transactions are subject to three restrictions under Regulation Y. Specifically, a BHC may invest or trade as principal in a derivatives contract only if:

- (1) a state member bank is authorized to invest in the underlying commodity;
- (2) the contract requires cash settlement; or
- (3) (A) the contract allows for assignment, termination, or offset prior to delivery or expiration, and
(B) the BHC makes every reasonable effort to avoid taking or making delivery of the underlying commodity.²

These restrictions effectively prohibit a BHC from physically settling on derivative contracts based on commodities that a state member bank is *not* permitted to own, such as derivatives contracts based on gas, oil, electricity and agricultural products. The purpose of these restrictions is to ensure that a BHC's role is limited to acting as a financial intermediary and that the BHC does not become involved in and bear the risk of physical possession, transport, storage, delivery and sale of underlying physical commodities that the BHC is not permitted to own.

The Proposal

The Board now seeks public comment on a proposal—brought forth at the urging of Citigroup and UBS—that would bring the restrictions on BHC commodities transactions under Regulation Y more in line with current practices in certain over-the-counter futures and forward markets, such as U.S. energy and agricultural markets. The proposal would allow BHCs to enter into derivative contracts that typically result in taking delivery of title to, but not physical possession of, commodities on an instantaneous, pass-through basis, regardless of whether the contract contains assignment, termination or off-set provisions.

The Board proposes to modify Regulation Y in two respects:

First, under the proposal, a BHC would not have to make every reasonable effort to avoid taking delivery of the underlying commodity; rather, the proposal would allow a BHC to take delivery of title to (but not physical possession of) the underlying commodity on an instanta-

¹ 12 C.F.R. 225.28(b)(8)(ii)(B).

² *Id.*

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neous, pass-through basis.

Second, for contracts based on assets for which futures contracts or options on futures have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission, the proposal would permit a BHC to enter into commodity contracts that do not specifically provide for assignment, termination or offset prior to delivery or expiration. This relief—which, to be clear, is limited to exchange-traded contracts—would allow a BHC to participate in transactions in markets where the standard industry documentation does not allow for assignment, termination or offset.

The Board bases its legal authority for this proposal on its powers under the Gramm-Leach-Bliley Act (“GLB Act”) to modify the terms and conditions applicable to those activities that the Board determined, prior to November 12, 1999, were closely related to banking under section 4(c)(8) of the Bank Holding Company Act.³ The GLB Act prohibits the Board from adding to the list of BHC permissible activities after November 11, 1999, but the Act allows the Board to relax limitations that apply to previously approved BHC activities.

Analysis of the Proposal

As noted above, the Board’s proposal is fairly narrow in scope. It would permit BHCs to receive and transfer title to the underlying commodity *only* on an instantaneous, pass-through basis, *without* taking

physical possession of the commodity. The proposal, while helpful in bringing BHCs’ commodity activities closer to current market practices, may not go far enough in ensuring the ability of BHCs to compete with other financial intermediaries in commodity-linked financial transactions.

Perhaps as recognition of this fact, the Board has indicated that it is reviewing whether to permit those BHCs that have elected financial holding company status under the GLB Act to take physical delivery of a limited amount of commodities as incident to their derivatives activities. The Board has said that it is considering whether such activity could be approved either as “incidental” or “complementary” to a financial activity. (The Board would need to consult with the Treasury Department to find an activity to be “incidental” to a financial activity under the GLB Act; the Board may decide on its own to find an activity to be “complementary.”) We will continue to monitor the Board’s progress in this area.

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If you would like further information regarding or a copy of the Board proposal, please contact any one of the following:

Greg Baer +1 (202) 663-6859
(Gregory.Baer@wilmer.com)

Satish Kini +1 (202) 663-6482
(Satish.Kini@wilmer.com)

Ursula Bass +1 (202) 663-6203
(Ursula.Bass@wilmer.com)

³ See 12 U.S.C. § 1843(c)(8).

This letter is for general informational purposes only and does not represent our legal advice as to any particular set of facts, nor does this letter represent any undertaking to keep recipients advised as to all relevant legal developments. For further information on these or other financial institutions matters, please contact one of the lawyers:

Philip D. Anker	+1 (202) 663-6613	Franca Harris Gutierrez	+1(202) 663-6557	James H. Mann	+1 (212) 230-8843
Gregory A. Baer	+1 (202) 663-6859	Wilhelm Hartung	+44 (0) 20 7872-1075	David Medine	+1 (202) 663-6220
Ursula Bass	+1 (202) 663-6203	Stephen R. Heifetz	+1 (202) 663-6558	Eric Mogilnicki	+1 (202) 663-6410
Clare D. Bracewell	+1 (202) 663-6944	Michael Hershaft	+1 (202) 663-6427	Matthew P. Previn	+1 (212) 230-8878
Russell J. Bruemmer	+1 (202) 663-6804	Kirk Jensen	+1 (202) 663-6182	Jessica E. Singer	+1 (202) 663-6133
J. Beckwith Burr	+1 (202) 663-6695	Satish M. Kini	+1 (202) 663-6482	Daniel H. Squire	+1 (202) 663-6060
David M. Capps	+44 (0) 20 7872-1080	Michael D. Leffel	+1 (202) 663-6784	Natacha Steimer	+1 (202) 663-6534
Ricardo R. Delfin	+1 (202) 663-6912	Christopher R. Lipsett	+1 (212) 230-8880	Todd Stern	+1 (202) 663-6940
Simon Firth	+44 (0) 20 7872-1036	David A. Luigs	+1 (202) 663-6451	Manley Williams	+1 (202) 663-6595
		Martin E. Lybecker	+1 (202) 663-6240		