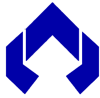

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Ruling

Category: **Business and Powers** **NOTICE***

Subject: **Physically Settled Commodity Trading**

No: **2004-05**

Issue: The issue was whether federally regulated financial institutions (FRFIs) [1] are permitted to engage directly in physically settled commodity trading and activities related thereto. In particular, the issue was whether this business activity should be regarded as (a) a financial service, which is a permitted activity; or (b) dealing in goods, wares or merchandise, or engaging in any trade or other business, which are prohibited activities under the federal financial institution statutes except as otherwise authorized.

Background: A foreign bank (FB) has asked OSFI to reconsider its legal interpretation that FRFIs may engage in physically settled energy trading, in Canada, only through their security dealer subsidiaries. The FB was of the view that the risks would be essentially the same in having its Canadian branch directly engage in physically settled commodity trading transactions as opposed to the current practice of indirectly engaging in the practice through a security dealer subsidiary.

The FB provided the following example involving a natural gas energy derivative transaction to illustrate its view. An energy producer had entered into a financing arrangement to finance a natural gas well development and wished to lock in production margins via hedges to manage the economic risk of its project. In order to protect itself from price decline, the producer would seek from a creditworthy party a fixed price for the natural gas it produced over a specified period. The transaction would unfold under cash settled and physically settled arrangements as follows:

Cash settled arrangement — The producer would enter into a natural gas swap with the FB whereby the producer would agree to pay the FB the floating market price for a notional amount of natural gas over a specified period, and the FB would agree to pay a fixed price for the same notional amount of natural gas over the specified period. The producer would still have to sell the natural gas to one or more purchasers that would take physical delivery of the natural gas from the pipeline on a given delivery date. At predetermined times, which could be set at or near

1 For the purposes of this Ruling, a FRFI refers collectively to banks, authorized foreign banks, associations incorporated or formed under the *Cooperative Credit Associations Act* and companies incorporated or formed under the *Insurance Companies Act* or the *Trust and Loan Companies Act*.

Canada

physical delivery dates, the producer and the FB would settle the difference between the agreed price and the floating market price. For example, if the market price was lower than the agreed price, the FB would pay to the producer the difference between the agreed price and the market price for the natural gas delivered at the delivery date. To hedge its risks in respect to this transaction, the FB would enter into one or more derivative contract(s) with other counterparties.

Physically settled arrangement — The producer would enter into a contract with the FB whereby the producer would agree to sell, and the FB would agree to purchase, a specified quantity of natural gas at an agreed price for a specified delivery period. The FB, not the producer, would have to find one or more purchasers that would take physical delivery on each specified delivery date. Upon delivery by the producer of the natural gas into the pipeline, the FB would be registered on the Nova Inventory Transfer System as the participant that would be receiving the natural gas out of the pipeline on each specified delivery date. The FB would take "transitory title" of the natural gas for the period between the producer delivery dates (Purchase Contracts delivery) and the buyer delivery dates (Sales Contracts delivery), which would be no later than the date the gas is delivered by the pipeline operator (the delivery date). If, at any delivery date, the FB's purchase volume of natural gas did not equal its sale volume as a result of a default by a buyer to take physical delivery of the natural gas, the FB would sell a position on the NGX (Natural Gas Exchange) within one trading day. This would ensure that a person other than the FB would take physical delivery of the natural gas, as required under the terms of the FB's participation in the Nova Inventory Transfer System.

Under the above cash settled or physically settled arrangements, the FB is essentially taking the economic/credit risk of the producer (i.e., the FB provides both a creditworthy counterparty and price stability in a market that is highly volatile) while hedging its own position against the effects of possible adverse pricing conditions. However, in the case of the physically settled arrangement, the FB is also taking on the producer's delivery risk (i.e., ensuring that someone will take physical delivery of the natural gas on each specified delivery date).

Considerations: The FB's request for a ruling has wider implications than the example provided. Other FRFIs are also engaged in cash settled commodity trading and may also want to undertake physically settled commodity trading. In assessing whether a FRFI may engage in physically settled commodity trading, OSFI considered the following:

1. Because of the clause "Except as authorized by or under this *Act*…." in subsections 410(2) and 539(2) of the *Bank Act*, the restriction in dealing in goods, wares or merchandise applies only in respect of dealings that do not constitute part of "the business of banking and such business as generally appertains thereto".

2. Canadian courts have ruled that the concept of the business of banking, which includes providing any financial service, is not a static concept but evolves as the activities of banks evolve. The scope of the power that a bank may exercise has been assessed in light of the activities that banks generally undertake, both within and outside Canada.

3. Cash settled commodity trading through derivative contracts is an activity that is currently carried out by several Canadian banks as part of their business of banking.

4. Under cash settled and physically settled commodity arrangements, the FRFI is taking the economic/credit risk of a client who is dealing in goods that are traded on a commodity exchange or market. In the case of physically settled commodity arrangements, the FRFI is also taking on the delivery risk of its client. In essence, the FRFI is enhancing the creditworthiness of the transaction between the seller and the purchaser of commodities. This is not significantly different from the role banks play in providing bankers' acceptances, which is readily recognized as that of providing financial intermediation.

5. Where a FRFI enters into physically settled commodity trading arrangements to provide economic or financial risk management:

   (a) the FRFI is holding "transitory title" to the commodity up to the designated delivery or maturity dates of the transaction (i.e., the day on which a person has to physically take possession of the commodity);

   (b) the holding by the FRFI of this transitory title is incidental to the provision of financial services;

   (c) the FRFI is holding its transitory title:

      (i) in a book-based system (e.g., Nova Inventory Transfer System; London Metal Exchange; Johnson Matthey; Royal Canadian Mint),
      (ii) as a book-based interest recorded on the records of another FRFI or a non-FRFI market intermediary, or
      (iii) by holding documents of title (e.g., warehouse receipts).

6. Taking transitory title, as described above, would not expose the FRFI to business risks of a nature that are different, either in nature or in degree, from the risks it already incurs in the course of derivative contracts settled in cash. The FRFI would not hold title to a specific or identified amount of commodity, and would not hold title, even to a rateable share of commingled commodity, past the designated delivery or maturity dates of the transaction unless a counterparty default takes place on that settlement date. Under such circumstances, it is expected that the FRFI would be able to promptly transfer title of the commodity to another person given that the commodity is traded on a commodity exchange or market.

7. The end result of a failure under a physically settled contract would be the same as a failure under a cash settled contract. For example, if the FRFI was the seller on a physical contract and buyer "A" (the original buyer) failed to pay and take delivery, the FRFI would have to sell to another person, buyer "B", who would pay the then market price and take delivery. If buyer B paid a lower price than the price that buyer A had agreed to pay, the FRFI would pursue buyer A for the difference between the agreed price and the market price. Similarly, in a cash settled transaction, buyer A would pay the FRFI the difference between the agreed price and the market price. If buyer A failed to pay, the FRFI would pursue buyer A for the payment.

8. Where a FRFI enters into a physically settled commodity arrangement for the purpose of providing financial risk management to its clients, the FRFI is providing a financial service. Any dealing in goods related to these arrangements would not offend subsections 410(2) and 539(2) of the *Bank Act* or the corresponding sections of the *Trust and Loan Companies Act*, the *Insurance Companies Act* and the *Cooperative Credit Associations Act*.

9. It is of interest to note that the Office of the Comptroller of the Currency in the United States (OCC)[2] has ruled that banks are permitted to settle and hedge energy derivative transactions by accepting and immediately relinquishing title to the energy product, as a party in a "chain of title transfers". The OCC considers such transactions to be "incidental or convenient" and useful to the bank's financial intermediation activities in energy derivative transactions, which assist customers of the bank in managing their financial exposure.

10. Given that physically settled commodity transactions are customer-driven, OSFI expects a FRFI to carry out appropriate reviews of these transactions so as to gain a thorough understanding of the nature and structure of the client's transaction.

Conclusion:

1. From a legal interpretation, OSFI concludes that FRFIs are permitted to engage in physically settled commodity trading and activities related thereto provided that the FRFI:

   (a) enters into such transactions only with customers who are producers or end users in the context of financial risk management services to those customers, or with other market intermediaries to manage its exposure to the relevant commodity; and

   (b) takes title to the commodity only on a "transitory" basis and only in connection with, or for the purpose of facilitating, the settlement of such transaction.

   When a bank, a FB through its Canadian branch, or any other FRFI engages in physically settled commodity trading under the aforementioned conditions, it is providing a financial service.

2. From a prudential standpoint, when a FRFI engages in physically settled commodity trading, OSFI expects that it:

   (a) will have appropriate risk measurement and management policies and procedures in place, including measures designed to:

      (i) offset the risk it may have to physically take possession of the commodity (e.g., engaging in physically settled commodity trading where there is an adequate and efficient inventory title transfer system, a recognized commodity exchange or market), and

      (ii) ensure that an appropriate review of complex structured transactions involving commodity derivatives is carried out so as to gain a thorough understanding of the nature and structure of its client's transaction; and

[2] See OCC Interpretive Letter No. 962 (Apr. 21, 2003).

(b) will be adequately capitalized for the risk assumed from engaging in physically settled commodity trading.

Legislative References: Subsection 538(1) of the *Bank Act* states that an authorized foreign bank shall not carry on any business in Canada other than the business of banking and any business generally that appertains to the business of banking.

Paragraph 538(2)*(a)* of the *Bank Act* states that the business of banking includes providing any financial service.

Subsection 539(2) of the *Bank Act* states that, except as authorized by or under the *Bank Act*, an authorized foreign bank shall not deal in Canada in goods, wares or merchandise or engage in any trade or other business.

Table of Concordance:

Section Description	BA	TLCA	ICA	CCAA
Main Business	409(1), 538(1)	409(1)	440(1)	375(1)*(a)*
Included Activities	409(2)*(a)*, 538(2)*(a)*			
Restriction	410(2), 539(2)	410(2)	441(3)	376(3)

The table of concordance makes cross-references to similar provisions of other FRE legislation that may be of relevance to the reader.

* Rulings describe how OSFI has applied or interpreted provisions of the federal financial institutions legislation, regulations or guidelines to specific circumstances. They do not negate the need to obtain any necessary approval of the transaction under the relevant federal financial institutions legislation. Rulings are not necessarily binding on OSFI's consideration of subsequent transactions as these transactions may raise additional or different considerations. Legislative references in a Ruling are not meant to substitute provisions of the law; readers should refer to the relevant provisions of the legislation, regulation or guideline, including any amendments that came into effect subsequent to the Ruling's publication.