FINANCIAL SERVICES ROUNDTABLE

April 16, 2014

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

Re: Complementary Activities, Merchant Banking Activities of Financial Holding Companies Related to Physical Commodities (Doc. No. 1479; RIN 7100-AE-10)

Ladies and Gentlemen:

The Financial Services Roundtable ("FSR")[1] welcomes the opportunity to provide comments on the above-cited advanced notice of proposed rulemaking ("ANPR") issued by the Board of Governors of the Federal Reserve System ("Board") on January 21, 2014. The ANPR requests public comment on various issues related to physical commodities activities conducted by financial holding companies and the restrictions imposed on these activities to ensure they are conducted in a safe and sound manner and consistent with applicable law.

FSR is a signatory to a joint trade comment letter (the "Joint Trade Comment Letter"), commenting on the ANPR.[2] FSR hereby adopts each of the comments made in the Joint Trade Comment Letter. The Joint Trade Comment Letter discusses the public benefits of physical commodities activities of financial holding companies and the important role that merchant banking investments play in the economy. As noted in the Joint Trade Comment Letter, financial holding companies effectively limit corporate veil piercing and tail risks associated with physical commodities activities and merchant banking investments by adopting a range of safeguards,

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1 As *advocates for a strong financial future*™, FSR represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for $98.4 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

2 Letter from The Securities Industry and Financial Markets Association, FSR, American Bankers Association (the "ABA"), Financial Services Forum ("FSF") and Institute of International Bankers (the "IIB"), to the Board. FSR is also a signatory to a second comment letter jointly submitted to the Board by The Clearing House Association L.L.C. the ABA, FSF and the IIB specifically addressing merchant banking activities.

including well-settled practices that enable investors to avoid veil-piercing liability. The Joint Trade Letter appropriately concludes that continuing to permit financial holding companies and their non-bank affiliates to engage in physical commodities activities and make merchant banking investments in portfolio companies engaged in physical commodities activities greatly outweighs the potential risks of those activities.

FSR is providing this additional comment letter to address specific questions raised in the ANPR relating to insurance companies affiliated with savings and loan holding companies (Question 12) and insurance companies that are supervised by the Board as nonbank SIFIs (Question 11). We submit that the unique business and regulatory model of insurance companies makes the imposition by the Board of any proposed restrictions on physical commodities activities or investments in companies engaged in physical commodities both unnecessary and inappropriate. We further submit that the imposition by the Board of any limitations or conditions on the investment authority otherwise available to insurance companies under state insurance law would raise serious concerns under the McCarran-Ferguson Act.

I. General comments on the ANPR

The ANPR notes that the Board has determined to review the scope of physical commodity activities authorized under Section 4(k)(1)(B) of the Bank Holding Company Act of 1956, as amended (the "BHC Act") to ensure that the activities continue to be consistent with the statutory requirements that they be complementary to a financial activity and do not pose substantial risks to the safety and soundness of depository institutions or the financial system generally. The ANPR also notes that the Board is reviewing whether it is appropriate to impose limitations or conditions on the conduct of other physical commodity activities by financial holding companies to ensure that these activities are conducted in a manner that is consistent with safety and soundness. The ANPR specifically requests comments on the risks that physical commodities activities may pose to financial holding companies, their insured depository institution affiliates, and U.S. financial stability.

In its discussion of physical commodity activities, the ANPR focuses on the three sources of authority in the BHC Act for financial holding companies to engage in physical commodity activities:

(i) the "complementary" activity authority under Section 4(k)(1)(B) of the BHC Act;

(ii) the merchant banking investment authority under Section 4(k)(4)(H) of the BHC Act; and

(iii) the specific grandfathering authority for certain financial holding companies under Section 4(o) of the BHC Act.

It is appropriate to note initially that the source of authority that the Board cites for any additional restrictions on the scope of these activities or any additional limitations or conditions on the conduct of physical commodity activities is the BHC Act. Companies not subject to the

BHC Act, because they are not bank holding companies, are not subject to any power of the Board to impose restrictions on their commercial activities.

The most extensive discussion in the ANPR relates to the complementary activity authority as the basis for physical commodity trading activities by financial holding companies that have specifically applied for and received that authority under Section 4(k)(1)(B)the BHC Act. In that context, the ANPR discusses a range of possible risks that may be associated with physical commodities activities, including environmental and other risks that can arise from oil spills, pipeline transmission, and earthquake damage to a nuclear facility, and other tail-risk that might be associated with commodities activities. The Board has in its individual orders already imposed restrictions of the complementary activity authority granted to specific financial holding companies pursuant to the power granted under Section 4(k)(1)(B).

We note that there is a wide variation even in the hypothetical risks that might be associated with physical commodities. The ownership of land to produce timber, for example, presents an entirely different risk profile than the operation of deep-water oil wells or a nuclear power facility. As the Board considers the range of risks that may arise from physical commodity activities, the Board must take account of these different risk profiles. The Board must also take recognition of the wide range of risk management and risk mitigation steps that companies have already taken to address the risks potentially associated with physical commodity activities. For the reasons discussed in detail in the Joint Trade Comment Letter, we believe that the risk management procedures and mechanisms that investing institutions have already implemented, tailored to their own investment and business models, present a better design than any regulatorily-mandated standard.

We also note that the discussion of the merchant banking authority in the ANPR suggests that the Board is putting a very broad, and perhaps an unreasonably broad, reading on the concept of physical commodity activities. The suggestion underlying the discussion in the ANPR is that the Board might propose restrictions on investments in portfolio companies under the authority of Section 4(k)(4)(H) of the BHC Act if the portfolio company is involved to some unspecified extent in producing, storing or shipping physical commodities or if its business is in some other way related to physical commodities or energy.

It is not possible from the discussion in the ANPR to discern the scope of what the Board may be considering with respect to the merchant banking authority under Section 4(k)(4)(H) or the analogous investment authority for insurance companies under Section 4(k)(4)(I). We would observe that the indistinct but potentially open-ended reference to merchant banking investments in the ANPR makes it difficult for the public to comment intelligently upon the ANPR. If the Board is suggesting the possibility of restrictions on investments in all portfolio companies even those that are unrelated to any aspect of a physical commodities business, we submit that the Board has provided no evidence for the need of such an intrusive imposition of regulatory restrictions on standard investment activity. As noted in the Joint Trade Comment Letter, the discussion in the ANPR provides no basis for the imposition of additional restrictions on portfolio investments made under the merchant banking authority of Section 4(k)(4)(H) or under the separate insurance investment authority of Section 4(k)(4)(I) in companies involved with physical commodities or indeed in any other companies.

II. Specific Comments Relating to Insurance Companies

In addition to the general comments we have offered in the preceding section of this letter, we wish to offer specific comments in response to Question 11 in the ANPR relating to investments made by nonbank financial companies supervised by the Board and Question 12 relating to investments made by insurance companies that are affiliated with savings and loan holding companies. These Questions appear to suggest that the Board might extend to such insurance companies any limitations or conditions that the Board might ultimately decide to impose on activities or investments of financial holding companies. As we indicated in the preceding section of this letter, we do not believe that the Board has established the need for additional limitations or conditions on the activities or investments of financial holding companies. In any event, even if the Board were to propose any such limitations or conditions for certain financial holding companies, there would be no legal or policy basis for extending them to insurance companies that are affiliated with savings and loan holding companies or that are supervised as nonbank SIFIs by the Board. Any such proposed extension to insurance companies would be inappropriate and in conflict with the extensive regulatory system to which insurance companies are subject under state law.

Moreover, we submit that the imposition by the Board of any regulatory limitations or conditions on the investment authority provided to an insurance company by state insurance law would raise serious concerns under the McCarran-Ferguson Act. That Act provides in relevant part that "[n]o [a]ct of Congress shall be construed to . . . impair . . . any law enacted by any State for the purpose of regulating the business of insurance . . . unless the [a]ct specifically relates to the business of insurance . . . ." The imposition of any limitations or conditions by the Board on the investment authority otherwise provided by state insurance investment law would impair insurance investment law, which is designed for the purpose of regulating the business of insurance.

The extensive state insurance regulatory system includes among its provisions investment laws that are specifically designed to meet multiple regulatory objectives, such as to diversify risk among investment categories, limit exposure to particular types of asset classes, and permit insurance companies to support their long-term liabilities with appropriate long-term assets. The state insurance regulatory system reflects an understanding of the clear differences between the insurance company business model and the business model of other financial institutions. The longer-term liability structure of life insurance companies means that they as a business and regulatory matter need to rely on longer-term assets to support their longer-term liabilities, including through investments in a wide range of sectors.

State investment laws have been designed by state authorities with long-standing and in-depth insurance expertise to ensure the safe and sound operation of insurance companies. These investment laws both reflect and reinforce the longer-term asset and liability components of the life insurance company business model. For example, state insurance company investment laws generally include (but are not limited to) specific limits on investments in equities, low-grade debt securities, or the securities of any one issuer. State investment laws also limit the type and extent of investments that an insurance company may include as "admitted" assets on its statutory balance sheet filed with state insurance regulators for purposes of determining whether it has sufficient assets to discharge its obligations and meet capital and surplus requirements.

In addition, insurance company investment activities are subject to comprehensive regulation and oversight. For example, state insurance regulators have broad oversight and examination power over all insurance company investments to ensure the investments are in compliance with state investment laws and that they do not threaten the solvency of the insurance company. As part of this regulatory and oversight regime, insurance companies are required to file annual financial reports that disclose each and every investment made by the insurance company. They are also subject to risk-based capital requirements that are designed to take into account the varying risk characteristics of permitted investments under insurance law. By impacting various parts of the insurance company's risk profile, including its statutory reserves, capital calculations, and overall solvency, existing state insurance law regimes serve as an effective mechanism for regulating insurance company investment activities.

State investment laws encourage diversification of investments across a wide range of asset classes, including government debt, corporate debt, preferred stock, mortgages, real estate, equity investments and foreign investments. Direct investments in commodities are subject to stringent limitations under state insurance investment laws. But investments in equity of commodities-related companies nonetheless are an important asset class, which historically have had a low correlation with other investment classes. These investments, though relatively small in size to the overall investment portfolio of an insurance company because of state law restrictions (they are subject to equity investment limits), represent an important element of diversification in the overall equity and debt portfolio of an insurance company. They also provide a very important hedge against inflation, which is particularly important to protecting the long-term capacity of an insurance company to pay its liabilities.

IV. <u>Conclusion</u>

In adopting the final regulations under the Volcker Rule, the Board and the other federal agencies recognized the importance of distinguishing the investment profile and activities of insurance companies that are affiliated with insured depository institutions from the investment and trading activities of other affiliates of insured depository institutions. This recognition flowed *inter alia* from the comprehensive system of state regulation and oversight applicable to insurance companies. The same comprehensive state regulatory system applies to all investment activities of insurance companies. We respectfully submit that it is unnecessary and inappropriate to impose federal restrictions on the investment activities of insurance companies. Moreover, any proposal to impose federal restrictions on the investment activities of insurance companies would raise serious concerns under the McCarran-Ferguson Act.

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Again, we appreciate the opportunity to comment on the insurance-related issues in the ANPR and would be happy to discuss our views further to assist the Board if you would find that helpful. Please feel free to contact me at (202) 589-2424 or via e-mail at Richard.Foster@FSRoundtable.org.

Very truly yours,

Rich Foster

Richard Foster
Vice President & Senior Counsel for Regulatory and Legal Affairs