CME Group

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April 16, 2014

VIA ELECTRONIC SUBMISSION

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C 20551

Re: Advance Notice of Proposed Rulemaking - Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities (Docket No. R-1479; RIN 7100-AE10)

Dear Mr. Frierson:

CME Group Inc. ("CME Group")[1] appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's (the "Board") recently issued Advance Notice of Proposed Rulemaking, titled Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities ("ANPR"). CME Group is the parent company of leading global markets for listed and cleared derivatives, including those based on physical commodities. These markets provide a means by which entities, including end-users, transfer and manage risks, and obtain liquidity and price discovery in derivatives that overlay core wholesale commodity market centers.

The ANPR solicits comment on certain Bank Holding Company Act ("BHC Act") provisions administered by the Board. Financial holding companies ("FHCs") engage in physical commodity activities under these provisions and pursuant to certain additional conditions established by the Board. Among other matters, the ANPR solicits comment on a central issue – whether the physical commodity activities of FHCs are supported by the relationship between commodity derivatives and the physical commodity markets. CME Group particularly appreciates the opportunity to comment on this issue. For the reasons discussed below, CME Group respectfully submits that the ability of FHCs to meaningfully

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[1] CME Group is the holding company for four separate designated contract markets, including the Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges"). The clearing house division of CME provides clearing and settlement services for exchange-traded contracts and over-the-counter ("OTC") derivatives contracts through CME ClearPort®. The CME ClearPort® service mitigates counterparty credit risks, provides transparency to OTC transactions, and brings to bear the Exchanges' market surveillance monitoring tools.

participate in the physical commodity markets directly supports the price basing and hedging utility of listed and cleared commodity derivatives.[2] In addition, the intermediary services provided by FHCs broadly benefit commodity end-users and have a complementary relationship with our markets.

Price Basing and Delivery Optionality

The Board first determined that certain physical commodity activities assumed by FHCs were complementary to their "financial activities" for purposes of the BHC Act over ten years ago. Under the Board's analysis of "complementarity," physical commodity activities are appropriate when "meaningfully connected" to financial activities. As determined by the Board, financial activities include issuing debt and establishing commodity derivatives positions.

The ANPR notes recent developments indicating a reduced level of FHC participation in the physical commodity markets. Partly because of this, the ANPR questions whether the relationship between commodity derivatives and physical commodity markets (or the relationship between participants in these markets) is in fact as close as previously claimed or expected.[3] As indicated by the analysis set forth below, an FHC's ability to make or take delivery under a futures contract, and the attendant ability to directly or indirectly own, store and transport related physical commodities, are integrally connected to the commercial hedging and price-basing utility of our physical delivery futures markets.[4]

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[2] Although the price-basing and hedging analysis that follows primarily considers exchange-listed derivatives, it nonetheless remains germane to bilateral OTC commodity derivatives that are not submitted for clearing.

[3] The cash, forward and derivatives markets for raw commodities and their by-products are intrinsically connected to one another. Indeed, the U.S. commodity futures markets evolved from Chicago's spot and forward markets for corn in the second half of the 19th century. Because of the significant mismatch between production and consumption cycles, farmers would sell a substantial portion of their harvest through spot (cash) sales to dealers with storage capacity along Chicago's canal system. The dealers in turn would store the corn for shipment to Chicago months later when consumption demand aligned with stored supplies. As the economy prospered, dealers along Chicago's canal system increasingly used forward contract sales "to finance the ever-increasing size of crops in storage and to expand storage space." Because of the relative uniformity of these contracts, the corn forward market began to function under organized Chicago Board of Trade rules allowing counterparties to collect performance margins and net transactions without delivery through ring settlements. In 1891, the first central clearing counterparty system was established, thereby completing the evolution of forwards into futures with clearinghouse offsets. Anne E. Peck, The Economic Role of Traditional Commodity Futures Markets, pp. 3 to 21 (published by the American Enterprise Institute for Public Policy Research, 1985).

[4] The Commodity Futures Trading Commission ("Commission") also recognizes the intrinsic connection between the physical and derivatives commodity markets. For example, part 23 of the Commission's regulations implements key Commodity Exchange Act ("CEA") provisions governing the transactional activities of swap dealers. In that part, swap activities are specifically identified "as activities related to swaps and any product used to hedge such swaps, including, but not limited to…physical commodities." See 17 CFR 23.600(a)(7).

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CME Group Exchanges' physical delivery futures markets play a critical role in our national economy. For example, commercial firms in a broad spectrum of industries actively use our physical delivery futures contracts for establishing spot and forward transaction prices.[5] In this regard, commercial firms prefer price-basing off of physical delivery futures contracts over cash-settled contracts because physical delivery futures can result in actual delivery. This physical-delivery mechanism, when well-constructed and safeguarded, ensures price convergence between derivatives and their underlying commodities.[6]

Looking inwardly, CME Group is deeply concerned that curtailing the ability of FHCs to meaningfully participate in the marketing channels for physical commodities, for example, by directly or indirectly owning, storing and transporting physical commodities, significantly diminish net liquidity in convergence trades. CME Group is concerned that this diminished liquidity, in turn, will weaken our physical delivery contracts' price convergence mechanism. As sophisticated market participants, FHCs have the ability to, and in fact do, make and take delivery of physical commodities under our contracts, typically opposite commercial hedgers.[7] Consequently, FHCs are a valuable source of liquidity for convergence trades critical to the price formation process. Weaker convergence, and concomitant increases in basis risk, particularly during episodes of sudden exogenous shocks to the markets, can in turn reduce the commercial impetus for using physical delivery futures; further exacerbating basis risk and diminishing end-user access to optimal price-basing and hedging tools.[8]

CME Group emphasizes that those regulatory policies that artificially direct transactions from one market to another can cause significant negative impacts. Regulatory policies curtailing the ability of FHCs to meaningfully participate in the physical commodity markets, for example, could artificially

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5 The pricing signals generated by these markets therefore can steer commodities to efficient specific uses, both across time and geographically.

6 Price convergence is accomplished because a short futures position can actually become a sale of the underlying commodity at the futures price and a long futures position can become a purchase of the deliverable commodity. If futures and cash commodity markets diverge, the actual deliverable commodity can be marketed to bring equilibrium to a contract through convergence trades. A well-constructed physical-delivery futures contract therefore facilitates price convergence with terms and conditions that are consistent with cash market practices.

7 The physical commodity activities of FHCs, in relation to our markets, are limited and typically involve taking title to commodities, warehousing and arranging for or intermediating the storage, processing or transportation of commodities.

8 The parties that engage in specialized but routine physical commodity activities, including FHCs, operate in accordance with vetted federal and state laws, administrative regulations and organized customs and practices developed over time to facilitate risk mitigation and promote transactional legal certainty. By employing many of the measures enforced by the Board under its complementary activities authority, including tailored corporate structures and the adoption of internal controls, FHCs and other physical market participants efficaciously reduce the likelihood of complications and limit their exposure to liability. For these reasons, and because of the nature and scope of routine physical commodity activities, the participation of FHCs in the physical marketing channels has not, in our experience, given rise to the possible types of liability flowing from catastrophic "tail risks" referenced in the ANPR (e.g., the Deepwater Horizon oil spill or radiation releases from the Fukushima Daiichi nuclear power plant).

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incentivize FHCs to leave primary physical delivery futures markets. Rather, FHCs may be incentivized to establish positions in price-linked secondary markets that are cash-settled. Artificially increasing liquidity in transactions that are purely derivative of a primary market paradoxically increases the influence of those purely derivative transactions on convergence in the primary market. Furthermore, reducing participation in the primary markets, particularly during the convergence process, decreases the likelihood that price determination in a primary market will be competitive.

In addition to improving convergence trade liquidity, FHCs are also a critical source of liquidity for bona fide hedgers that benefit from delivery optionality. Delivery optionality, which is facilitated by the physical commodity activities of FHCs, increases the hedging value of physical-delivery futures to end-users. By way of example, consider a commercial hedger located in Illinois that may not initially intend to take delivery of natural gas at Henry Hub in Louisiana for power production purposes. The settlement optionality provided by a physically-delivered NYMEX natural gas contract's delivery mechanism, as supported by FHC liquidity, enables the commercial hedger to either: (i) take delivery on the natural gas if at expiration the Henry Hub natural gas price plus the transportation cost to Illinois is lower than the spot natural gas price delivered in Illinois, (ii) take delivery on the natural gas at expiration and then exchange the gas at Henry Hub for natural gas at the needed delivery location, or (iii) liquidate the hedge position before expiration. In general, this optionality, and the enhanced hedging flexibility it offers, not only increases the hedging value of physical-delivery futures but also improves futures-cash market convergence as noted above.

OTC Intermediary Services

The role that FHCs play in the OTC markets as intermediaries substantially benefits commodity end-users, the listed derivatives markets and the broader economy. FHCs and other bank holding companies registered as swap dealers are reliable, well-capitalized and regulated institutions that are credible counterparties to customized long-term transactions of importance to end-users. The approach that FHCs take with respect to physical commodities and their derivatives activities is that of an intermediary – seeking to balance the needs of a client base comprised of producers, consumers and investors. This balanced approach is reflected in the risk management and arbitrage positions FHCs establish on our markets. Additionally, this balanced approach is reflected in generally low FHC commodity value-at-risk metrics relative to the gross value of commodity trading inventories.[9]

The CEA, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), recognizes the role of banks as swap intermediaries[10] and the significance of OTC swaps to commercial end-users.[11] For example, Dodd-Frank Act amendments to the CEA transfer the status of a

9 See, e.g., September 30, 2013 Form 10-Q Reports for JPMorgan Chase & Co. and Morgan Stanley, as well as their Form FR Y-9C Reports for the same period. Notably, to the extent that physical commodity inventories are acquired by other market participants, the Board, other regulators and the public will likely lose a substantial measure of transparency into the physical and derivatives commodity markets.

10 See 7 U.S.C. § 4s.

11 7 U.S.C. § 4a(c)(2).

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bona fide hedger from an end-user to its swap counterparty for position limit purposes.[12] Transferring bona fide hedging status to swap dealers allows dealers to accommodate the customized needs of end-users, to establish large offsetting positions in standardized futures and to channel the pricing signals embedded in customized trades to related exchange-listed and cleared derivatives. In this regard, FHCs are again an important source of liquidity and price discovery for exchange-listed and cleared physical commodity futures contracts, including those listed on CME Group Exchanges.

Conclusion

The ability of FHCs to meaningfully participate in the physical commodity markets directly supports valuable liquidity for convergence trades and delivery optionality in physical delivery futures and thereby the price basing and hedging utility of our benchmark markets. The intermediary services provided by FHCs also broadly benefit end-users and transfer liquidity and price signals embedded in customized derivatives to the listed and cleared derivatives markets, including those operated by CME Group Exchanges. Preventing FHCs from acting in this capacity may ultimately affect the cost of commodities as FHCs will no longer be able to provide an integrated set of services to commercial end-users.

In connection with any proposal by an FHC to engage in a complementary activity, the Board must consider whether performance of the activity may reasonably be expected to produce benefits to the public that outweigh possible adverse effects. Given the demonstrated benefits that FHCs provide to the commodity markets and their participants, and the conjectural nature of the adverse effects noted in the ANPR, CME Group respectfully urges the Board to not further curtail the physical commodity activities of FHCs.

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CME Group thanks the Board for the opportunity to comment. Should you have any comments or questions regarding this submission, please contact me by telephone at (312) 930-3488 or via e-mail at Kathleen.Cronin@cmegroup.com, Christopher Bowen, Managing Director and Chief Regulatory Counsel by telephone at (212) 299-2200 or via email at Christopher.Bowen@cmegroup.com, or Bruce Fekrat, Executive Director and Associate General Counsel by telephone at (212) 299-2208 or via e-mail at Bruce.Fekrat@cmegroup.com.

Sincerely,

Kathleen M Cronin

Kathleen Cronin
Senior Managing Director,
General Counsel and Corporate Secretary

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12 Id.