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Mr. Robert de V. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Via Agency Website

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

FIA appreciates the opportunity to provide the Board of Governors of the Federal Reserve System (the "Board") with the comments and recommendations set forth below in response to the Board's Advance Notice of Proposed Rulemaking relating to the physical commodities activities conducted by financial holding companies (the "ANPR").

I. Introduction

FIA is the leading trade organization for the futures, options, and over-the-counter cleared swaps markets. FIA's regular and associate members, their affiliates, and their customers are active participants in the physical commodity markets and the physical commodity derivatives markets.[1] Consequently, FIA and its members have an interest in any potential restrictions in the physical commodities markets, and any corresponding effect on the related derivatives markets.

We have significant concerns regarding any potential new restrictions on financial holding companies' ("FHCs") physical commodities activities, including the physical settlement of commodity-linked swaps and other derivatives. Restrictions on those

[1] FIA members are active users of the physical commodities, futures and over-the-counter derivatives, and include commodity firms, banks and brokerage firms, among others.

activities would adversely affect the critical intermediary role that FHCs play, could reduce competition and liquidity, and lead to inefficient pricing, which, in turn, may increase costs for end-users and consumers. Robust commodities markets are as important to end-users as transparent markets. The ANPR would reduce the available counterparties for physical commodities by imposing unnecessary burdens on FHCs. As is discussed further below, the participation of FHCs in the physical commodities markets is of great importance to end-users, which would suffer negative consequences should FHCs become less active in these markets.

Our discussion below responds broadly to the ANPR's request for public comment and specifically to Questions 14, 17, and 18.[2]

II. Robust Markets are as Important as Transparent Markets

Robust markets for physical commodities are essential for all market participants and especially for ensuring that end-users are able to manage risk and hedge price volatility in the normal course of business. The cumulative effect of recent regulatory efforts – including the Commodity Futures Trading Commission's ("CFTC") regulation of derivatives markets under the "Dodd-Frank Act" and new Basel III capital requirements – have made FHCs less likely to be active in these markets. The ANPR's proposed actions would only further this trend, and with little, if any, public benefit in return.

A large number of counterparties in the physical commodities markets, and a thoughtful regulatory approach to physically-settled commodity derivative transactions by FHCs, have led to greater liquidity and a wider range of available contracts. This conclusion is supported by findings in a recent IHS study, which noted that limiting FHC involvement "would impair liquidity, increase risk for market participants, reduce energy investment, and make disruptions more likely."[3] Dissuading FHCs from participating in these markets would not reduce potential risk to the financial system, but would rather remove market makers and increase the likelihood for illiquidity and inefficient pricing. End-users and consumers would suffer the adverse effects of such developments. For example, there have been noticeable FHC departures from California's physical electricity markets in the last several years, decreasing liquidity due to the reduction in large counterparties in the

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[2] Advance Notice of Proposed Rulemaking, Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities, 79 Fed. Reg. 3329, 3334 (Jan. 21, 2014) ("Question 14. *What are the complementarities or synergies between Complementary Commodities Activities and the financial activities of FHCs? How have these complementarities or synergies changed over time?*") ("Question 17. *What are the potential adverse effects and public benefits of FHCs engaging in Complementary Commodities Activities? Do the potential adverse effects of FHCs engaging in Complementary Commodities Activities, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, unsound banking practices, or risk to the stability of the United States banking or financial system, outweigh the public benefits, such as greater convenience, increased competition, or gains in efficiency?*") ("Question 18. *In what ways would FHCs be disadvantaged if they did not have authority to engage in Complementary Commodities Activities? How might elimination of the authority affect FHC customers and the relevant markets?*").

[3] IHS Global Inc., The Role of Banks in Physical Commodities (2013).

market. Physical wholesale power sales at the California Independent System Operator's three main delivery points fell 36 percent between the third quarter of 2010 and the third quarter of 2012, while "financial trading in the electricity sector also declined by 11.9%" from 2011 to 2012.[4]

In response to the Board's Questions 17 and 18, we note that the demonstrable public benefits of FHCs engaging in Complementary Commodities Activities outweigh the potential adverse effects, if any, of FHC market participation. Contrary to the assumptions in Question 17, removing FHC authority could lead to "undue concentration of resources," "decreased . . . competition," and greater "risk to the stability of the United States . . . financial system." For the same reasons, in response to Question 18, the elimination of FHC authority would negatively affect end-users and harm the physical commodities markets. Further, we note the ANPR provides no empirical evidence of FHCs participation in the physical commodities markets harming those markets or the FHCs participating in them, nor is FIA aware of any such evidence of market harm.

III. FHCs Are Ideal Counterparties for End-Users

A. FHCs as Intermediaries Perform Unique Functions in the Market

As financial intermediaries, FHCs perform unique functions in the physical commodities markets that are unlikely to be replicated by replacement market participants. FHCs provide both cash-settled and physically-settled alternatives for end-users, including custom-designed products that meet particular business needs; end-users thus benefit from a wider variety of product options and can choose which option best suits their business needs. It is unclear whether any other business entities could or would be able to provide similar services if the Board required FHCs to exit these markets.

Moreover, FHCs also serve a market-making role, and bring numerous buyers and sellers together – buyers and sellers that would not otherwise have an efficient means of contracting. For example, buyers and sellers often have mismatching needs concerning timing, location, product and transaction size. Often, buyers and sellers do not contract directly with each other but FHCs act as necessary intermediaries to bridge these gaps in needs. Moreover, as principal counterparties to end users in commodities transactions, FHCs can efficiently absorb risk and effectively act as counterparties to market participants who might not naturally match in the marketplace. This service is essential for ensuring a liquid and efficiently-priced market for the numerous physical commodities that are traded and hedged on a daily basis. As noted above, removing FHCs from the equation will significantly limit options for end-users.

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[4] *See* Jeffrey Ryser, *Analysis: regulatory scrutiny, market changes contribute to JP Morgan exiting physical trading*, PLATTS ENERGY TRADER, Jul. 30, 2013.

B. FHCs Provide Wide-Ranging Services as a Result of Their Full-Service Role in These Markets

End-users also rely on FHCs for a broad spectrum of significant commodity-related financial services, many of which are dependent upon FHC market expertise and participation. In response to Question 14, we do not believe this fact has changed since the Board initially looked at the issue. Credit intermediation, structured finance arrangements, project finance, and risk-mitigating commodity-linked swaps and other derivatives are key components for the operations of many end-users' businesses, providing the necessary financing for both daily operations and the building of capital-intensive infrastructure, such as power plants. Because of the familiarity with end-users' businesses that FHCs gain in providing such services, FHCs are better able to accommodate specific end-user needs in the physical commodities markets. Moreover, the FHCs that engage in physical commodities activities are able to provide these services on a larger scale, adding efficiencies to markets where end-users may otherwise have more limited access to necessary counterparties. Such market efficiencies reduce costs for end-users.

C. FHCs Are Highly-Regulated Entities and Thus Inherently Transparent

FHCs are highly-regulated and publicly-traded entities making them especially credit-worthy counterparties. As a result, end-users favor transactions with FHCs, as such transactions are transparent and less risky than transactions with unregulated alternatives. If FHCs are removed from the physical commodities markets, end-users may be forced to correspondingly increase trading with unregulated business entities. Despite the ANPR's statement that "the costs and liability related to physical commodity activities can be difficult to limit and higher than expected,"[5] the Board does not provide evidence of an FHC being harmed by any particular catastrophic events relating to physical commodities. On the other hand, the financial crisis clearly evidences the risks to the financial system from an increasing reliance on unregulated institutions. The scope of regulation and relative transparency of FHC operations, combined with the essential services and key intermediary role of FHCs, demonstrate that the public benefit of continued FHC involvement in the physical commodities markets greatly outweighs potential risks.

IV. Conclusion

As explained above, the FIA believes that any additional restrictions on FHCs physical commodities activities could have significant negative effects on the market. End-users benefit from robust physical commodity and physical commodity derivatives markets with numerous active counterparties, especially FHCs that provide unique functions in the market, offer additional beneficial services for end-users, and are already highly-regulated. The FIA recommends that the Board not proceed with a rulemaking

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[5] 79 Fed. Reg. at 3331.

regarding physical commodities activities. We appreciate this opportunity to comment on the ANPR.

Respectfully yours,

Walt L. Lukken
President and Chief Executive Officer