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## OCC & Federal Reserve Report and Proposed Rules - Limitation on Banks Dealing & Investing in Metals and other Physical Commodities

### At a Glance...

On September 8, 2016, as required by Section 620 of the Dodd-Frank Act, the Board of Governors of the Federal Reserve System (the “**Board**”), the Office of the Comptroller of the Currency (the “**OCC**”) and the Federal Deposit Insurance Corporation (the “**FDIC**”) released a joint report to Congress and the Financial Stability Oversight Council (the “**Report**”), on the activities and investments that banking entities may engage in under applicable law.<sup>1</sup> The Report discusses the OCC’s intention to address national banks’ authority to hold and trade copper as well as other physical commodities. The OCC published a Notice of Proposed Rulemaking (the “**OCC Proposed Rule**”) on the same day which would prohibit national banks and federal savings associations (“**FSAs**”) in the United States from dealing and investing in industrial and commercial metal, including copper as well as other physical commodities.<sup>2</sup> The OCC Proposed Rule would also apply indirectly to federal branches and agencies of foreign banks in the United States, and insured state banks and state savings associations.<sup>3</sup>

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Additionally, on September 23, 2016, the Federal Reserve Board announced a proposed rule (the “**Board Proposed Rule**”) (the “Board Proposed Rule” and “OCC Proposed Rule,” collectively the “**Proposed Rules**”) that would strengthen existing requirements and limitations on the physical commodity activities of financial holding companies (“**FHCs**”) and bank holding companies (“**BHCs**”). This rule would (i) require FHCs to hold additional capital in connection with activities involving certain physical commodities<sup>4</sup>; (ii) require FHCs to tighten

the quantitative limit on their amount of physical commodity trading activity; (iii) rescind authorizations that allow FHCs to engage in physical commodity activities involving power plants; (iv) remove copper from the list of precious metals that all BHCs are permitted to own and store<sup>5</sup>, and prohibit them from engaging in derivatives contracts that require physical delivery of copper (consistent with the OCC Proposed Rule for national banks); and (v) establish new public reporting requirements on the nature and extent of FHCs' physical commodity holdings and activities. This Client Alert focuses on the aspect of the Board Proposed rule that would remove copper from the list of precious metals that BHCs that are not FHCs are permitted to own and store, and the prohibition on entering into derivatives contracts that require taking delivery of copper as principal.<sup>6</sup> The Proposed Rules generally would not prohibit banks from receiving such interests as collateral in lending transactions, or taking hedging positions as part of customer-driven financial intermediation or reverse repos that are the economic equivalent of lending.

While the OCC Proposed Rule applies to national banks, federal agencies, and branches of foreign banks, the Board Proposed Rule (with respect to the removal of copper from the list of precious metals BHCs may own and store) applies to BHCs. Furthermore, as proposed, the Board Proposed Rule only reclassifies copper, while the OCC Proposed Rule's prohibition covers "metals primarily suited for industrial or commercial use," *including* copper. A wider variety of metals may therefore be affected by the OCC Proposed Rule, such as bullion metals in industrial or commercial form. Although the Report and the Proposed Rules apply to other physical commodities, this alert focuses on provisions applicable mainly to metals.

## Background

Traditionally, a national bank, FHC or BHC (including those that do not qualify as an FHC) ("**Regulated Banking-Entity**"), may engage in activities that are part of, related to, or incidental to the business of banking<sup>7</sup>, including buying and selling exchange, coin, and bullion. Prior to the Proposed Rules, the OCC and the Board had interpreted "exchange, coin and bullion" to include copper on the basis that the trading of copper was becoming more similar to the trading of "precious metals."<sup>8</sup>

## The OCC Proposed Rule

The OCC proposes to prohibit national banks from dealing and investing in copper and similar metals or alloys<sup>9</sup> in a form primarily suited to industrial or commercial use.

The rule allowing national banks to deal in precious metals was based on the premise that dealing in coin and bullion (which are composed of precious metals) is incidental to the business of banking.<sup>10</sup> The OCC holds that the definitions of "coin" and "bullion" do not encompass industrial or commercial metal, and

moreover the buying and selling of industrial or commercial metal is not part of or incidental to the business of banking.”<sup>11 12</sup> The OCC Notice supports this interpretation by explaining that in the mid-19th century, when Congress passed the National Bank Act, “bullion” meant metal suitable for coining, not metal suitable for making wires.<sup>13</sup> The rule specifically designates gold jewelry as commercial metal; however, it is unclear if bullion such as a gold bar that is destined to become jewelry (e.g., held for or to be sold to a jeweler) would be considered commercial metal.

The OCC Proposed Rule would require insured state banks from a state that permitted the trading of physical commodities that are copper, and other industrial and commercial metals, to apply to the FDIC for a determination that the activity does not pose a significant risk to the Deposit Insurance Fund.

The OCC Proposed Rule would not prohibit buying or selling industrial or commercial metal: (i) of nominal amounts to hedge customer-driven derivatives<sup>14</sup>; (ii) through transitory title transfers entered into as part of a customer-driven financial intermediation business, such as hedging metal derivative transactions on a portfolio basis with over-the-counter derivative transactions that settle in cash or transitory title transfer (such a transaction typically does not entail physical possession of a commodity);<sup>15</sup> or (iii) incidental to lending activities, i.e., a mining company posts copper cathode as collateral for a loan. The OCC considers national banks’ lending authority to include buying and selling industrial or commercial metal under reverse repurchase agreements that are the functional and economic equivalent of secured loans (as determined on a per transaction basis).<sup>16</sup>

The OCC is currently soliciting comments, which must be submitted within 60 days from the date of publication of the OCC Proposed Rule, meaning by November 14, 2016.

### **The Board Proposed Rule**

Among its many provisions, the Board Proposed Rule would remove copper from the list of precious metals that all BHCs are permitted to own and store and<sup>17</sup> prohibit BHCs from entering derivatives contracts that require taking delivery of the underlying metal as principal (consistent with the OCC Proposed Rule for national banks).

The Board Proposed Rule would treat the purchase and sale of copper in the same manner as it does other non-precious metals; specifically, as an activity requiring FHC status and complementary authority. Such a transaction would also be subject to the restrictions and limitations (including the 5 percent of Tier 1 capital cap) imposed on FHCs engaged in complementary commodity activities.<sup>18</sup> Furthermore, the Board Proposed Rule would not authorize services such as arranging for storage, safe custody, assaying and shipment of copper.<sup>19</sup>

The Board is also proposing to make a corresponding change in the language of section 225.28(b)(8)(ii)(B) of Regulation Y to remove copper from the list of metals on which a BHC may enter derivatives contracts that require taking delivery of the underlying metal as principal. Removing copper from this list will ensure that the metals specifically listed as financial assets for purposes of derivatives trading activities remain consistent with the metals permitted to be bought, sold and stored by BHCs; however, BHCs would still be able to trade in cash-settled derivatives and similar financial contracts that have copper as a reference asset.<sup>20</sup> The staff of the Board has requested a 90-day comment period on the Board Proposed Rule, meaning comments must be received on or before December 22, 2016. The Board Proposed Rule would take effect one year after the rule is finalized to provide BHCs time to conform to this change.

**Conclusion**

If the OCC Proposed Rule is finalized as is, national banks will be prohibited from dealing and investing in metals primarily suited for industrial or commercial purposes, such as copper, including trading in derivatives that are physically settled in such metals (subject to the limitations stated herein), or bullion in commercial or industrial form, or jewelry made of precious metal. The Board Proposed Rule would have a similar effect for BHCs that are not FHCs specifically with regard to copper. Under the Proposed Rules, Regulated Banking Entities would still be permitted to trade in derivatives and similar financial contracts that have copper or other commercial or industrial metals as a reference asset.

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1. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation & Office of the Comptroller of the Currency, *Report to Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act* (September 2016) (hereinafter referred to as The Report); available at <https://www.fdic.gov/news/news/press/2016/pr16079a.pdf>, at pp. 78 et seq.; 86 et seq.
  2. OCC Notice of Proposed Rulemaking, Industrial and Commercial Metals (September 8, 2016), available at <https://www.occ.gov/news-issuances/news-releases/2016/nr-occ-2016-108a.pdf> at 5-14
  3. The proposed rule indirectly applies to federal branches and agencies of foreign banks because they operate with the same rights and privileges (and are subject to the same duties, restrictions, penalties, liabilities, conditions, and limitations) as national banks. 12 CFR 28.13(a)(1). The proposed rule also indirectly applies to insured state banks and state savings associations. See 12 U.S.C. 1831a, 1831e; See also Notice of proposed rulemaking, Risk-based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-based Capital Requirements for Merchant Banking Investments (Sept. 23, 2016) at FN 7 (hereinafter referred to as “NPRM”); available at <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160923a2.p>; See 12 CFR 28.13(a)(1); see also 12 U.S.C. 1831a, 1831e
  4. Specifically, the capital requirements would require FHCs to risk weight at 300 percent the value of covered physical commodities held by an FHC pursuant to complementary authority. 1,250 percent risk weight to covered physical commodities and related on-balance-sheet assets held by an FHC under section 4(o) grandfather authority if not permitted under complementary authority, such as storage facilities, refineries and transportation vessels. Board of Governors of the Federal Reserve System Memo at 6-8 (Sept. 12, 2016)
  5. BHCs would still be able to trade in derivatives and similar financial contracts that have copper as a reference asset. Board of Governors of the Federal Reserve System Memo at 12 (Sept. 12, 2016)
  6. NPRM at p. 47
  7. With regard to BHCs under section 4(c)(8) of the BHC Act (“activities closely related to banking”) and Regulation Y, and with regard to national banks under 12 U.S.C. 24 (Seventh) (“activities incidental to the business of banking”)

8. In 1995, the OCC issued one Interpretive Letter 693 reaffirming that national banks could buy and sell precious metals that included gold, silver, platinum and palladium, and also adding to the list copper, which was previously considered a “base metal,” on the basis that the trading of copper was becoming more similar to trading of “precious metals.” The scope of this authorization was sufficiently broad to permit national banks to buy and sell precious metals (including industrial copper) in forms that are used for industrial purposes. Board of Governors of the Federal Reserve System Memo at 3 and 12 (Sept. 12, 2016). After the OCC made it permissible for national banks to trade copper as a precious metal, the Board followed suit by amending Regulation Y in 1997. 62 FR 9290, 9336 (Feb. 28, 1997); NPRM, at p. 27
9. Other examples of metals or alloys primarily suited for industrial or commercial use include: copper cathodes, aluminum T-bars, and gold jewelry. 12 CFR Part 7 at 63428, September 2016; The OCC Proposed Rule also cited that the London Mercantile Exchange, which describes itself as the “world centre for trading of industrial metals,” trades aluminum, aluminum alloys, copper, lead, nickel, tin, and zinc; although nickel, tin and zinc were not specifically mentioned as examples of industrial metals. 12 CFR Part 7 at 63429
10. Banking Circular 58 (BC-58) defines coin” as “coins held for their metallic value which are minted by a government, or exact restrikes of such coins minted at a later date by or under the authority of the issuing government.” BC-58 defines “bullion” as “uncoined gold or silver in bar or ingot form.” BC-58 at 5
11. *Id.* at 10
12. “Some customers may wish to trade industrial or commercial metal with national banks. However, because few banks buy or sell industrial or commercial metal in the ordinary course of business, it does not appear that dealing or investing in industrial or commercial metal significantly enhances national banks’ ability to offer banking products and services, including those related to precious metals.” 12 CFR Part 7 at 9-10
13. BC-58 at 6
14. *Id.*; see also Interpretive Letter 684 (Aug. 4, 1995), 1995 WL 550219; see also OCC Bulletin 2015-35, Quantitative Limits on Physical Commodity Transactions (Aug. 4, 2015)
15. *Id.* at 13 Notwithstanding the above, the OCC may consider alternative approaches for transitory title transfers in the final rule if it determines that these transactions present risks similar to holding physical metal; see also Interpretive Letter 962 (Apr. 21, 2003), 2003 WL 21283155 (“[T]ransitory title transfers preclude actual delivery by passing title down the chain from the initial seller to the ultimate buyer in a series of instantaneous back-to-back transactions. Each party in the chain has title for an instant but does not take actual physical delivery (other than the ultimate buyer which, in no case, will be the Bank.”)
16. *Id.* at 10-11; see also *Cf. Cooper v. Hill*, 94 F. 582 (8th Cir. 1899) (foreclosure of a mine); *First Nat’l Bank of Parker v. Peavy Elevator Co.*, 10 S.D. 167, 170 (1897) (foreclosure of grain seed and subsequent sale).
17. BHCs would still be able to trade in derivatives and similar financial contracts that have copper as a reference asset. Board of Governors of the Federal Reserve System Memo at 12 (Sept. 12, 2016)
18. Under the Proposed Board Rule, copper would be removed from the list of metals BHCs are permitted to own and store without limit as an activity closely related to banking under section 4(c)(8) of the BHC Act and Regulation Y, meaning that like other non-precious metals, the purchase and sale of copper would require FHC status and be subject to the restrictions and limitations (including the 5 percent of Tier 1 capital cap) imposed on FHCs engaged in physical commodity activities under “complementary” authority.
19. 12 CFR Parts 217 and 225 at 47
20. *Id.*

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