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Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th St. and Constitution Avenue, NW
Washington, DC 20551

Via Electronic Submission

Re: Comment letter on Advanced Notice of Proposed Rulemaking regarding "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities" (Docket No. R-1479)

Dear Mr. Frierson:

Questions 16 and 17 of the ANPR ask whether allowing FHCs to engage in Complementary Commodities Activities creates "conflicts of interest" or other "adverse effects." We believe a number of adverse effects have arisen in the aluminum market due to FHCs simultaneously owning physical metal, trading in metal derivatives, and owning official LME storage warehouses of the metal. We further believe the negative dynamics occurring in the aluminum market also appear in the markets for other industrial metals, and could appear in markets for other commodities.

Four negative effects of allowing FHCs to engage in Complementary Commodity Activities stand out in particular (and for further detail, please see http://www.sunesiscapital.com/aluminum):

1) FHCs have been permitted to own an outsize share of official LME metals warehousing. With such warehouse market power, they can exercise manipulative control over aluminum prices and stifle competition. Anyone who buys metal on the LME and wishes to take possession of it is forced to do so through an LME warehouse. Warehouse owners with such outsize market power have driven up wait times for these buyers to hundreds of days, and have increased rents on their metal during the wait. This behavior constricts supply and drives up the costs of getting metal out of the LME system. In turn, this creates a distortive force on the broader market for metal—thereby driving up industrial costs, which are passed down to consumers in the form of higher prices. The LME system—a so-called market of last resort—should be a force for keeping industrial premiums down, but it has ceased to function in this role.

   Additionally, with the profits from higher rents flowing from longer queues, FHCs can incentivize producers to sell more aluminum into their warehouses, and thereby compete with industry and bid up the price of metal—again, driving up aluminum prices.

As J. Christopher Giancarlo said in a confirmation hearing before the United States Senate Committee on Agriculture, Nutrition, and Forestry, "Absolute dominance can lead to absolute abuses." Sharon Bowen, at the same hearing, echoed these sentiments: "Any time you can control both the demand and supply of a commodity, that . . . needs to be looked at, because it could be recipe for manipulation."

2) Allowing FHCs to own metal, trade derivatives, and own the LME warehouses in which metal is stored gives FHCs the ability to gain insider information about the future moves of metal in and out of the market, and then trade on such information. The rest of us, who don't own warehouses, cannot do the same.

   Insider trading in equities markets is illegal. Those laws are designed to prevent individuals from profiting from non-public information. But no such laws exist in commodities markets, thereby misaligning incentives, and, most importantly, eroding public trust in commodities markets. If a CEO can't sell his company's shares because he knows the company is about to report small profits, why can a trader sell metals futures right before he knows his company is about to dump large amounts of metal on the market?

3) Allowing FHCs to own metal, trade derivatives, and control warehouses allows FHCs to profit by quickly moving large amounts of metal in and out of the LME market system. When large quantities of metal leave or enter the system, the broader market perceives shifts in supply and demand. A FHC with outsize stocks of metal could take advantage of such a scenario by buying futures, moving a large quantity of metal off LME warrant (signaling a greater demand and reduced supply, causing prices to rise), and then selling the futures at a higher price. But the metal may have never left the warehouse at all. There is, in reality, no industrial demand for the metal, but its price has gone up.

4) And all of this behavior is financed by the American taxpayer. Owning and trading in physical metal requires significant upfront capital, which is typically borrowed. Because FHCs have access to the discount window, and benefit from an implied "too big to fail" loan guarantee, they have a government subsidized advantage over industrial buyers and smaller traders who must pay higher financing fees. Quite ironically then, it is the American taxpayer who is subsidizing FHC activity that causes higher prices on the everyday goods purchased by those same taxpayers.

Sincerely,

/s/ Manal Mehta

Manal Mehta
Principal
Sunesis Capital, LLC