SUTHERLAND

SUTHERLAND ASBILL & BRENNAN LLP
1275 Pennsylvania Ave., NW
Washington, DC 20004-2415
202.383.0100 Fax 202.637.3593
www.sutherland.com

May 25, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW,
Washington, DC 20551

VIA ELECTRONIC SUBMISSION

Re: *Definition of "Predominantly Engaged in Financial Activities"*
Docket No. R-1405; RIN 7100-AD64

Dear Secretary Johnson:

On behalf of The Commercial Energy Working Group (the "Working Group"), Sutherland Asbill & Brennan LLP hereby submit these comments in response to the request for public comment set forth in the Board of Governors of the Federal Reserve System's (the "Board" or "Federal Reserve") Notice of Proposed Rulemaking, *Definition of ''Predominantly Engaged in Financial Activities''* (the "Proposed Rule").[1]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities. The Working Group appreciates the opportunity to provide the comments set forth herein and respectfully requests the Board's consideration of such comments.

I. COMMENTS OF THE WORKING GROUP.

A. COMMERCIAL ENTITIES SHOULD NOT BE REGULATED AS SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS.

The intent of Congress in passing Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (the "Dodd-Frank Act") was to "establish a new framework to prevent a recurrence or mitigate the impact of financial crises that could cripple financial markets and damage the economy." As part of that effort, Congress created the Financial Stability Oversight Council ("FSOC") "to monitor emerging risks to U.S. financial stability, recommend heightened prudential standards for large, interconnected financial companies, and require nonbank financial

---

[1] *See Definition of "Predominantly Engaged in Financial Activities,"* 77 Fed. Reg. 21,494 (proposed Apr. 10, 2012) ("Proposed Rule").

[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").

companies to be supervised by the Federal Reserve if their failure would pose a risk to U.S. financial stability."[3]

The FSOC is tasked with identifying those nonbank financial companies that could pose a systemic risk to the U.S. financial system (each a "Systemically Important Financial Institution" or "SIFI") and subjecting such entities to heightened prudential regulation. Congress was explicit that this heightened regulation should only be applied to financial entities and "that commercial companies, such as manufacturers, retailers, and others, would not be considered to be nonbank financial companies."[4] Therefore, the regulations adopted by the FSOC and Board to identify and regulate SIFIs should clearly exclude commercial entities, such as commercial energy firms.

B. THE DEFINITION OF "FINANCIAL" SHOULD BE CONSISTENT WITH CONGRESSIONAL INTENT AND NOT COVER COMMERCIAL ACTIVITY.

In order to be subject to regulation under Title I of the Dodd-Frank Act, a nonbank entity must first be deemed a nonbank financial company. An entity is a nonbank financial company if it is "predominantly engaged in financial activity."[5] Under Section 102(a)(6) of the Dodd-Frank Act, an entity is "predominantly engaged in financial activities" if 85% or more of the gross revenues of the entity and its subsidiaries are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956[6] (the "BHC Act") or 85% or more of the entity's and its subsidiaries' assets are financial in nature as defined in Section 4(k) of the BHC Act. Section 102(b) of the Dodd-Frank Act further directs the Board to "establish, by regulation, the requirements for determining if a company is predominantly engaged in financial activities as defined in subsection (a)(6)."

---

[3] Sen. Rep. No. 117-176 (Apr. 30, 2010) at 2 ("Senate Report") available at: http://banking.senate.gov/public/_files/Committee_Report_S_Rept_111_176.pdf.

[4] Senate Report at 46.

[5] It should be noted that the version of Title I passed by the Senate Committee on Banking, Housing and Urban Affairs set the standard for being a nonbank financial company at "substantially engaged in financial activities." Section 102 of the Dodd-Frank Act was amended on the Senate floor to change the standard from "substantially engaged" to "predominantly engaged" and to include the two prong 85% test. This amendment was intended to "focus the legislation on truly financial companies" and to ensure that "manufacturing companies, retailers and other non-financial companies" would not be "subject to enhanced supervision by the Federal Reserve." *See* Dodd-Frank Act § 102; and statements of the amendment's co-sponsors Sen. Mark Pryor (AR) and Sen. David Vitter (LA), available at: http://www.pryor.senate.gov/public/index.cfm/pressreleases?ID=a6aeda38-103d-491e-8d24-930837c25949
and
http://www.vitter.senate.gov/public/index.cfm?FuseAction=PressRoom.PressReleases&ContentRecord_id=b6ae7b7b-d9a9-a93d-9634-70fcdc661f07.

[6] 12 U.S.C. 1842(c)(8).

The determination of whether an activity is "financial in nature" is made by reference to Section 4(k) of the BHC Act and Regulation Y.[7] Section 4(k) of the BHC Act and Regulation Y set forth a broad list of activities in which it is permissible for bank holding companies to engage, and then impose conditions under which bank holding companies are permitted to engage in such activities. The list is broad and, as discussed below, includes a number of activities that are not commonly thought of as financial. An expansive reading of the BHC Act and the resulting broad list of activities listed in Regulation Y was deemed necessary to allow bank holding companies and their affiliates to function in a commercially viable manner, not because the full list of activities was determined to be clearly financial in nature.[8] The conditions placed on the manner and degree to which a bank holding company can engage in the activities listed in Section 4(k) of the BHC Act and Regulation Y are to ensure that the activities do not threaten the "safety and soundness of [a] subsidiary depository institution."[9]

Because Section 4(k) of the BHC Act and Regulation Y are designed to address the activities in which a bank holding company may engage as well as any limitations thereon, there is confusion as to what activities are "financial in nature" for the purposes of Title I of the Dodd-Frank Act. The Board, in Appendix A to Subpart N ("Appendix A") of the Proposed Rule, seeks to clarify which activities are "financial" for the purposes of determining whether an entity is "predominantly engaged in financial activity."[10]

Appendix A lists the activities that are "financial in nature." Those activities include a number that are inherently financial, such as underwriting or making a market in securities.[11] However, Appendix A also lists a number of activities that generally are *not* thought of as being financial in nature, such as providing management consulting services,[12] providing employment histories to third parties,[13] operating a travel agency,[14] and investing and trading in contracts on non-financial assets, regardless of whether those contracts contemplate physical delivery of a commodity.[15]

---

7 As Regulation Y is the implementing regulation for Section 4(k) of the BHC Act, the Board states that Regulation Y's list of approved activities for bank holding companies is incorporated by reference. Proposed Rule at 21,495.

8 *See, e.g.*, *Bank Holding Companies and Change in Bank Control*, 68 Fed. Reg. 39,807 at 39,800 (Jul. 3, 2003) (expanding bank holding companies' ability to trade in physical commodities to allow them to "compete effectively with non-BHC participants in commodity derivatives markets.")

9 Proposed Rule at 21,495.

10 *Id.*

11 *See Id.* at 21,502, Appendix A(5).

12 *See Id.*, Appendix A(27).

13 *See Id.*, Appendix A(23).

14 *See Id.*, Appendix A(28).

15 *See Id.*, Appendix A(13).

The list in Appendix A catalogs the activities in which bank holding companies may engage, but is not a direct recitation of Section 4(k) of the BHC Act or Regulation Y. Instead, the Board exercised what it claims to be interpretive authority under Section 102(b) of the Dodd-Frank Act and explicitly listed the activities in Appendix A free from any of the limitations imposed by the BHC Act or Regulation Y on bank holding companies when conducting such activities. The Board did so because "to include all of the conditions imposed on the conduct of the activities by bank holding companies likely would enable some companies that are predominantly engaged in financial activities to avoid consideration for designation by the FSOC simply by choosing not to abide by the conditions."[16] More importantly, the Board states that listing the activities free from statutory and regulatory conditions was necessary to adhere to Congressional intent.[17]

In effectively creating two separate lists, one under Section 4(k) of the BHC Act and Regulation Y, and another under Appendix A to the Proposed Rule, the Board misinterprets its authority under Section 102(b) of the Dodd-Frank Act. A plain reading of the statute makes it clear that Congress did not intend the Federal Reserve to redefine an already-defined term: Section 102(b) explicitly directs the Board "to establish . . . the requirements for determining" if a company derives 85% of its assets or revenues ("predominantly engaged") from those activities described as "financial" in Section 4(k) of the BHC Act.

Establishing the "requirements for determining if a company is predominantly engaged in financial activities" is not synonymous with redefining which activities are financial in nature. Instead, the requirements for assessing whether a company derives its assets or revenues from those activities listed in Section 4(k) of the BHC Act could include guidance on whether minority interests in joint ventures are to be included in a calculation of the 85% threshold, or whether the use of alternative accounting standards (such as mark-to-market versus fair value) is acceptable in calculating a firm's financial assets.

If Section 102(b) of the Dodd-Frank Act were intended to give license to the Board to redefine "financial activities," it would not have explicitly referenced the statutory definition in the BHC Act. In fact, since Section 4(k) of the BHC Act already contains explicit and restrictive procedures for adding items to the list of "financial activities" through regulation,[18] the Board's interpretation of Section 102(b) of the Dodd-Frank Act effectively renders Congress' reference to Section 4(k) irrelevant. The authors of Section 102(b) of the Dodd-Frank Act have explicitly stated that at the time they proffered their amendment, they were concerned with language that could have inappropriately opened up many commercial enterprises to "inappropriate bank-style regulation." Thus, the two Senators tied the definition of "financial activity" back to Section 4(k) of the BHC Act, in the belief that this definition was "well defined and properly

---

16 *Id.*

17 *Id.* at 21,495-96.

18 For instance, Section 4(k)(2) of the BHC Act requires the Board to consult the Secretary of the Treasury before determining whether an activity is "financial in nature."

circumspect," and would ensure that commercial businesses "would be able to operate free of the fear that they would be ensnared in regulations designed to address a financial crisis which they did not create…"[19]

However, by listing in Appendix A the activities described in Section 4(k) of the BHC Act and Regulation Y independent of the accompanying limitations, the Board could capture commercial entities in the definition of "nonbank financial company," which could result in SIFI status for entities that Congress clearly intended to exclude from such regulation. For example, a plain reading of Appendix A could lead to a large management consulting firm or an energy merchant whose predominant business is the delivery of physical energy to customers being regulated as SIFIs.

Further, the conditions to the financial activities described in Section 4(k) of the BHC Act and Regulation Y are important because they distinguish those actions that are "complementary to a financial activity" from those that are "financial in nature or incidental to such financial activity."[20] Removal of these limitations has a distinct definitional impact of converting generally accepted *non*-financial activities, such as physically-settled energy commodity transactions, into activities that are financial in nature. In the Federal Reserve's own BHC Supervision Manual, the Board determined that to "purchase and sell commodities in the spot market and to take and make delivery of physical commodities to settle commodity derivatives" is "complementary to a financial activity."[21] The true "financial activity" was conducting commodity-derivatives activities under Regulation Y "subject to certain restrictions … designed to limit the BHC's activity to trading and investing in financial investments rather than dealing directly in physical nonfinancial commodities."[22] By removing this condition to the financial activities listed in Regulation Y and Section 4(k) of the BHC Act, the Board is making a substantive change to the definition of "financial activity," and is violating its own proposal to only remove those conditions that are not definitional.[23]

Both Sections 113(c) and 167(a) of the Dodd-Frank Act rebut the proposition that Section 102(b) allows the Board to redefine "financial activities" for purposes of Title I of the Dodd-Frank Act. The Proposed Rule points to Section 167(a) of the Dodd-Frank Act and states "Congress intended that companies could be eligible for designation by the Council regardless of

---

[19] Letter from Senators David Vitter and Mark Pryor to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System (May 16, 2012).

[20] *See* 12 U.S.C. 1843(k)(1)(A) and (B).

[21] *See Bank Holding Company Supervision Manual*, Board of Governors of the Federal Reserve System (January 2012) at 1,343, available at http://www.federalreserve.gov/boarddocs/supmanual/supervision_bhc.htm.

[22] *See Id.* The Federal Reserve made the same distinction by permitting a subsidiary of JPMorgan Chase & Co to "engage in activities complementary to a financial activity," including taking and making delivery of physical commodities to settle BHC-permissible commodity derivatives. *See JPMorgan Chase & Co.*, 91 Federal Reserve Bulletin C57 (2005) at 3-4.

[23] *See* Proposed Rule at 21,496.

whether these companies complied with the non-definitional conditions applied to bank holding companies in the implementation of section 4(k)."[24] Section 167(a) of the Dodd-Frank Act relates only to limitations on the Board after a company has already been designated as a nonbank financial company by the Council. Additionally, as Section 113(c) of the Dodd-Frank Act makes clear, if a company has intentionally structured itself so as to evade regulation, it is the Council alone that has the authority to designate such company for enhanced supervision. This authority does not support the proposition that the Board may *a priori* modify Section 4(k) in this context in order to capture companies that the Board believes are financial.

C. "FINANCIAL ACTIVITY" SHOULD NOT BE REDEFINED.

For the reasons discussed above, the Working Group respectfully requests that the Board withdraw the Proposed Rule and reissue it in accordance with Congress's intent that the Board establish "requirements to determine" if a company derives the relevant portion of its assets or revenues from those activities described in Section 4(k) of the BHC Act.

Additionally, the Working Group respectfully requests that the Board adopt criteria to clearly distinguish between activities in physical commodity markets that are "financial" and those activities that are not. Those criteria should be similar to the limitations imposed on bank holding companies when trading physical commodities.[25] Specifically, if a contract (i) imposes an enforceable obligation to take and make physical delivery of a commodity,[26] and (ii) is between two parties that are capable of taking or making delivery of the underlying commodity, then that transaction should not be treated as "financial" activity. In the event that parties elect to book-out or net their delivery obligations in a manner consistent with the Commodity Futures Trading Commission's (the "CFTC") Brent Interpretation, then the transaction should remain

---

[24] Proposed Rule at 21,496.

[25] In order to trade or invest in physical commodities a bank holding company must trade or invest in contracts (i) that a state member bank is authorized to invest in the underlying asset; (ii) that require cash settlement; (iii) that allow for assignment, termination, or offset prior to delivery or expiration and the company (a) makes every reasonable effort to avoid taking or making delivery; or (b) receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery; or (iv) that do not allow for assignment, termination or offset prior to deliver or expiration and are based on an asset for which futures contracts have been approved and (a) makes every reasonable effort to avoid taking or making delivery; or (b) receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery. *See Bank Holding Companies and Change in Bank Control (Regulation Y)*, 12 C.F.R. § 225.28 (2003).

[26] In this context an option on a physical commodity, such option should be considered to impose an enforceable obligation to take and make physical delivery if, upon exercise, one party to the option is required to deliver to the other the underlying commodity.

non-financial.[27] These criteria are consistent with the CFTC's approach to distinguishing financial contracts (*e.g.*, futures and swaps) from non-financial contracts (*e.g.*, physically delivered forward contracts), and would ensure that the scope of regulation under Title I of the Dodd-Frank Act is consistent with Congressional intent.[28]

II. CONCLUSION.

The Working Group appreciates this opportunity to provide comments on the Proposed Rule and respectfully requests that the Board consider the comments set forth herein as it develops a final rule in this proceeding.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe
David T. McIndoe
R. Michael Sweeney, Jr.
Alexander S. Holtan

Sutherland Asbill & Brennan LLP
1275 Pennsylvania Ave., NW
Washington, DC 20004

Counsel for The Commercial Energy Working Group

---

[27] In this CFTC interpretation, a safe harbor from futures regulation is created for book-out transactions in non-financial commodities with underlying contracts that (i) create a binding obligation to make or take delivery without providing any right to offset, cancel or settle on a payment-of-differences basis, and (ii) are between market participants that regularly make or take delivery of the referenced commodity in their ordinary course of business. *See Statutory Interpretation Concerning Forward Transactions* 55 Fed. Reg. 39,188 (Sep. 25, 1990) (the "Brent Interpretation").

[28] For a full discussion of the factors that distinguish futures and swaps from physically settling forward contracts, see *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 76 Fed. Reg. 29,818 (proposed May 23, 2011); the Brent Interpretation; and *Exemption for Certain Contracts Involving Energy Products*, 58 Fed. Reg. 21,286 (Apr. 20, 1993).