NEW AMERICA
FOUNDATION

April 16, 2014

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

Re: Docket No. 1479 and RIN 7100 AE-10: Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities, Advance Notice of Proposed Rulemaking

The Markets, Enterprise, and Resiliency Initiative at the New America Foundation appreciates the opportunity to comment as the Federal Reserve considers restricting the role of taxpayer-backed banks in physical commodity markets. As documented by market participants, experts, and journalists, the ownership and control of physical commodity assets by banks endangers the public welfare in a host of ways.[1] Our work has focused on one aspect of this threat: the manipulation of market prices by large integrated companies free to make financial trades based on their "inside" knowledge about the flow of physical commodities through the pipelines, steamship lines, storage facilities, and other infrastructure that they directly or indirectly control.

As we document in a forthcoming report, commodity markets in the United States remain highly susceptible to this sort of manipulation. One key factor enabling this is that the companies that manage most commodities businesses in America have generally grown significantly in size over the last 20 years and have vertically integrated into many new lines of business. This is true of corporations that traditionally earned most of their revenue through the transportation, storage, and handling of commodities – such as BP, Cargill, and Trafigura – many of which have greatly increased their "paper trading"

[1] U.S. Senate Committee on Banking, Housing and Urban Affairs, *Examining Financial Holding Companies: Should Banks Control Power Plants, Warehouses, and Oil Refineries?* 113th Cong. (2013) (statement of Timothy Weiner, Global Risk Manager, MillerCoors LLC); Saule Omarova, "The Merchants of Wall Street," *Minnesota Law Review*, Vol. 98 (2013); Lina Khan, "Why Goldman Sachs Has No Business Owning a Coal Mine in Colombia," *Quartz*, July 22, 2013.

activities in recent years.[2] And it is true of corporations that have traditionally earned most of their revenue by providing paper trading and other banking services – such as Goldman Sachs, JP Morgan, and Morgan Stanley – many of which in recent years have integrated into direct or indirect control over the transportation, storage, and handling of physical commodities.[3]

The vast new scale and scope of today's commodity "handler-trader" companies is not the only factor that has transformed our commodity markets. Over the last 20 years we have also seen dramatic changes in the structure of delivery contracts and the commodities markets themselves, the emergence of extremely sophisticated surveillance technologies and data analytics tools, and a surge in the amount of money in these markets thanks to the creation of new investment vehicles. In combination, this cluster of changes affords the individuals who work at these massive handler-traders both far greater ability and far greater incentive than even a decade ago to manipulate markets using "inside" information.

This type of manipulation results when a company makes a financial trade based on information about the physical movement of goods that it also controls. Importantly, this is different from a hedge – where a company is looking to *cover* a physical position it already has or intends to hold. And it is different from a pure bet, where a trader without concrete and certain knowledge of commodity flows speculates as to the future of some commodity price. What we increasingly have is the potential for teams of executives and traders simultaneously to alter the physical flow of a commodity and then use that information to place an advance bet in the market. One expert has likened these schemes to a baseball manager wagering on his own team to lose, then taking steps to ensure that outcome.[4]

To be clear, this sort of manipulation is technically illegal. It is also not abstract: in October 2007 BP paid $303 million to settle charges that the company's energy trading division used the company's control over energy infrastructure to manipulate the U.S. market for TET propane gas.[5] Yet, as we show in our forthcoming report, the laws and mechanisms available to regulators to detect and prosecute manipulation in commodity markets appear to be grossly inadequate to the task. The asymmetry in information and power grows by the day. On one side we see a few very large commodity handler-trader companies that enjoy an ever wider, ever deeper, ever more multidimensional view of commodity flows, cash flows, and regulatory regimes and actions. On the other we see siloed regulators who have comparatively little ability to see the full picture and thereby

[2] Lina Khan, "The Folks Who Sell Your Corn Flakes are Acting Like Goldman Sachs – and That Should Worry You," *New Republic*, September 11, 2013.
[3] Omarova.
[4] Shaun Ledgerwood, "Uneconomic trading, market manipulation and baseball," Risk.net, June 7, 2013.
[5] "BP Agrees to Pay a Total of $303 Million in Sanctions to Settle Charges of Manipulation and Attempted Manipulation in the Propane Market," CFTC Release 5405-07, October 25, 2007, www.cftc.gov/PressRoom/PressReleases/pr5405-07

to detect and document how handler-trader corporations might be manipulating the flows of commodities to manufacture opportunities for lucrative paper trades. In short, the license that handler-traders continue to enjoy to make bets using "inside" information is a dangerous anachronism, one that Congress should move swiftly to eliminate.

One good measure of what's at stake here is that the top 20 commodity handler-trader companies netted some $250 billion in profits between 2003 and 2013. Even after record volatility subsided, they continued to earn 15 times what they made in the late 1990s.[6] Another good measure of what's at stake is that pure paper traders who do not enjoy a clear view of commodities flows via any direct control of commodity infrastructure are willing to invest large sums just to get a partial idea of what's inside – such as through the services of the energy market surveillance company Genscape.[7]

Specific to the immediate decision facing the Federal Reserve, we urge regulators to prohibit taxpayer-backed banks from engaging in the ownership of physical commodity assets and movement of physical commodities. Allowing banks to continue trading and owning assets in physical commodity markets perpetuates an opportunity for them to use "inside" information to manipulate markets, especially as regulators presently have limited ability to detect these schemes. This prohibition must extend to merchant banking arrangements where banks still hold effective control over commodity operations and can use information gleaned from those businesses to benefit their trading desks. Adopting partial measures like surcharges is not sufficient. While some banks have moved recently to dispense with part or all of their commodity handling and trading operations, limits that rely only on capital restrictions all but invite these corporations to return to these markets whenever the political and economic moment is again ripe.

The Federal Reserve has the authority to rebuild a clear and strong firewall between banking and commercial activities in the United States. Eliminating the license of banks to own physical commodity assets and to move physical commodity goods would serve as a vital first step. Anything less will fail to serve the interest of the American public and of everyone around the world who depends on the safe and transparent functioning of these markets for essential goods.

Sincerely,

Markets, Enterprise, and Resiliency Initiative
New America Foundation

[6] Javier Blas, "Traders reap $250 bn harvest from boom in commodities," *Financial Times*, April 15, 2013.
[7] Michael Rothfeld and Scott Patterson, "Traders Seek an Edge With High-Tech Snooping," *Wall Street Journal*, December 18, 2013.