

By e-mail followed by mail

Our File: P3120-D2-1

March 31, 2004

Mr. Ronald Baird
Director, Banking Operations
Canadian Bankers Association
Box 348, Commerce Court West
199 Bay Street, 30th Floor
Toronto, Ontario
M5L 1G2

Dear Mr. Baird:

Subject: Draft Ruling - Physically Settled Commodity Trading

This is in response to your letter of February 6, 2004, in which you requested certain clarifications/revisions be made to our draft Ruling on physically settled commodity transactions. We are pleased to note that our draft Ruling has been generally well accepted and supported by your members. However, as you indicate, some concerns remain.

Following are the amendments we have made to the draft Ruling to address concerns expressed by your members and other stakeholders.

1. We have revised the introductory paragraph of the Considerations section to clarify that the Ruling applies to all federally regulated financial institutions (FRFIs).
2. We have revised Considerations # 4 and added a new paragraph 8 to further spell out our justifications for considering physically settled commodity transactions to be a financial service.
3. We have added paragraphs 5 and 6 to the Considerations section to provide further guidance on the issue of holding transitory title. We understand that in undertaking physically settled commodity transactions, the FRFI may be required to hold title for more than “a moment in time”. So long as the purpose of taking title is to provide financial and risk management services and to facilitate the settlement of the transaction on the maturity date with a client, OSFI would view this as a period of “transitory title”. In the case of a default on the settlement date, it is expected that title of the commodity would be promptly transferred by the FRFI to another person given that the commodity is traded on a commodity exchange or market.
4. It appears that your members’ main concern is that they wish to have the ability to enter into commodity derivative transactions with market intermediaries (i.e., other than producers or end

users of the commodity). OSFI understands that one way for a FRFI to manage its risks under a commodity transaction may be to enter into a derivative contract with other market intermediaries. For example, a FRFI has entered into a physically settled commodity arrangement to purchase from a producer a specified quantity of a commodity at an agreed price for a specified delivery period, and another market intermediary has entered into a physically settled commodity arrangement to sell to an end-user a specified quantity of the same commodity for all or part of the same specified delivery period, the FRFI could engage in a physically settled commodity transaction with the other market intermediary to hedge all or part of its exposure. We have amended Conclusion 1(a) to provide clearer guidance on this matter.

5. You have also indicated a preference to remove the condition in Conclusion 1(a)(i) “e.g., only engaging in physically settled commodity trading where there is an adequate and efficient inventory title transfer system, and a recognized commodity exchange”. While we are aware your members may see this requirement as being restrictive, we are not prepared to broaden our interpretation at this time. The Ruling that was requested of OSFI was based upon an argument that the physically settled commodity trading 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. Clearly, in the absence of an adequate and efficient inventory title transfer system and a recognized commodity exchange or market, as was present in the requested Ruling, the business risks could be different. OSFI would consider making a new Ruling based upon any additional information provided in any new proposal should one be forthcoming.

Attached is a revised draft Ruling on physically settled commodity trading. We trust the revisions adequately address the concerns of your members. Once again we thank you for your helpfulness in providing commentary on our draft Ruling.

If you have any further commentary with regards to the revised draft Ruling, we would appreciate your comments prior to April 23, 2004. Your comments can be directed in writing or by telephone to me at (613) 990-2957 or alternatively, Mr. Bob Creppin at (613) 998-5608. In the absence of additional commentary, it is our intention to post the Ruling on our website on or shortly after April 23, 2004.

Yours very truly,

Louis Bourgeois
Director
Approvals and Precedents
Legislation and Approvals Division

c.c. Ms Genie Panos (CBA)