



April 21, 2003

Jennifer J. Johnson, Esq.
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. R-1146

Dear Ms. Johnson:

The Securities Industry Association (“SIA”)¹ appreciates the opportunity to comment on the proposed rule issued by the Federal Reserve Board (the “Board”) to broaden the circumstances under which bank holding companies (“BHCs”) may engage as principal in derivatives contracts. *See* 68 Fed. Reg. 12316 (Mar. 14, 2003). Specifically, the proposal would amend the Board’s Regulation Y and allow BHCs to take delivery of title to, but not physical possession of, commodities underlying derivative contracts on an instantaneous, pass-through basis.

Under the current Regulation Y, 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) the contract allows for assignment, termination, or offset prior to delivery or expiration, and the BHC makes every reasonable effort to avoid taking or making delivery of the underlying commodity. These restrictions preclude BHCs from participating in certain forward markets, such as U.S. energy and agricultural markets, because, as the Board has noted in

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 700,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$214 billion in U.S. revenue and \$285 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

its proposed rulemaking, participants in these markets typically settle derivatives contracts by taking title to the underlying commodities.

SIA strongly supports adoption of the proposed rule. By allowing BHCs to take delivery of title to commodities on an instantaneous pass-through basis, the proposed rule would allow BHCs and their affiliates to compete more effectively. In addition, and for all the reasons noted in the preamble to the proposed rule, the expanded derivatives authority does not expose BHCs to expanded or materially different risks than BHC's current derivatives activities.

The Board also notes in the preamble to the proposed rule that it is giving consideration to permitting those BHCs that elect financial holding company ("FHC") status to take physical delivery of commodities. The Board is apparently considering whether to permit this activity as one that is "incidental" or "complementary" to a financial activity. 68 Fed. Reg. at 12317 n.5.

Under the Gramm-Leach-Bliley Act ("GLB Act"), the Board, in consultation with the Treasury Department, may permit a FHC to engage in an activity that is "incidental" to a financial activity. 12 U.S.C. § 1843(k)(1). The Board has previously noted that the "incidental" test is necessarily broader than the "closely related to banking" test that previously applied under the Bank Holding Company Act. 65 Fed. Reg. 80384, 80385 (Dec. 21, 2000). The new test allows FHCs to engage in a far broader range of activities than BHCs and does so to permit FHCs to "compete effectively with any company seeking to provide financial services in the United States." 12 U.S.C. § 1843(k)(3)(D)(i).

In addition, the GLB Act permits the Board to authorize FHCs to engage in activities that are "complementary" to a financial activity. Specifically, the Act authorizes complementary activities – including commercial, as opposed to financial, activities – that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system in general. 12 U.S.C. § 1843(k)(1)(B).

SIA believes that, under the new GLB Act standards, the Board should allow FHCs – as either an "incidental" or "complementary" activity – to take possession of physical commodities. This authority should permit FHCs, for example, to take possession of an underlying commodity in the event that a derivatives contract in that commodity fails. It also should enable FHCs to take advantage of hedging and arbitrage opportunities that may exist due to price differentials in the futures and spot prices for certain commodities. In addition, SIA believes that FHCs should be able to trade physical commodities on the spot market (regardless of whether such spot trading is related to a derivatives transaction that an FHC has entered into).

Other financial services firms that participate in the forwards and futures markets are not restricted from taking physical possession of commodities, and they may do so for various purposes, including hedging and arbitrage. As the Board knows, the central purpose of the GLB Act was to place FHCs on equal competitive footing with other financial services entities, and allowing FHCs to take physical possession of commodities

as “incidental” or “complementary” to their derivatives activities would be in furtherance of that goal. In addition, trading in physical commodities would not pose a safety and soundness risk because the types of commodities that FHCs would come to possess, such as energy and agricultural products, may be traded easily in deep and liquid markets and, therefore, would be unlikely to be held by FHCs for significant periods of time.

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SIA appreciates the opportunity to comment on the Board’s proposed rule. Please contact the undersigned at 202-296-9410 if we can provide you with any further information.

Sincerely,

Alan E. Sorcher
Associate General Counsel