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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219  
October 19, 2006

Patrick S. Antrim, Assistant General Counsel  
Bank of America, N.A.  
Legal Department  
NC1-002-29-01  
101 South Tryon Street  
Charlotte, NC 28255

**Interpretive Letter #1073**  
**November 2006**

Subject: Portfolio-hedged Metal Derivative Transactions

Dear Mr. Antrim:

Bank of America, N.A. (“Bank”) is seeking confirmation from the Office of the Comptroller of the Currency (“OCC”) that it is permissible for the Bank and its London branch to engage in customer-driven,<sup>1</sup> metal<sup>2</sup> derivative transactions<sup>3</sup> that settle in cash or by transitory title transfer and that are hedged on a portfolio basis with derivatives that settle in cash or by transitory title transfer. Presently, the Bank has authority to enter into customer-driven, cash-settled derivative transactions on aluminum, nickel, lead, zinc and tin, and simultaneously enter into perfectly matched offsetting derivative transactions on these same reference assets.<sup>4</sup> Under this proposal, rather than simultaneously entering into a perfectly matched offsetting transaction, the Bank will hedge metal derivative transactions on a portfolio basis with exchange-traded and over-the-counter (“OTC”) derivative transactions that settle in cash or by transitory title transfer as

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<sup>1</sup> A “customer-driven” transaction is one entered into for a customer’s valid and independent business purposes. *See* OCC Interpretive Letter No. 892 (September 13, 2000).

<sup>2</sup> The term “metal” includes all metals (*e.g.*, aluminum, nickel, lead, zinc and tin) other than those that the Bank has the express authority to buy and sell as “exchange, coin and bullion” under 12 U.S.C. § 24(Seventh). *See, e.g.*, OCC Interpretive Letter No. 693 (November 14, 1995); OCC Interpretive Letter No. 685 (August 5, 1995); and OCC Interpretive Letter No. 553 (May 2, 1991). The Bank already has the authority under Section 24(Seventh) to use “exchange, coin and bullion” metals as reference assets for perfectly matched and portfolio-hedged derivative transactions.

<sup>3</sup> “Metal derivative transactions” include forwards, options, swaps, caps, floors and collars, and options on futures, swaps, caps, floors and collars, in which a portion of the return (including interest or principal or payment streams) is linked to metal or the price of metal.

<sup>4</sup> *See, e.g.*, OCC Interpretive Letter No. 1039 (July 25, 2005) (“IL No. 1039”).

permitted for the Bank in OCC Interpretive Letter No. 962 in the context of electricity derivative transactions.<sup>5</sup> For the reasons discussed below, based on the facts and representations provided by the Bank, we conclude that the proposed transactions are legally permissible for the Bank, including its London branch. However, before the Bank may engage in such transactions, the Bank must notify its examiner-in-charge (“EIC”), in writing, of the proposed activities and must receive written notification of the EIC’s supervisory non-objection, based on the EIC’s evaluation of the adequacy of the Bank’s risk measurement and management systems and controls to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC’s evaluation of any other supervisory considerations relevant to the particular proposal.<sup>6</sup>

## **I. Background**

The Bank is an active and significant participant in customer-driven financial intermediation transactions involving a wide range of commodities. The Bank recently received authority to engage in customer-driven, perfectly matched, cash-settled metal derivative transactions on aluminum, nickel, lead, zinc, and tin.<sup>7</sup> Thus, the Bank presently enters into a derivative transaction on aluminum, nickel, lead, zinc, or tin and simultaneously enters into a perfectly matched offsetting derivative transaction. Under the Bank’s proposal, it will enter into customer-driven,<sup>8</sup> metal derivative transactions and hedge the transactions, on a portfolio basis, with cash-settled, exchange-traded and OTC metal derivative transactions and transitory title transfers, based on the aggregate unmatched position in the portfolio. The Bank represents that correlative data suggests that the relationship between different metals is not strong enough to allow effective cross-hedging using derivative transactions based on different metal types (*e.g.*, nickel vs. tin). However, the Bank represents that data shows that the business would recognize risk-mitigation benefits by cross-hedging derivative contracts that have different contract specifications, but that are based on like metals (*e.g.*, contracts listed on the London Metals Exchange (“LME”) for primary aluminum and North American Special Aluminum Alloy (“NASAAC”) and the US Commodity Exchange (“COMEX”) aluminum contract). Accordingly, the Bank proposes to use such related derivative contracts and take transitory title to the underlying metal in its overall portfolio management. As new derivative transactions are added to the Bank’s metal derivative portfolios resulting in changes to the unmatched position, the Bank will adjust its hedging position to manage its aggregate exposure to market risk (*i.e.*, the risk to earnings or capital arising from changes in the value of portfolios of metal derivative transactions). The purpose of the proposed hedges, similar to the transactions addressed in IL No. 1039, is to offset market risk from its metal derivative transactions.

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<sup>5</sup> OCC Interpretive Letter No. 962 (April 21, 2003) (“IL No. 962”).

<sup>6</sup> The Bank may also engage in customer-driven, perfectly matched, cash-settled derivative transactions on the metals captured by this letter not previously approved for such transactions by the OCC, on the basis of the analysis and subject to the conditions set forth in detail in IL No. 1039.

<sup>7</sup> *See*, IL No. 1039, *supra*.

<sup>8</sup> The Bank’s customers for this purpose include producers and consumers of metals, utilities, hedge funds, and merchant/trading companies.

The Bank believes that the expansion of the Bank's derivatives business to include the proposed transactions is a natural extension of the Bank's existing customer-driven financial intermediation products and encompasses products regularly requested by the Bank's customers. The Bank represents that the purpose of expanding its metal derivative business is to provide risk management and other tools to the Bank's customers in substantively the same manner as is currently done with respect to its existing derivatives business. The major difference between the financial intermediation activities the OCC recently approved for the Bank involving metal derivatives and the proposed activity, is that here the Bank will manage risks arising from derivative transactions on a portfolio basis rather than on a perfectly matched basis. When transactions are perfectly matched, the primary risk to the Bank is counterparty credit risk (*i.e.*, the risk that a counterparty will not make payments according to the terms of the transaction). With portfolio-hedging, the Bank may also be exposed to market risk, basis risk<sup>9</sup> and calendar spread risk,<sup>10</sup> however, these risks will be subject to risk management limits. The Bank has demonstrated the ability to successfully manage and control such risks in its portfolio-hedged electricity derivative transactions.

The Bank represents that portfolio-hedging is a more cost effective means of managing risks arising from permissible derivative activities than perfectly matching transactions because it reduces transactional costs and operational risks (*i.e.*, the risk of incurring financial loss due to human or technical errors). Metals portfolios resulting from customer-driven portfolios will naturally contain offsetting transactions. Thus, the Bank need only hedge the net residual risk position in each portfolio when it engages in portfolio-hedging and manage this risk similarly to how it manages the residual risk in its existing commodities business. With perfectly matched transactions, the Bank must offset each metal transaction that it enters into and pay the costs associated with executing each of these trades. Because the Bank must execute a greater number of transactions to perfectly match transactions than it would if it were portfolio-hedging, there is also greater opportunity for back office error and reconciliation issues in perfectly matched trades.

Periodically the Bank may hedge metal derivative portfolios by using hedging instruments that result in basis risk. Such mismatches, and thus the resulting basis risk, tend to become more pronounced progressively during the life of the transactions, thus making accurate hedging essential. In some instances, cash-settled transactions may provide less than completely accurate hedges. The Bank believes that the ability to engage in metals transitory title transfers will enable the Bank to more accurately and precisely hedge its proposed metal derivative transactions and substantially reduce its basis risk in portfolio-hedged metal derivatives. The Bank represents that it will engage in the proposed title transfer transactions solely for the accommodation of customers or for its own risk management purposes.

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<sup>9</sup> Basis risk is the risk that the price fluctuations of the hedging instruments will not exactly match price fluctuations of the underlying transactions. *See* OCC Interpretive Letter No. 1060 (April 26, 2006) ("IL No. 1060").

<sup>10</sup> Calendar spread risk occurs when the Bank acquires short and long futures or options positions to hedge metal derivatives on the opposite position(s) on the same metal in the portfolio, which have expiration dates different from the contracts in the portfolio and can potentially result in a gain or loss as the difference between the portfolio and the hedge contracts widens or narrows.

The Bank states that its ability to engage in the proposed activities will enable the Bank to meet the growing demand for these products to manage metal prices by customers such as metal producers and consumers. In addition, the Bank believes that by offering customers a broader range of risk management products that more effectively address their individual risk management needs, the Bank will have the ability to attract a broader customer base. Finally, the Bank represents that by participating in a broader range of markets and expanding its customer base, it may diversify and reduce credit and other risks arising from its financial intermediation business. Accordingly, the Bank believes the proposed transactions will enable it to meet customer demand and operate its metal derivatives business more effectively and efficiently.

In sum, the Bank contends that the proposed transactions pose risks similar in nature to those inherent in its portfolio-hedged electricity derivative transactions (*e.g.*, market risk, basis risk, and calendar spread risk), which it has demonstrated the ability to successfully manage and control. The Bank maintains that the proposed transitory title transfers do not pose risks different from the transitory title activities the OCC addressed in prior OCC precedent in the context of coal and electricity derivative transactions.<sup>11</sup> Notably, because the title transfer transactions involving metals will not entail the physical possession of commodities, these transactions will not involve the customary activities relating to, or risks attendant to, commodity ownership (*e.g.*, storage costs, insurance, and environmental protection).

The Bank expects to clear at least some of the exchange-traded future contracts it enters into, through Banc of Americas Securities Limited (“BASL”), a foreign bank subsidiary of the Bank,<sup>12</sup> and Bank of America Securities LLC (“BAS”), an affiliate of the Bank. The Bank

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<sup>11</sup> See IL No. 1060, *supra*; OCC Interpretive Letter No. 1025 (April 6, 2005); and IL No. 962, *supra*.

<sup>12</sup> BASL is a foreign bank incorporated in the United Kingdom and, as such, is supervised by the United Kingdom’s Financial Services Authority. BASL is a wholly owned subsidiary of the Bank. Under the Federal Reserve Act at 12 U.S.C. § 601 and the Federal Reserve Board’s (“Board”) implementing Regulation K at 12 C.F.R. § 211.8(b)(1), a member bank has the authority to directly invest in a foreign bank subject to the requirements in U.S. statutes and regulations. The Bank states that it expects BASL to become a clearing member of the LME and to provide clearing services on contracts listed on that exchange on aluminum, NASAAC, aluminum alloy, nickel, lead, zinc, and tin. LME rules provide that LME clearing members must become exchange clearing members of LCH.Clearnet Ltd. (“LCH”), which is the contracted central counterparty (“CCP”) clearinghouse that clears LME contracts. LME Rules, Part 1, Section 1.1.3.1; [http://www.lme.co.uk/what\\_clearing.asp](http://www.lme.co.uk/what_clearing.asp). As the CCP, LCH acts as an intermediary between two parties to a contract, taking on any monetary risk involved (*e.g.*, if one party fails to meet its obligations due to bankruptcy) as guarantor for the trade. See, *e.g.*, [http://www.lme.co.uk/membership\\_associatebroker.asp](http://www.lme.co.uk/membership_associatebroker.asp). The LME does not act as a counterparty or guarantor to LME contracts. BASL is not exposed to unlimited liability to either the LCH or the LME for the defaults of other members. A defaulting LME clearing member’s unsettled registered LCH contracts are handled under LCH Rules, which provide that an exchange member’s liability for the default of other members is limited up to the amount of the member’s default fund contribution. LCH Rulebook, *Default Fund Rules* 32 - 35. The rights and liabilities under unsettled LME contracts not registered with LCH are deemed discharged under LME Rules and replaced with an obligation of the defaulter to pay the counterparty or vice versa, a default settlement amount, and does not impose liability on uninvolved counterparties. LME Rules, Part 9, Section 3.3.4. The determination of the default settlement amount by the LME is final, conclusive, and binding upon the defaulter and each counterparty. LME Rules, Part 9, Section 3.6. The Board’s Regulation K at 12 C.F.R. § 211.10(a)(18), requires a member bank to give the Board prior notice before any subsidiary joins a mutual exchange or clearinghouse, unless the potential for liability of the subsidiary to the exchange, clearinghouse, or other members of the exchange, as the case may be, is legally limited by the rules of the exchange or clearinghouse to an amount that does not exceed the applicable \$ 25

anticipates that either BAS or BASL will act as a clearing member of one or more metal exchanges, or will enter into an introducing broker arrangement to clear through another clearing member of such exchange(s). The Bank represents that if the Bank engages in any transactions subject to sections 23A and 23B of the Federal Reserve Act and the Federal Reserve Board's Regulation W with or through its affiliates in connection with its proposed metal derivative activities, including transactions with third parties that might benefit an affiliate such that the transaction would be attributable to that affiliate under Regulation W, the Bank will do so in compliance with those authorities.

The Bank commits that it will: (1) not engage in metal derivative transactions other than cash-settled transactions and those that settle by transitory title transfer, (ii) not run a proprietary book in metal derivatives (except insofar as that book is created to accommodate customer-driven transactions or as part of the Bank's portfolio hedging strategy), (iii) limit trading in the proposed metal derivatives exclusively to hedge residual open positions arising from customer transactions, (iv) not take physical positions in metals, and (v) conduct its metal derivative business in a safe and sound manner and consistent with prudent risk management practices prescribed the *OCC Handbook: Risk Management of Financial Derivatives*<sup>13</sup> and Banking Circular 277.<sup>14</sup>

The Bank commits that the metal derivative portfolio-hedging and transitory title transfer transactions will be conducted in a manner consistent with the policies, procedures, and controls that it applies to its existing commodities derivatives business.

## **II. Discussion**

For the reasons discussed below, based on the facts and representations provided by the Bank, we conclude that the proposed transactions are legally permissible for the Bank, including its London branch. However, before the Bank may engage in such transactions, the Bank must notify its EIC, in writing, of the proposed activities and must receive written notification of the EIC's supervisory non-objection, based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems and controls to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC's evaluation of any other supervisory considerations relevant to the particular proposal.

### **A. National Bank may engage in Customer-driven, Portfolio-hedged Metal Derivative Transactions**

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million general-consent limit under Regulation K at 12 C.F.R. § 211.9(b)(4). The Bank represents that BASL's liability would be less than the applicable \$ 25 million general consent limit of 12 C.F.R. § 211.9(b)(4) that would trigger notice to the Federal Reserve Board.

<sup>13</sup> *OCC Handbook: Risk Management of Financial Derivatives* (January 1997) ("*OCC Handbook*").

<sup>14</sup> OCC Banking Circular No. 277 (October 27, 1993) ("BC-277").

The OCC has previously determined that the Bank may engage in perfectly matched cash-settled derivatives on aluminum, nickel, lead, zinc, and tin as a financial intermediary under 12 U.S.C. § 24(Seventh).<sup>15</sup> The Bank now proposes to use any metal not already authorized for the Bank under its 12 U.S.C. § 24(Seventh) “exchange, coin and bullion” authority as a reference asset in portfolio-hedged derivative and transitory title transfer transactions that settle in cash or by transitory title transfer. The ability to engage in these transactions will increase the Bank’s hedging options and its ability to control risks in its metal derivatives business. A difference between the activities previously approved for the Bank and those for which approval is sought here is that rather than simultaneously entering into metal derivative transactions with perfectly matched offsetting transactions, the Bank will manage the transactions on a portfolio basis with exchange-traded and OTC cash-settled derivative transactions, in the same manner as the Bank currently manages its electricity derivatives.<sup>16</sup> The Bank will also settle metal derivative transactions by transitory title transfer and hedge these transactions with derivative transactions that settle by transitory title transfer, in a manner previously addressed for the Bank in IL No. 962 in the context of electricity derivative transactions.

The expansion of the Bank’s derivatives business to include the proposed transactions is a natural extension of the Bank’s existing financial intermediation activities. The OCC has previously addressed the permissibility under Section 24(Seventh) of portfolio-hedging and transactions that settle in cash or by transitory title where the bank takes title to the commodity in a “chain of title” and relinquishes title instantaneously.<sup>17</sup> Portfolio-hedging can be a more cost effective means of managing risks arising from permissible derivative activities than perfectly matching transactions because it reduces transactional costs and operational risks. Portfolio-hedging and transitory title transfer activities allow banks to meet customer demand, and operate more efficiently and effectively. Transitory title transfers also enable banks to participate in markets using this form of settlement and provide customers a broader range of sophisticated risk management tools to address their financial, risk management, and liquidity needs. In conducting transitory title transfers in connection with a permissible derivatives business, banks act as financial intermediaries, ultimately exchanging payments between counterparties managing financial risks or otherwise meeting financial needs.<sup>18</sup> Executing transactions and hedging in this manner is consistent with a portfolio-hedged financial intermediation business.

The risks to which the Bank is exposed under this proposal are similar in nature to those arising in other commodity derivative transactions where the Bank has a demonstrated ability to manage and control such risks. Accordingly, the Bank may act as a financial intermediary in customer-driven, metal derivative transactions that settle in cash or by transitory title transfer, and portfolio-hedge those transactions with metal derivative transactions that settle in cash or by

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<sup>15</sup> See IL No. 1039, *supra*.

<sup>16</sup> Another difference is that the Bank will enter into derivative transactions with customers on a broader range of metals.

<sup>17</sup> See, e.g., IL Nos. 1060, 1025, and 962, all *supra*.

<sup>18</sup> See, e.g., IL No. 1025, *supra*.

transitory title transfer. Before the Bank engages in the transactions, however, the Bank's EIC must be satisfied that the Bank has established adequate risk measurement and management systems and controls to engage in the activities on a safe and sound basis, as discussed below.

**B. The Portfolio-hedged Metal Derivative Transactions must be Conducted in a Safe and Sound Manner**

For the Bank to permissibly engage in the proposed activities, the Bank's risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner and in accordance with applicable law. Before the Bank engages in the transactions, the Bank's EIC must be satisfied that the Bank has established adequate risk measurement and management systems and controls to engage in the activities on a safe and sound basis. As detailed further in the *OCC Handbook* and BC-277, an effective risk measurement and management process includes board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function that oversees and ensures the appropriateness of the risk management process. The Bank's risk control processes should include the Bank's compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income and generally accepted accounting principles.

In implementing these policies, procedures, and controls, the Bank shall commit to conducting a full evaluation of: (i) pricing, hedging (including portfolio-hedging), processing, recordkeeping, documentation, accounting, "back office" and risk management; (ii) the development of adequate knowledge, staff, oversight management and technology (including contingency planning) to accommodate the activity; (iii) the implementation of appropriate controls; (iv) the establishment, implementation and monitoring of appropriate risk management limits with respect to various types of risks —such as credit, market and basis risk —associated with metal derivatives and transitory title transfers of metal; and (v) Compliance Department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. Risk Control, Operations, Accounting, Legal, Compliance, Audit and Senior and Line Management will all be involved in assuring that the risks undertaken by the Bank are comparable to, and are addressed in ways comparable to those applicable to, the Bank's existing commodity derivative products and business.

In addition to a satisfactory risk management program, the Bank's process must include an independent compliance monitoring program to ensure ongoing compliance with the specific commitments made by the Bank in its proposal, including the commitment to continue to conduct its financial intermediation activities in metal derivatives as a customer-driven and non-proprietary trading business. The compliance-monitoring program should also ensure that the Bank has a supervisory framework that protects against manipulative practices of any kind. An adequate and effective compliance-monitoring program will include policies, training, independent surveillance and well-defined exception approval and reporting procedures.

### C. London Branch Activities

National bank foreign branches<sup>19</sup> may engage in general banking activities, which are determined under national banking law.<sup>20</sup> A national bank, via its foreign branch, may engage in such general banking activities, permissible for a national bank in the United States, in a foreign country.<sup>21</sup> Accordingly, the proposed activities may be permissible for the London branch as “general banking activities” permissible for a national bank in the United States on the basis of the analysis set forth in detail above.

### III. Conclusion

We conclude that the proposed transactions are legally permissible for the Bank, including its London branch. Before the Bank may engage in such transactions, however, the Bank must notify its EIC, in writing, of the proposed activities and must receive written notification of the EIC’s supervisory non-objection, based on the EIC’s evaluation of the adequacy of the Bank’s risk measurement and management systems and controls to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC’s evaluation of any other supervisory considerations relevant to the particular proposal. Our conclusions herein are specifically based on the Bank’s representations and written submissions describing the facts and circumstances of the subject transactions. Any change in the facts or circumstances could result in different conclusions. If you have any questions please contact Tena M. Alexander, Special Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

/s/

Julie L. Williams  
First Senior Deputy Comptroller  
and Chief Counsel

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<sup>19</sup> OCC regulations define the term “foreign branch” to mean an office of a national bank (other than a representative office) that is located outside the United States at which banking or financing business is conducted. 12 C.F.R. § 28.2(d). Similarly, Regulation K defines a “foreign branch” as an office of an organization that is located outside the country in which the organization is legally established and at which a banking or financing business is conducted. 12 C.F.R. § 211.2(k).

<sup>20</sup> See 12 U.S.C. § 604a; 12 C.F.R. § 211.4(a).

<sup>21</sup> 12 C.F.R. § 28.4(a).