Morgan Stanley

2000 WESTCHESTER AVENUE
PURCHASE, NY 10577-2530

April 17, 2014

By electronic submission to www.federalreseve.gov

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: **Comment Letter on the Advance Notice of Proposed Rulemaking on Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities (Docket No. R-1479; RIN 7100 AE-10)**

Dear Mr. Frierson:

Morgan Stanley welcomes the opportunity to comment on the Advance Notice of Proposed Rulemaking of the Board of Governors of the Federal Reserve System (the "**Board**"), entitled *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities*, and published in the Federal Register on January 21, 2014 (the "**Notice**").[1]

Morgan Stanley supports in general the comments on the Notice that have been submitted by the Securities Industry and Financial Markets Association, American Bankers Association, Financial Services Forum, Financial Services Roundtable and Institute of International Bankers, The Clearing House Association L.L.C., and the International Swaps and Derivatives Association. Morgan Stanley submits these further comments to provide the Board with additional information to assist it in its review of the authority of financial holding companies ("**FHCs**"), such as Morgan Stanley, to engage in physical commodities activities under the Bank Holding Company Act of 1956, as amended (the "**BHC Act**"). According to the Notice, "the activities under review include physical commodities activities that have been found to be 'complementary to a financial activity' under section 4(k)(1)(B) of the [BHC Act] ["**Complementary Commodities Activities**"], investment activity [in commodities portfolio companies] under section 4(k)(4)(H) of the BHC Act ["**Merchant Banking Commodities Investments**"], and physical commodities activities grandfathered under section 4(o) of the BHC Act ["**Grandfathered Commodities Activities**"]."

[1] 79 Fed. Reg. 3329 (Jan. 21, 2014).

I. Section 4(o) Grandfather Authority

The Notice discusses the Grandfathered Commodities Activities and poses questions relating to a number of safety and soundness considerations related to these activities and investments.[2] As a general proposition, Morgan Stanley believes that whether one is engaging in Complementary Commodities Activities, Merchant Banking Commodities Investments or Grandfathered Commodities Activities, the common element that should apply to all such activities and investments is the obligation that such activities and investments be conducted in a safe and sound manner through the means of a robust risk management framework that focuses on all significant categories of risks potentially posed by such activities. This is so, in large part, because many of the same activities can be conducted, or investments made, under any of these three legal authorities, depending on the particular FHC conducting the activity or the purpose of the investment. For all these activities, the risk management framework should include the measuring, monitoring and mitigation of environmental, legal and other forms of operational risk. An FHC should be required to demonstrate to supervisors and its own senior management that such activities are operated pursuant to well-established safeguards and the risk management framework established by the FHC's board of directors.

Through its diverse lines of business, Morgan Stanley supports activities and companies that endeavor to protect the environment in connection with their other operations. Morgan Stanley seeks to understand and mitigate the environmental risks that it as a firm may face, and it encourages its clients to do the same. Morgan Stanley also strives to reduce the environmental impact of its own operations, including but by no means limited to the commodities division.[3] As stated in a report issued by Morgan Stanley in 2012, "[t]he firm has formal environmental and social risk management processes and due diligence policies and procedures in place. We consider sustainability in all aspects of our business: the way we evaluate companies, transactions and risk; how we advise our clients and collaborate with our financing partners and employees; how we conduct our own operations; and how we promote and develop new market opportunities."[4] Consistent with Morgan Stanley's strong commitment to the environment, it believes that all FHCs should be required to maintain a robust risk management program designed to avoid or significantly mitigate any environmental, legal or other operational risks

---

[2] The questions to which this section is responsive are:

> *Question 23. What are the advantages and disadvantages of the Board instituting additional safety and soundness, capital, liquidity, reporting, disclosure requirements for BHCs engaging in activities or investments under section 4(o) of the BHC Act? How should the Board formulate such requirements?*

> *Question 24. Does section 4(o) of the BHC Act create competitive equity or other issues or authorize activities that cannot be conducted in a safe and sound manner by an FHC? If so, describe such issues or activities.*

[3] http://www.morganstanley.com/globalcitizen/environment.html

[4] See Morgan Stanley 2012 Sustainability Report, available at http://www.morganstanley.com/globalcitizen/environment.html.

attendant to their physical commodities activities, regardless of the authority pursuant to which they conducts such activities under the BHC Act.

II. Complementarity of Current Activities

In addressing the "Complementarity of Current Activities", the Notice states that:

> *"Two of the 12 FHCs that currently conduct physical commodities activities under complementary authority recently have publicly reported that they intend to cease such activities while continuing to engage in related financial activities, including commodities derivatives activities. Another FHC that conducts physical commodities activities pursuant to section 4(o) of the BHC Act .. has recently agreed to sell the global oil merchanting unit of its commodities division to a foreign oil and gas company and is in the process of selling other physical commodities units."*[5]

In support of the latter sentence, the Notice references Morgan Stanley's December 20, 2013 Press Release regarding a Purchase Agreement for the sale of the global oil merchanting unit of its commodities division. The Notice provides further that:

> *"Although market developments such as these may be caused by a variety of factors, the developments may indicate that Complementary Commodities Activities are not necessary to ensure competitive equity between FHCs and competitors conducting commodities derivatives or other financial activities. Moreover, these developments, including a FHC's sale of a physical commodities business to a nonfinancial firm, may suggest that the relationship between commodities derivatives and physical commodities markets (or the relationship between participants in such markets) may not be as close as previously claimed or expected."*[6]

Morgan Stanley believes that it would be an error to conclude, based on the announcement of the proposed sale of its oil merchanting business, either that Complementary Commodities Activities are not necessary to ensure competitive equity between FHCs and competitors conducting commodities derivatives or other financial activities, or that the relationship between commodities derivatives and physical commodities markets (or the relationship between participants in such markets) may not be as close as previously claimed or expected. First, as stated in the Notice, Morgan Stanley conducts much of its physical commodities activities, not pursuant to an order issued under section 4(k)(1)(B) of the BHC Act, but rather, as noted by the Board in its Notice, pursuant to section 4(o) of the BHC Act. Secondly, as recognized in the Notice, there are a number of factors that supported Morgan Stanley's decision to enter into the Purchase Agreement. Such factors included the increased costs associated with regulatory capital requirements and a desire to refocus on businesses that are core to Morgan Stanley's client franchise, such as through the continued provision to its clients of risk management services and solutions that incorporate both financial instruments (including commodity derivatives) and physical commodities activities. The close relationship

[5] 79 Fed. Reg. at 3334.

[6] 79 Fed. Reg. at 3334.

of these markets is perhaps best demonstrated by the examples in the following section of this letter.

III. Public Benefits of Physical Commodities Activities

The public benefits of continuing to permit FHCs and their non-bank subsidiaries to engage in physical commodities activities are real and significant. Commodity producers, end users, and other commodity businesses rely on market makers as intermediaries to help them address complex and long-term commodity risks, as a number of them have explained in their own comments on the Notice. FHCs play a key role in these markets – one that other types of market participants are unlikely to fill.[7] This section describes the needs of commodity businesses for risk intermediation services provided by FHCs.

A. Specialized financing and risk management solutions are essential for the operations of U.S. commodity producers, end users, and other commodity businesses

Firms that produce, distribute and consume commodities are subject to significant commodity-related risks, which must be managed to enable their profitable operation over time. Many of these firms have high fixed costs in cyclical industries and are vulnerable to fluctuations in the price and availability of commodities. The U.S. airline and automotive industries represent two such sectors. In 2011, energy costs comprised approximately 27% of total costs for U.S. airlines, while approximately 20% of total costs for car manufacturers are attributable to the plastics, metals, and composites they use to build cars.[8] Relatively small price fluctuations can dramatically raise operating costs for these companies. Delta Air Lines, for example, has estimated that a $1 increase in the per barrel price of oil results in a $100 million increase in annualized costs.[9]

Without certainty about the costs of inputs (such as natural gas for generation projects or raw materials for steel mills) and outputs (such as power for generation projects), these firms are hesitant – and often unable – to make new investments to develop commodity resources or to use them to manufacture consumer goods. Firms that are unable to mitigate these risks face a higher cost of capital, since investors demand a greater return for the increased risks they bear. In short, firms that cannot mitigate these risks do not make the kind of investments required to drive growth in the U.S. economy.

Some of these commodity-related risks may be addressed by using standardized products available in the futures markets and cleared swap markets. Commodity businesses, however, are

---

[7] For comparable views of commodity producers and end users, see the Letter from The American Gas Association (AGA), America's Natural Gas Alliance (ANGA) and The American Exploration & Production Council (AXPC) to the Board regarding the Notice (Mar. 31, 2014),

[8] Airlines For America, Quarterly cost index: U.S. passenger airlines, 3Q 2010. CIBC, "Auto Sector Outlook: Still waiting for the green light?" Sept. 2, 2011.

[9] Delta Airlines, Comment Letter to Commodity Futures Trading Commission Proposal Rule on Position Limits for Derivatives, Comment No. 33989, pgs. 1-2 (Mar. 28, 2011).

rarely able to eliminate their long-term, company-specific risks through transactions in these markets. Instead they must seek tailored solutions involving complex combinations of commodity physically-settled forwards, options and over-the-counter and cleared derivatives to meet their needs.

B. FHCs are uniquely positioned to provide these services

In the United States, FHCs play a key role in commodity markets. They provide integrated services – financing, credit, hedging, risk management, risk intermediation, advisory, and capital markets, among others – that either cannot be provided, or cannot be provided efficiently, by other market participants. Commodity businesses, or businesses with significant exposure to commodity price risk (such as airlines and many manufacturers), depend on the provision of these integrated financing and risk management services.

The role of FHCs in providing critical commodity services to clients is shaped by the commodity markets themselves. Commodities vary by product grade or other specifications and seasonal, cyclical, and location factors, such as origin and delivery destination. Accordingly, although commodity markets include exchange-traded futures contracts, they also encompass large over-the-counter markets, which commodity producers and consumers rely on for longer-term contracts and customized transactions.

Companies across many sectors of the economy seek the assistance of FHCs, such as Morgan Stanley, to reduce or eliminate commodity-related risks that constrain their ability to make investments and maintain profitability over time. The following examples illustrate how Morgan Stanley helped such companies to eliminate these risks and achieve their goals of profitably growing their businesses.

1. *Helping Renewable Energy Producers Build Wind Farms*

Morgan Stanley regularly helps renewable energy project developers finance the construction and operation of their projects. Developers may require a suite of products, including tax equity investment,[10] construction loans, and full-service power scheduling into real-time markets. Perhaps most critically, developers typically require a revenue hedge to assure their investors that their projects will produce a minimum level of cash flow necessary to fund operations and to service construction debt. In 2013, for example, Morgan Stanley's expertise and operational capabilities in power markets, capital markets and project finance, translated into at least three significant transactions with wind farm developers that each provided an integrated, comprehensive solution to the developers' individual needs, including a power price hedge that assured the developer a minimum revenue stream.

Were it more restricted in its ability to engage in physical commodities activities, Morgan Stanley may not have been able to provide these hedges to the developers and, absent the hedges, the wind farms would likely have been uneconomic and therefore not built. To provide the power price hedges to the developers in a safe and sound manner, Morgan Stanley

[10] Because U.S. public policy supports clean energy development through tax incentives, developers seek to partner with investors who can benefit from these tax incentives based on their other taxable income.

entered into power transactions ancillary to its obligations to the developers to hedge its exposures. As an active participant in the power, gas and transmission markets, Morgan Stanley was able to develop internal price information (including forward price and volatility curves, correlations, assessments of market depth, the availability of hedging alternatives, and associated transaction costs) to price the hedges efficiently. These physical commodities activities were thus essential to Morgan Stanley's ability to support the development of renewable energy projects, a key element to the United States' efforts to reach energy independence.

2. *Helping a Major U.S. Airline Reduce Jet Fuel Costs*

As part of a Chapter 11 restructuring, a leading U.S. airline sought Morgan Stanley's help to reduce its operating costs, working capital requirements, and balance sheet usage associated with its jet fuel supply. Prior to bankruptcy, the airline managed a large jet fuel supply operation in which it maintained up to a month's inventory, creating significant operational overhead and a need for costly financing. To reduce these expenses, Morgan Stanley provided the airline a long-term contract for delivery of jet fuel, typically one day prior to the airline's daily need to service its fleet. Morgan Stanley provided all logistical support and sold the airline jet fuel at better price than it was paying previously. This enabled the airline to reduce its operating expenses, reduce the size of its balance sheet and lower its overall interest expense.

If it were more restricted in its ability to engage in physical commodities activities, Morgan Stanley may have been unable to provide the airline with this service in a safe and sound manner because the expertise in jet fuel markets required to price and structure the transaction could only be developed by actively trading in these markets. There are 80 different jet fuel markets around the world. Morgan Stanley was only able to price the transaction by acting as a principal in physically-settled forward contracts and making and taking delivery of physical inventory in many of those markets.

Moreover, to obtain the most effective hedge for its own risk management, Morgan Stanley needed to trade in not only jet fuel, but also the related, but not identical, heating oil markets. Morgan Stanley was able to offer the airline competitive jet fuel prices in part from its ability to trade in those markets and through the use of storage assets leased from the airline. If it were more restricted in its ability to engage in these physical commodities activities, Morgan Stanley would have been prevented from helping this airline reduce its fuel-related costs during and after bankruptcy.

3. *Assisting an Independent Refining Client in the Acquisition and Continued Operation of its Refineries*

A Morgan Stanley subsidiary assisted a U.S.-based client in the independent refining sector in its acquisition of a closed refinery and in the continued operation of the client's existing refinery by entering into a product off-take at the two domestic refineries. Under the product off-take arrangement, the Morgan Stanley subsidiary purchased all of the transportation fuels produced at the two refineries along with certain other products. Also, in conjunction with its planned acquisition, the client entered into financing commitments with a number of entities, including a separate Morgan Stanley affiliate, for a large term loan and an even larger asset based loan. The loans were secured by working capital at one refinery and the assets at the other refinery, along with other collateral.

The client entered into these transactions because the arrangements would conserve capital for continued growth and provide a strong supply and distribution chain for added value for its investors. Thus, the combination of physical commodities activities and financing arrangements resulted in the restarting of a closed refinery and the continued operation of another refinery, thereby creating jobs and enabling a U.S. producer to compete more efficiently in the global market.

4. *Enabling Natural Gas Producers to Develop New Fields*

As part of the current expansion in domestic shale gas, U.S. natural gas producers have approached Morgan Stanley for price hedges on their future production. The price hedge provides the producer the funds it needs to expand its drilling operations and develop new gas fields. To meet the client's needs, Morgan Stanley has helped the producer hedge by purchasing a large volume of long dated natural gas call options from the producer. Additionally, Morgan Stanley did not require the producer to post margin as the price of natural gas changed; instead, it took a secured interest in the producer's exploration and production assets. This permitted the producer to use available cash to immediately develop new gas fields and invest future cash in new gas field developments while ensuring its future production margin was still profitable. The increase in gas supply during this period has led to the current record low prices in natural gas.

If it were more restricted in its ability to engage in physical commodities activities, Morgan Stanley may have been unable to offer U.S. natural gas producers the margin-free hedging and many of these new fields would not have been developed. In order to provide the hedge needed by a natural gas producer in a safe and sound manner, Morgan Stanley needed to be an active participant in the relevant market. Such participation enabled it to develop internal price information, including data such as forward price and volatility curves, price correlations, assessments of market depth, and evaluations of hedging alternatives and associated transaction costs. In addition, Morgan Stanley entered into swaps, options and futures to hedge its own risk; these positions were needed to manage the risk (e.g., time spread, volatility, and location risk) created by purchasing the options written by the producer. These risk solutions provided by Morgan Stanley combined Grandfathered Commodities Activities, such as physically-settled transactions in natural gas, certain activities permitted pursuant to Regulation Y, such as the trading of swaps, options and futures, and concepts similar to the traditional banking activity of credit extension on a secured basis. Clearly this example demonstrates how engaging in physical commodities activities is complementary to financial activities.

Any proposed rulemaking that the Board may consider as a result of comments received in response to the Notice should not result in restrictions that would unnecessarily impair Morgan Stanley and other FHCs' ability to continue to provide such innovative risk management services and solutions to their clients and provide these critically important public benefits to the financial and U.S. economy.

* * * * * * *

We thank the Board for its consideration of our comments. If you have any questions, please do not hesitate to contact William McCoy at 914-225-5540.

Sincerely,

Nancy A. King

Nancy A. King
Managing Director