Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

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NC1-002-29-01
101 South Tryon Street
Charlotte, NC 28255

Re: Authority to Expand Customer-Driven Financial Intermediation Transactions in Electricity Derivatives to Include Transitory Title Transfers

Dear Mr. Huffstutler:

This letter responds to your request for approval from the Office of the Comptroller of the Currency ("OCC") for Bank of America, N.A. ("Bank") to expand its financial intermediation business to include customer-driven, electricity derivative transactions that involve transfers of title to electricity.[1] For the reasons discussed below and subject to the limitations described herein, we believe that the proposed transactions are permissible for the Bank.

I. Background

The Bank engages in a variety of cash-settled, customer-driven financial intermediation transactions involving exchanges of payments based on interest rates, and the value of equities and commodities. The Bank's cash-settled financial intermediation derivative transactions involve a wide range of energy-related commodities, including electricity. The Bank received authority to engage in customer-driven, cash-settled electricity derivative transactions and hedges in OCC Interpretive Letter No. 937 to assist customers in meeting their financial and risk management needs.[2] The Bank now proposes to settle and hedge electricity derivative transactions by accepting and immediately relinquishing title to electricity, as a party in a "chain

[1] For the purposes of this letter, the term "electricity derivative transactions" encompasses electricity linked transactions of every type -- including derivative products such as futures, forwards, options, swaps, caps, floors and collars, and options thereon -- where a portion of the return (including interest, principal or payment streams) is linked to electricity or the price of electricity.

[2] OCC Interpretive Letter No. 937 (June 27, 2002) *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-462.

of title" transfers ("transitory title transfers").[3] The Bank represents that it does not intend to ever be in a situation where it is required to receive or deliver actual power as a result of an electricity derivative transaction. And, the Bank represents that it will engage in transitory title transfers solely for the accommodation of customers or for its own risk management purposes.

The Bank has obtained an order from Federal Energy Regulatory Commission ("FERC") granting it general authority to act as a power marketer, thus enabling the Bank to engage in transitory title transfers in electricity in interstate commerce at market-based rates.[4] As part of the FERC Order, the Bank received a number of waivers and authorizations granted to other power marketers (including a waiver of certain FERC filing and accounting requirements, and a blanket authorization to issue securities and assume obligations and liabilities without prior FERC approval).[5]

Under the Bank's proposal, it will settle all of its customer-driven electricity derivative transactions in cash or by transitory title transfers. Currently the Bank acts as a financial intermediary under electricity derivative contracts that provide for cash settlement.[6] In certain electricity derivatives markets, contracts do not specifically provide for assignment, termination, or offset prior to a transitory title transfer. Instead, participants in these markets settle electricity derivative contracts through title transfers. Financial intermediaries in these markets enter into back-to-back-contracts providing for the receipt and immediate transfer of title to electricity. In order to participate in these markets, the Bank seeks to engage in transitory title transfers where the Bank takes title to electricity in a "chain of title" and relinquishes title instantaneously.[7]

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[3] Examples of a cash-settled electricity swap, forward and option transaction are contained in OCC Interpretive Letter No. 937, *supra.* The swap, forward, and option transactions at issue are similar, except that the transactions will provide for transitory title transfer to settle the contracts. The Bank expects that less than 20% of the total volume (in megawatt hours) associated with the Bank's electricity derivative transactions (electricity derivative contracts and hedges) will involve transitory title transfers. The Bank will consult with its OCC examiner-in-charge ("EIC") and address any supervisory concerns raised before exceeding the 20% of total volume limit.

[4] FERC asserts jurisdiction over entities such as the Bank that engage in transitory title transfers. *See Bank of America, N.A.,* 101 FERC ¶ 61,098 (Oct. 30, 2002) (the "FERC Order"). Other financial institutions that participate in electricity derivatives markets -- including affiliates of Credit Suisse First Boston, Goldman Sachs & Co., Merrill Lynch & Co., Morgan Stanley & Co. and UBS -- have also received FERC approval to operate as power marketers authorized to sell electricity in interstate commerce at market-based rates.

[5] By Declaratory Order, dated Dec. 19, 2002 (Docket Nos. EL02-130-000 and EC02-120-000), FERC granted in part the Bank's request for a blanket authorization to acquire "securities" of public utilities without prior FERC approval, subject to certain conditions. Because such Declaratory Order did not grant all aspects of the Bank's request in this regard, the Bank has petitioned FERC for a reconsideration of certain of the conditions set out in the Order. Any such acquisitions would have to be permissible under Federal banking law.

[6] OCC Interpretive Letter No. 937, *supra.* The term "cash-settled electricity derivative transactions" includes any electricity derivative contract that is cash-settled or that can be assigned, terminated or offset prior to any transitory title transfer.

[7] Accordingly, as noted above, the Bank will not enter into transactions where it will hold title to electricity for more than a legal instant. The Bank expects that only a small volume of electricity derivative transactions that it enters into (in general, less than 20%) will involve transitory title transfers. (*See* note 3 above.)

The Bank states that it will engage only in wholesale electricity transitory title transfers. “Wholesale” electricity transitory title transfers are principally to and from other market intermediaries, some of which may, in turn, affect retail delivery. “Retail” delivery involves the transmission of power to an end-user customer and involves a more extensive scheduling function than wholesale delivery.

The Bank represents that transitory title transfer transactions pose risks[8] similar in nature to those inherent in cash-settled electricity derivative transactions and it has a demonstrated ability to successfully manage and control such risks. And, because transitory title transfer transactions typically do not entail the physical possession of commodities, these transactions do not appear to involve the customary activities relating to, or risks attendant on, commodity ownership, *e.g.,* production, transportation, transmission, distribution. While transitory title transfer transactions will require the introduction of some new operational processes (*e.g.*, scheduling of power flows), the majority of operational functions, such as passing notices, document transfers, and payments, are similar to those regularly performed by national banks in their role as financial intermediaries. Moreover, national banks that engage in transitory title transfer transactions face risks such as counterparty credit risk that are not significantly different than the risks associated with cash-settled electricity derivative transactions.

The Bank will manage the market risks in its electricity derivative transactions on a “portfolio basis,” and will hedge the resulting net risk exposures. Because the market risk exposures arising from transactions with customers may offset each other, the Bank will not need to hedge each transaction individually. The Bank will use both cash-settled hedges and those that involve transitory title transfers. There will normally be some market risk that will not be hedged and this residual exposure will be subject to risk management limits as discussed below. The Bank represents that residual market risk arising from this activity at all times will be *de minimis* relative to the Bank’s earnings and capital and will be consistent with a customer-driven business strategy.

The Bank believes that electricity transitory title transfers are a natural extension of the Bank’s existing financial intermediation activities in electricity that will benefit customers as well as the Bank. The Bank represents that its ability to engage in transitory title transfers will enable the Bank to offer customers a broader range of intermediation services that more fully accommodate customers’ financial, risk management, and liquidity needs. In many areas of the United States, contracts reflecting the market convention provide for settlement through transitory title transfers. If the Bank cannot engage in transitory title transfers it will not be able to provide customers with the option of participating in these markets to address financial and risk management needs. For the Bank to provide effective liquidity and risk management solutions for its electricity derivatives customers, the settlement terms in the electricity derivative transactions it intermediates need to satisfy each customer’s particular needs. Accordingly, the Bank believes that its ability to settle electricity derivative transactions by transitory title transfer is vital to its ability to assist customers with their particular financial, risk management, and liquidity needs.

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[8] Risks that are similar in nature include credit, compliance, market, transaction and reputation.

The Bank states that its ability to participate in a broader range of markets, and offer a broader range of products, also enables the Bank to compete more effectively with other intermediaries, diversify its business risks and operate more efficiently and profitably. The Bank's proposed expansion of its existing electricity derivatives business will enable the Bank to compete more effectively with other market intermediaries that offer customers the option of selecting electricity derivative contracts that settle in cash or by transitory title transfer. By offering customers a broader range of risk management products that more effectively address their individual financial needs, the Bank has the ability to attract a broader customer base. Also, as a participant in more than one type of electricity derivative settlement market, the Bank will have greater access to relevant price and other related information. And, with greater access to market information, the Bank can provide more extensive services to current and prospective customers. In addition, by participating in a broader range of markets and expanding its customer base, the Bank may diversify and reduce credit and other risks arising from its electricity derivatives business. Consequently, transitory title transfers enable the Bank to operate its electricity derivatives business more competitively, efficiently, and profitably.

The Bank represents that the ability to engage in electricity transitory title transfers can reduce the risk that it will be subject to a "market" or "liquidity" squeeze. The Bank contends that being limited to electricity derivative transactions that require cash settlement may be disadvantageous because market participants know that the Bank is constrained in its ability to cover and exit electricity derivative transactions. In addition, the Bank believes if there is limited liquidity or substantial volatility in the electricity derivatives market, the Bank's inability to enter into electricity derivative transactions settled by transitory title transfer, constrains its ability to choose among various risk management tools to guard against a possible "market" or "liquidity" squeeze.

The Bank also represents that the ability to engage in transitory title transfers will increase the Bank's hedging options and its ability to control risks in its electricity derivatives business. The Bank asserts that this capability will enable the Bank to broaden its ability to hedge, on a portfolio basis, its electricity derivative business.

The Bank has expertise in conducting energy derivative transactions. Consistent with this expertise, the Bank has well-established policies, procedures and controls that it applies to its customer-driven, cash-settled oil, gas, and electricity derivatives businesses. For example, the Bank: (i) hedges the price risk arising from commodity derivatives on a portfolio basis and values transactions using data sets and models implemented in accordance with Bank standards; (ii) records credit exposure against customer credit limits; (iii) documents cash-settled customer transactions using the ISDA Master Agreement, with appropriate confirmations;[9] and (iv) uses operations systems that permit booking and settlement of commodity derivatives transactions. The Bank represents that it will continue to conduct its activities in customer-driven electricity derivatives consistent with the same policies, procedures and controls it applies to its existing energy commodity derivatives business (the "Commodity Derivative Product Controls").

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[9] We would expect the Bank to document all electricity transitory title transfer transactions with appropriately comparable confirmations.

The Bank commits that before engaging in transitory title transfers it will adopt and implement all necessary policies, procedures and controls to assure that (i) its electricity derivative business is customer-driven and meets all required regulatory standards for conducting a customer-driven derivative business, and (ii) the Bank has in place all appropriate mechanisms to identify, monitor, limit and control the risks inherent in conducting this business so that it complies with all applicable OCC guidance and requirements.[10]

To manage the risks in its expanded electricity derivatives business, the Bank represents it will implement those policies, procedures and controls set forth in OCC guidance, *e.g., OCC Derivatives Handbook* and BC-277, to assure the ongoing function and maintenance of an effective risk management process. The Bank specifically acknowledges that, as contemplated by the *OCC Derivatives Handbook* and BC-277, an effective risk management process includes appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification, measurement and management information systems, and effective risk control functions that oversee and ensure the continuing appropriateness of the risk management process.

In implementing those policies, procedures, and controls, the Bank commits 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 (including the Commodity Derivative Product Controls discussed above); (iv) the establishment, implementation and monitoring of appropriate risk management limits with respect to various types of risks--such as market risk, credit risk, and liquidity risk--associated with transitory title transfers;[11] and (v) Compliance Department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. Such a framework will strictly prohibit manipulative practices of any kind, including patterns of trading related to so-called "round tripping" of electricity derivatives transactions and will promote compliance with FERC and other relevant regulatory requirements.[12] Risk Control, Operations, Accounting, Legal, Compliance, Audit and Senior and

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[10] *See, e.g.*, OCC Handbook: *Risk Management of Financial Derivatives* (January 1997) ("*OCC Derivatives Handbook*"); OCC Banking Circular No. 277 (October 27, 1993), *reprinted in* 5 Fed. Banking L. Rep. (CCH) ¶ 62-152 ("BC-277"); OCC Bulletin 94-31 (May 10, 1994), *reprinted in* 5 Fed. Banking L. Rep. (CCH) ¶ 62-152.

[11] For example, in the context of market and related risks of electricity derivatives, the Bank will specifically address such matters as price volatility and concentration of market participants on a geographic and power exchange/power pool/individual customer basis. In the context of options, it will specifically address all of those characteristics identified in the *OCC Derivatives Handbook* (*e.g.,* at 20-21 and Appendix B) as primary component measures of option sensitivity.

[12] To illustrate, the head of the electricity derivatives desk will be provided with a "best practices" policy that describes the responsibilities of the position in monitoring transactions for market manipulation, including round-tripping. This individual will receive daily position and activity reports to review and monitor consistent with the best practices policy. The Bank's Compliance Division will also receive and review position and activity reports on a daily basis, test for proprietary trading, test the appropriateness of derivative transactions and hedges, and review documentary support on a quarterly basis. Bank employees involved in this business will be subject to

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 energy-based derivative products and business.

The Bank further commits that: (i) it will not run a proprietary book in electricity/electricity derivatives, (ii) any trading in derivatives will be done exclusively to hedge residual open positions related to customer transactions (or incurred in anticipation of customer transactions), and (iii) its electricity derivatives business will be conducted in a safe and sound manner and consistent with prudential risk management practices as prescribed in the *OCC Derivatives Handbook* and BC-277.

Furthermore, the Bank commits that complex structured transactions involving electricity derivatives will be subject to appropriate review and oversight of the Bank's risk management approval process to ensure that such transactions conform to the Bank's standards of appropriateness and integrity. In this risk management approval process, committees that are independent of the sponsoring business will review complex structured transactions. These committees will review the transactions for risks presented by the transactions, including credit risk, market risk, operations risk, legal risk and reputation risk. Furthermore, in the normal course of risk management, the Bank will typically evaluate the purpose of transactions to assess whether the client has attempted to achieve a financial statement objective that could be construed as materially misrepresenting its financial condition, even if in conformance with generally accepted accounting principles ("GAAP"). In any instance where it is determined that a proposed transaction may result in materially misleading financial statements, the Bank will decline the transaction, condition approval upon the counterparty making express disclosures regarding the nature and financial impact of the transaction on the counterparty's financial position or take other steps to assure that the Bank's role is appropriate. The Bank will also have an appropriate process for verifying customers have satisfied any conditions the Bank establishes concerning disclosures. As part of the process to determine the appropriateness of a transaction, the Bank may seek representations and warranties from the counterparty to the complex structured transaction stating the purpose of the transaction, how the counterparty will account for the transaction, and that the counterparty will account for the transaction in accordance with GAAP, consistently applied.

II. Discussion

In our opinion, the proposed title transfer transactions may be permissible under 12 U.S.C. § 24(Seventh) as an activity incidental or "convenient and useful" to its electricity derivatives business, provided the Bank has established an appropriate risk measurement and management process for the activity that is satisfactory to the Bank's EIC.[13]

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applicable "Standards of Professional Conduct" and will be required to attend compliance training. Furthermore, the Bank's Legal Department will provide guidance to the Compliance Department to ensure FERC rules and regulations as prescribed by the National Power Act are understood with appropriate compliance policies and procedures developed and implemented.

[13] This process is necessary for the Bank to achieve its customer risk management objectives in a safe and sound manner and, thus, must be established before the OCC can conclude that activities are permissible for the Bank.

National Banks May Engage in Electricity Title Transfers to Settle and Hedge Customer-Driven Electricity Derivative Transactions as Activities Incidental to the Business of Banking

The OCC previously determined that the Bank may engage in electricity derivative transactions and hedges that are cash-settled.[14] The Bank proposes to settle and hedge electricity derivative transactions by transitory title transfers where the Bank takes title to electricity in a "chain of title" and relinquishes title instantaneously. The proposed transitory title transfers will enable the Bank to participate in markets using this form of settlement and provide customers with a broader range of sophisticated risk management tools to address their financial, risk management, and liquidity needs. Further, the proposed transitory title transfers will enable the Bank to compete more effectively and operate more efficiently and profitably. Transitory title transfer capability also will increase the Bank's hedging options and its ability to control risks in its electricity derivatives business.

Engaging in transitory title transfers will subject the Bank to risks similar in nature to those inherent in cash-settled electricity derivatives where the Bank has demonstrated risk management procedures, systems and controls to appropriately manage and controls such risks. Transitory title transfer transactions typically do not involve taking physical possession of commodities, and thus do not appear to involve the customary activities relating to commodity ownership. While transitory title transfer transactions will require the introduction of some new operational processes (*e.g*., scheduling of power flows), the majority of operational functions, such as passing notices, document transfers, and payments, are similar to those regularly performed by national banks in their role as financial intermediaries.

The OCC has previously concluded in a variety of contexts that national banks may engage in instantaneous title transfers as an activity permissible under 12 U.S.C. § 24(Seventh). In OCC Interpretive Letter No. 684, for example, the OCC determined that it was permissible for a national bank to engage in instantaneous warehouse receipt transfers in furtherance of managing the risks in financial intermediation transactions with customers, involving the exchange of payments based on the value of commodities.[15] The instantaneous warehouse receipt transfers, entailed the bank taking possession of a warehouse receipt and instantaneously passing it on to a third party under an offsetting transaction. In OCC Interpretive Letter No. 684, as here, the Bank did not propose to take actual delivery by receipt of physical quantities of commodities on Bank premises. Rather, transitory 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). The OCC

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[14] OCC Interpretive Letter No. 937, *supra.*

[15] OCC Interpretive Letter No. 684 (August 4, 1995), *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,632. Warehouse receipts evidence title to commodities. While OCC Interpretive Letter No. 684 characterized the transactions in that letter as involving the "physical delivery" of commodities, included within that characterization were instantaneous warehouse receipt transfers.

determined that the warehouse receipt transfers were permissible, where consistent with safe and sound banking principles, and with prior written authorization from OCC supervisory staff.

Analogously, the OCC has previously determined that a national bank may instantaneously acquire and transfer equity and debt securities in the secondary market under 12 U.S.C. § 24(Seventh), in financial intermediary transactions with customers.[16] The bank purchased the equities and debt securities only for immediate resale to an ultimate purchaser as a riskless principal. The OCC approved the transactions because the bank did not assume any of the customer's risk of loss, did not assume any liability as guarantor or endorser of the value of the securities, and did not have any beneficial ownership of the securities. The purchases and sales of equity and debt securities were in furtherance of bank permissible brokerage activities.

In sum, the ability of the Bank to engage in transitory title transfers in connection with its customer-driven electricity derivative transactions will allow the Bank to provide customers with a broader range of tools to address their financial, risk management, and liquidity needs. Transitory title transfer capability also will permit the Bank to conduct its electricity derivatives business more competitively, efficiently, and profitably and increase its hedging options. The risks to which the Bank is exposed are similar in nature to cash-settled electricity derivative transactions where the Bank has a demonstrated ability to manage and control such risks. The Bank's proposed transitory title transfers are functionally comparable to other title transfers that the OCC has permitted under 12 U.S.C. § 24(Seventh). Accordingly, subject to satisfying the safety and soundness factors discussed below, the Bank's proposed transitory title transfers are incidental or "convenient and useful" to the Bank's financial intermediation activities in electricity derivative transactions.

Safety and Soundness Requirements and EIC Approval

For the Bank to permissibly engage in transitory title transfers, 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. Consequently, in order for the OCC to conclude that this activity is permissible for the Bank because it is convenient or useful to conducting authorized banking activities, the Bank must demonstrate to the satisfaction of the OCC that the Bank has established an appropriate risk measurement and management process for its transitory title transfers. As detailed further in the *OCC Derivatives 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. Risk control processes will need to become increasingly sophisticated as this business activity grows in size and complexity.

Additionally, the Bank's risk management approval process must subject complex structured electricity derivative transactions to appropriate review and oversight to ensure that these

[16] OCC Interpretive Letter No. 626 (July 7, 1993) *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,508.

transactions conform to the Bank's standards of appropriateness and integrity. This should include review and approval of these transactions by independent and qualified individuals. The structured transaction approval process should consider all relevant risks, should require review of transaction appropriateness, and should include evaluation of the purpose of these transactions to determine whether the Bank's customer is attempting to achieve a financial statement objective that materially misrepresents its financial condition, regardless of being in conformance with GAAP.

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 electricity 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, including "round tripping," and promotes compliance with FERC and other regulatory requirements. An adequate and effective compliance monitoring program will include policies, training, independent surveillance and well-defined exception approval and reporting procedures.

The OCC will make these determinations though the Bank's EIC and the Bank may not commence the proposed activities unless and until its EIC has concluded that the foregoing standards are met.

III. Conclusion

The Bank may settle and hedge its customer-driven bank permissible electricity derivative transactions by transitory title transfers as an activity incidental to its existing electricity derivatives business, provided the Bank has established, to the satisfaction of its EIC, an appropriate risk measurement and management process for its transitory title transfers.

Sincerely,

/s/ Julie L. Williams

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel