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April 16, 2014

Via Electronic Mail

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

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs") is pleased to provide its comments[1] on the Advance Notice of Proposed Rulemaking of the Board of Governors of the Federal Reserve System (the "Federal Reserve") entitled *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities* (the "ANPR").[2] We believe that financial holding companies ("FHCs") provide substantial benefits to consumers, commodity producers, investors, financial markets and the broader economy by participating in physical commodities markets and by making merchant banking investments. Through these activities, FHCs assist companies in transferring risks relating to price exposures, resolving mismatches in timing, grade and location between commodity assets and liabilities and obtaining an important source of financing and investment capital. These benefits, which extend across the economy, clearly outweigh potential risks associated with these activities. We base this conclusion on the extent and importance of these benefits, the limited scope of risks involved in these activities and the ability of FHCs to manage the risks through a comprehensive framework that is subject to appropriate regulatory oversight.

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1 Goldman Sachs also has participated in the preparation of the comment letter written by the Securities Industry and Financial Markets Association ("SIFMA") and submitted jointly with The American Bankers Association, Financial Services Forum, Financial Services Roundtable and Institute of International Bankers (such organizations, the "Trade Organizations," and such letter, the "Trade Organizations Letter"), and we support the comments in that letter.

2 79 Fed. Reg. 3329 (Jan. 21, 2014).

In our view, the recent public debate on the involvement of FHCs in commodities markets reflects a widespread misunderstanding of the role FHCs play. We seek to address this by describing in some detail our role and the benefits that flow from our involvement in physical commodities and merchant banking activities, and by discussing how we identify and manage the risks associated with our participation. We first address the role—engaging in "intermediation activities"—that we and other FHCs conduct either under Section 4(o) of the Bank Holding Company Act (the "BHC Act") ("Grandfathered Activities") or under the authority the Federal Reserve has granted to FHCs by order to engage in complementary activities related to physical commodities ("Complementary Commodities Activities").[3] We then address investments made in reliance on the merchant banking provisions (the "Merchant Banking Authority") under Section 4(k)(4)(H) of the BHC Act.

As described below, we believe that FHCs that engage in physical commodities activities and that make merchant banking investments in companies engaged in commodities activities should maintain a robust program designed to address potential risks associated with these activities and investments. We believe that enhanced risk management guidelines could be incorporated in guidance from the Federal Reserve to ensure that FHCs have in place consistent and appropriate safeguards for participating in physical commodities activities and making merchant banking investments in a safe and sound manner.

In connection with both our intermediation activities and our merchant banking activities, we have developed and maintain an integrated risk management program that consists of policies, procedures, diligence practices, governance arrangements, approval processes and insurance coverage designed to enable us to identify, avoid or otherwise mitigate potential risks associated with these activities. We devote considerable time and resources to reviewing new activities and investments, conducting due diligence of vendors and promoting and confirming internal compliance with applicable policies. We believe that our program enables us to limit and manage appropriately the risks posed by our business activities. We evaluate the strength and sufficiency of our risk management program on an on-going basis, both periodically and as events dictate.

During the course of preparing this response to the ANPR, we again reviewed our risk management practices, taking into account the current state of the law on the allocation of environmental liabilities as detailed in the Joint Memorandum of Law prepared by four law firms with substantial experience in the field, which was submitted on behalf of the Trade Organizations (the "Joint Memorandum of Law").[4] Based on this review, we have determined to further enhance certain of our policies and procedures by, among

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3 The three types of complementary activities related to physical commodities that the Federal Reserve has approved by order are: purchasing and selling physical commodities in the spot market and taking and making delivery of physical commodities to settle commodity contracts and activities ancillary thereto ("Physical Commodity Trading"); entering into "tolling" agreements that involve paying power plant owners fixed periodic payments that compensate the owner for its fixed costs in exchange for the right to all or part of the plant's power output ("Energy Tolling"); and providing transactions and advisory services to power plant owners ("Energy Management Services").

4 The Joint Memorandum of Law was submitted on behalf of SIFMA by Covington & Burling LLP, Davis Polk & Wardwell LLP, Sullivan & Cromwell LLP and Vinson & Elkins LLP.

other things, broadening the scope of our vendor reviews and reinforcing our emergency management procedures to provide additional insulation against potential liabilities.

We have identified one particular aspect of the merchant banking rule that would benefit from enhancement. The rule's prohibition on investor participation in the day-to-day activities of portfolio companies is an appropriate means of protecting FHCs from environmental liability in the normal course. This general prohibition contains an exception that allows FHC personnel to assume day-to-day management in order to take steps to address unanticipated exigent circumstances (such as the departure of management). We believe this exception is an important tool that enables a merchant bank to protect the value of its investment. Nevertheless, because there are increased risks of liability associated with an investor assuming routine decision-making authority for environmental matters at the portfolio company, we believe it would be appropriate to require an FHC to engage a third party to assume operational responsibility for such matters even in such exigent circumstances.

Accordingly, we are revising our policies to require the engagement of qualified third parties, such as professional management firms with relevant industry experience, to assume front-line decision-making responsibility with respect to environmental matters or day-to-day control over facility operations with environmental effects if it becomes necessary to utilize this exception. Because the exception to the routine management prohibition applies only in limited circumstances, there has apparently not been an incident in which the exercise of this limited exception has resulted in an FHC being liable for the portfolio company's activities. Nevertheless, we believe that it is an area where problems *could* arise, and thus we recommend that the Federal Reserve consider providing guidance on the need for FHCs to take into account potential exposure before utilizing the special circumstances exception to routine management of portfolio companies. We discuss this and our recommendations further in Section II.E.

I. EXECUTIVE SUMMARY

A. Commodities Intermediation

Goldman Sachs has been active in commodity and commodity derivatives markets since 1981. We serve a wide range of clients, including producers, end-users, investors and governmental entities, and we provide intermediation services with respect to a wide range of commodities.[5]

Although these intermediation activities involve physical commodities, they otherwise mirror our market-making role in purely financial instruments, such as loans, bonds, equities and currencies. Accordingly, they present similar market and credit risks as those presented by other financial activities. The intermediation services that we and other FHCs offer provide significant public benefits, including serving as an efficient means of providing financing and hedging products to producers and end-users and of promoting greater market liquidity and access to markets, which enhances transparency and pricing.

5 FHCs serve as intermediaries across a broad range of commodities, including precious metals (such as gold and silver), base metals (such as aluminum and tin), bulk commodities (such as coal and iron ore), agricultural commodities (such as corn and palm oil), environmental commodities (such as carbon credits and offsets) and energy commodities (such as crude oil and crude products, natural gas and associated products).

These benefits clearly outweigh the associated risks, which, as we discuss below, can in any case be contained and mitigated by policies and procedures that are subject to regulatory oversight.

Citing several catastrophic events that directly or tangentially involved physical commodities and subjected the responsible parties to financial liability, the ANPR asks whether the involvement of FHCs in physical commodities markets exposes them to an unacceptable level of risk.[6] We discuss risk avoidance and mitigation in detail in Section II.D. and make the following observations here:

- Most of the commodities with respect to which we engage in physical activities present little—if any—risk to the environment if released inadvertently.

- Even with respect to environmentally sensitive commodities, an FHC engaged in intermediation will not be subject to liability under well-settled environmental law by adhering to straight-forward policies and procedures designed to prevent an owner of commodities from assuming the status of "operator" of facilities in which commodities are stored, transported or processed.

- Even in the rare case when reputational concerns might lead an FHC to consider assuming some liability for an environmental event, despite the protections discussed above, the FHC would not do so on a scale that could threaten the viability of the FHC itself.

As the Federal Reserve has noted, banking organizations have numerous ways to identify and minimize their exposure to environmental liability.[7] Indeed, as reflected in the Joint Memorandum of Law, the vast body of law that has been enacted to deter and address environmental damages provides the basis for developing a framework that market participants may and do utilize to substantially reduce the risk of liability or otherwise mitigate it. These principles have guided our own integrated risk management program, which is designed to minimize, to the fullest extent possible, the risk that Goldman Sachs will be liable under applicable environmental law and to otherwise facilitate our mitigation of residual risks.

We believe that the Federal Reserve should consider articulating standards to be included in the risk management framework of an FHC that engages in physical commodity activities. In particular, key elements of a risk management framework for an FHC engaged in physical commodity intermediation should include:

- A prohibition on participation in the operational decision-making that is the province of the owner or operator of facilities in which commodities are stored or transported.[8]

- A requirement that the FHC conduct appropriate diligence prior to selecting facilities or operators used to store or transport commodities, taking into account the specific nature of such arrangements.

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[6] 79 Fed. Reg. at 3331–32.

[7] Supervision and Regulation Letter 91-20, *Environmental Liability* (Oct. 11, 1991) ("SR 91-20").

[8] This may include storage facilities (such as tanks) and transportation facilities (such as ships and pipelines).

- A requirement that the FHC design contingency policies designed to prevent FHC personnel from becoming involved in the management of an environmental accident involving commodities owned by the FHC.

Adherence to these or similar standards is the most direct way to manage the specific risks associated with physical commodity intermediation activities. Other measures, such as additional capital requirements or quantitative limits, would not address the specific risks and could impair our ability to serve as intermediaries, reducing the availability of liquidity and risk management products for commodity producers and end-users, as well as other market participants.

B. Merchant Banking Activities

Goldman Sachs has also engaged in merchant banking activities for over 30 years, providing crucial capital to a wide variety of businesses. We believe that involvement in merchant banking has facilitated the transformation of many businesses and has promoted broader economic growth. The risks of merchant banking activities are similar in many respects to those posed by more traditional banking activities. To the extent that these activities present different risks, they are substantially addressed by the existing merchant banking rule and its implementation. They are also addressed within our integrated risk management program, including the policies and procedures that we have developed over time to ensure thoughtful selection of investment opportunities, as well as standards to protect corporate separateness to limit the risk of environmental liability as outlined in the Joint Memorandum of Law. These policies and procedures are applicable equally to all of our merchant banking investments, including those in companies involved in physical commodities, and are reflected in the manner in which we make such investments.

As discussed further below, we believe that compliance with the merchant banking rule restriction on routine management, together with appropriate policies and procedures, provides significant safeguards from the threat of corporate veil piercing and from other means of potential liabilities attaching to the FHC. At the same time, reflecting on the conclusions of the Joint Memorandum of Law and the ways they may be appropriately incorporated into a FHC's risk management program, we believe that it is prudent for FHCs that engage in merchant banking activities to take steps as described in Appendix C to the Trade Organizations Letter to protect corporate separateness. In addition, we recommend that FHCs adopt policies as described herein with respect to the exception to the routine management prohibition.

This reflects our view that FHCs should follow consistent standards with respect to avoiding and mitigating liability associated with activities ***regardless*** of the legal authority under which the relevant activity is or may be conducted under the BHC Act. We believe that further restrictions on holding periods and additional capital requirements are not needed to manage the risks of these activities and that these would be constraints on these important activities that are less targeted, and therefore less effective, than the steps described in this letter.

II. Commodities Intermediation Activities

A. Overview of Goldman Sachs's Role as Intermediary in Commodities Markets

Our involvement in owning physical commodities is limited to performing an intermediation function.[9] As an intermediary, we take title to physical commodities and arrange for the storage and transport of commodities with independently managed service providers. In our intermediary capacity, we serve as a bridge between producers on the one hand and consumers and investors on the other, whose interests and exposures offset each other but do not perfectly match.[10]

In commodities markets, we act as an intermediary for various types of clients, notably including:

- **Producers**, such as natural gas or oil suppliers, power generators and miners that rely on commodities markets to hedge the risks associated with their long-term investment projects.
- **Consumers**, such as transport companies, utilities and governmental entities that require fuels as well as manufacturers that consume raw materials.[11]
- **Investors**, such as pension funds and asset managers that buy and sell financial contracts in commodity derivatives markets in order to participate in price movements, act on their market views and obtain diversification.[12]

We enter into transactions to achieve one or more client objectives, including:

Funding and financing. We provide funding to producers and other sellers by agreeing to pay for the commodities we purchase sooner than other purchasers would. We also enter into financing arrangements that effectively monetize client inventories, increasing the amount of capital that these companies have available to invest in their day-to-day businesses and longer-term capital projects.

We provide financing to commodity consumers by accepting payment for the commodities we sell them later than other sellers would require. We also provide indirect funding to commodity consumers and other purchasers by maintaining inventory positions in anticipation of near-term customer demand, which clients access as a source of supply. As with other forms of market-making and financings, these arrangements help alleviate the funding demands and smooth the expenditures that would otherwise be required of end-user clients. We also extend credit by offering hedging arrangements that allow clients to

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[9] We discuss investments that we make in companies that may own commodities or engage in commodities-related activities as part of their business in Section III, Merchant Banking.

[10] In acting as an intermediary for clients, we also enter into transactions with other market participants to obtain liquidity or offset risks.

[11] Importantly, the same company may be both a producer and a consumer depending on the circumstances. For example, a farm "produces" commodities such as corn and "consumes" commodities such as natural gas. The same may be said of refiners and processors.

[12] Financial investors tend to trade short-term derivatives contracts and rarely accept delivery of the physical commodities underlying their financial contracts.

secure their commitments by means other than posting cash margin; this enables them to deploy liquid assets to other purposes, including investments.

Hedging/investment. We enter into transactions that assist clients in managing the exposures to commodity prices that are inherent in their business activities. Producers may enter into fixed-price sale agreements to protect against price decreases, while consumers may enter into fixed-price purchase agreements to protect against price increases. Bespoke hedging transactions tailored to their specific requirements allow both producers and consumers to increase the efficiency of their operations and lower their costs, which results in more stable prices for the ultimate consumers, who include airline passengers and consumers heating their homes. Customized products also facilitate the ability of end-users to achieve hedging treatment under accounting principles, which is important in allowing them to manage risk without having the unintended consequence of increasing earnings volatility. For investors, who may enter into both sale and purchase agreements, we provide exposure to commodity prices to diversify their investment portfolios, express directional views on markets and hedge inflation risk.

Liquidity. We also provide liquidity to market participants through our willingness to make prices and transact as a market maker.

The connection between physical and financial products is critical in many transactions, and there is a broad range of transactions in which intermediaries need to participate in both markets in order to facilitate client business or hedging requirements. We believe it is possible to categorize physical commodity transactions as follows:

Principal market commodities. The physically-settled market is the predominant type of transaction in several markets, including the delivery of physical power and natural gas delivered at specific locations. For many arrangements with clients, the very substance of the transaction involves the taking or making of delivery of a physical commodity because the primary market for the particular commodity in which the client wishes to transact *is* the physical market.

Client selection commodities. For other situations, even where a liquid market for financially-settled transactions in the commodity exists, the most efficient means of providing the client with the funding, financing, hedging or liquidity that it seeks is through a transaction involving physical settlement. An example of this would be an inventory financing involving a grade of copper that is deliverable into futures contracts listed on the CME or London Metals Exchange.

Material relationship commodities. For certain commodities, physical markets provide an important source–often the best source–of the liquidity and price discovery that support the intermediary's ability to provide customized financial products. In some cases the intermediary's best source of liquidity to manage the risks it incurs on the client's behalf is the physical market. We provide an example of this type of transaction below involving an agricultural cooperative.

Basis commodities. In certain instances, having access to physical markets enables the intermediary to offer products (both financially- and physically-settled) that are structured based on relationships between the same commodities at different locations and/or different grades or types of commodities and the propensity for prices of these various products to come into alignment based on the natural arbitrages of location and grade.

The ANPR questions whether the relationship between physical and financial markets is sufficiently close to justify allowing FHCs to continue to access the physical markets in order to provide financial products.[13] We believe that the connection between physical and financial products continues to be meaningful, and that access to physical markets is important in facilitating our provision of a broad range of services to our clients.[14] In fact, looking at the commodities transactions on our books at the end of the first quarter of 2014, we find that nearly half of the "unique commodity underliers" or "UCIs" (the identifiers that we use to denote particular commodities at specific locations) referenced in our transactions provide for physical settlement.[15] We believe this demonstrates the need for intermediaries to engage in physical markets in order to achieve their clients' objectives in the broadest sense.

B. Significant Benefits Derived from the Participation of FHCs in the Commodities Markets

1. Benefits of FHC Intermediation to Markets and the Broader Economy

FHCs' capabilities in and approach toward commodities markets provide substantial benefits to these markets and thus to the broader economy, in which commodities play a significant role. We estimate that 39% of the $17.2 trillion equity capitalization of the S&P 500 index has meaningful exposure to commodities, either through direct exposure or as an important component of input costs.[16] Companies manage their commodities exposure by participating in physical or financial markets, or both, often using FHCs as intermediaries. For producers and consumers, hedging the risks associated with their day-to-day operations or their long-term investment projects can support higher returns, lower capital costs and stronger growth, particularly if it encourages companies to undertake worthwhile investment projects. In particular, hedging in commodities markets allows companies to adjust the size and timing of the capital they need to borrow or raise. It reduces the size of required equity reserves, allowing more resources to be shifted to profit-making opportunities, and it allows companies to avoid project disruptions and undesirable asset sales, the net economic impact of which can be considerable. In many instances, standardized contracts offered on exchanges are not perfect matches for these risks.

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[13] 79 Fed. Reg. at 3334.

[14] In the ANPR, the Federal Reserve notes in particular the recent announcements by a number of FHCs that they propose to divest their physical commodity business or certain business lines. *Id.* Complementary Commodities Activities remain complementary to financial activities on the same bases that the Federal Reserve initially determined the activities were complementary. We strongly believe that changes in the market since these authorities were granted have ***not*** changed their complementary nature. The decision by some FHCs to limit the services they provide to clients and thereby divest their physical commodity business does not necessarily reflect a lack of complementarity between participation in the financial and physical markets but more likely reflects a determination by a particular firm to reduce the range of services that it provides to its clients in particular markets.

[15] Of the UCIs referenced in transactions on our books at the end of the first quarter of 2014, we estimate that 22% involve principal market commodities, 5% involve client selection commodities, 3% involve material relationship commodities and 14% involve basis commodities.

[16] Sources: Goldman Sachs Global Investment Research and Standard & Poor's.

As an example, we estimate the impact of hedging on a medium-sized oil company's ability to produce oil. We assume that the company invests $100 million in an oil production project over a ten-year period, and analyze the outcomes under two scenarios. Under the first scenario, we assume that the company does not hedge its exposure to fluctuations in oil price changes. It is able to produce 4.3 million barrels of oil over the ten years, earning a return on equity ("ROE") of 10.1%. Under the second scenario, we assume that the company does hedge its exposure by accessing the intermediation services provided by an FHC. In doing so, the company is able to limit revenue downside and generate higher cash from operations. The incremental cash can be reinvested into the project, expanding it to about $120 million in total capital invested, 20% more than under the original scenario. This results in a higher ROE of 14.5% and incremental oil production of 17%-18% (or five million total incremental barrels of oil over the ten-year period) compared to the un-hedged program.[17]

FHCs are particularly well-suited to provide solutions to clients whose businesses are in the midst of fundamental transformation. Often, these changes are caused by advances in technology, changes in a regulatory structure or some combination of the two. The global energy industry, including the sectors involving upstream sources of fuel and both mid- and down-stream infrastructure, is experiencing such a transformation, particularly in North America. Changes in regulation designed to encourage market-based solutions and to respond to climate change have fundamentally altered how power and its feedstock fuels are produced and distributed. FHCs have played a key role in this transformation by helping to develop new sources of capital and to support emerging competition in sectors that had been integrated for decades.

FHCs' ability to serve as credible intermediary counterparties and provide capital (in a merchant banking context, as a lender and otherwise) has enabled us to play a leading role in assisting companies involved in this transformation through a range of hedging, financing and capital-raising transactions. These include private equity investors developing renewable energy facilities; smaller producers at the forefront of developing shale technologies and related infrastructure; and manufacturers seeking to build new facilities in the United States for the first time in decades to take advantage of the availability of production inputs, such as natural gas liquids, that have only become economical in recent years.

FHCs' participation in both financial and physical commodities markets not only provides greater transparency and liquidity but also promotes price convergence, which helps ensure price integrity in the market. Convergence is the phenomenon whereby the prices of the physical commodity meet the settlement prices of the derivative contracts based on that commodity. Any divergence between these prices may undermine the efficiency of the financial instrument as a hedge for commodity prices, potentially forcing end-users to absorb risks that they otherwise seek to shed through the purchase or sale of such financial instruments. When end-users purchase a physical commodity for their business, the price they pay is the prevailing price in the market for the actual commodity. To the extent that an end-user relies on

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[17] For further discussion of the assumptions in this example, see Steve Strongin, Amanda Hindlian & Sandra Lawson, *Effective Regulation: Part 4: Turning Good Ideas Into Good Outcomes*, Goldman Sachs Global Markets Institute (2009), http://www.goldman sachs.com/our-thinking/archive/effective-regulation-4.html.

financial instruments (such as futures contracts) to hedge against changes in that price, the end-user is at risk if the settlement price of the hedge diverges from the price of the actual commodity.[18]

2. *Examples of Transactions that Illustrate Benefits to Clients*

The following examples illustrate the types of transactions involving physical commodities that we and other FHCs enter into in order enable our clients to achieve their objectives relating to funding, financing, hedging or obtaining investment exposures.[19]

Supply/Offtake. For entities that use and/or produce commodities (such as refined or finished products), a very significant cost of doing business arises from funding inventory of fuels or inputs for their businesses and the products they produce. Limiting the time during which the client holds inventory reduces these costs. An FHC intermediary can assist a client in achieving this by entering into an agreement to purchase inventory inputs or fuels and then sell them as and when required by the client. Similarly, as the client produces finished products, the FHC can purchase and retain title on them until the client sells them to its customer. The FHC's ability to take title to and the right to dispose of the commodity inventories allow it to provide more financing than would be possible were the transaction structured as a secured loan. This kind of arrangement has provided an effective means of financing for a range of companies, including manufacturers, commodity processors, utilities and transportation companies. For example, we have recent experience in implementing this kind of arrangement for private equity investors acquiring generation assets from a traditional utility that divested such assets in order to concentrate on its core distribution function.

Asset/Liability Mismatches. End-users are subject to mismatches between the liabilities in their business and the assets that are readily available to offset them. FHC intermediaries offer products to address these mismatches. Below are examples:

Timing Mismatches: Manufacturers and utilities often budget for materials (including fuels such as natural gas) on a quarterly or annual basis. A significant cost component of fuel procurement is the transportation of the fuel from the point of its production to the point of consumption, much of which is done through pipelines. Because pipeline developments are capital-intensive, many pipeline companies require a multi-year utilization commitment from shippers. As such, the duration of the commitment required by a pipeline operator extends beyond the budgeting cycles of most end-users. FHCs bridge this mismatch by, on the one hand, providing the necessary commitment to obtain the pipeline capacity and by, on the other

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18 See Staff of Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Gov'tal Affairs, 111th Cong., *Excessive Speculation in the Wheat Market* 61 (2009) ("The ability to successfully hedge against price risk . . . depends upon the convergence of the cash price and the futures price as a contract approaches expiration."). *See also Excessive Speculation in the Wheat Market: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Gov'tal Affairs*, 111th Cong. 39–50, 135–42 (statement of Steven H. Strongin, Head of Global Inv. Research Div., The Goldman Sachs Grp.).

19 Please also refer to the comment letter filed in response to the ANPR by the Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce on April 3, 2014 for a statement by consumers of commodities and physically-settled commodities derivatives discussing the importance of FHCs' intermediation services to their businesses.

hand, providing an offsetting annual commitment to deliver natural gas to the end-user, while managing residual market risks.

Reliability Assurances: A fundamental objective for power and gas utilities is to distribute electricity and fuels safely and reliably. Utilities require a high degree of confidence that the commodities they distribute or use as fuel for generation (such as natural gas) will be available as required. At the same time, marginal capacity to store and transport these commodities is often offered only on an "interruptible" basis. That is, the right of the capacity holder to move the commodity out of storage or transport it to its destination is subject to having to yield to holders of "firm" capacity on peak days of demand. An FHC intermediary may enter into a transaction with a utility that provides surety of supply, while taking the risk associated with interruptible capacity. In the event that capacity is interrupted, the FHC will source the commodity in geographic proximity to the utility. Transactions of this type facilitated the ability of utilities in the Midwest to meet unprecedented customer demand this winter.

Hedging Transactions. Both producers and consumers of commodities seek instruments to manage risks that are as closely tailored as possible to the risks in their business operations. In some instances, the product that the FHC provides more closely matches the needs of the end-user simply by providing for a settlement payment that is determined with reference to the average of prices over a month (corresponding to the end-user's inputs procurement program) rather than the settlement price of a futures contract determined on a single day within the month. Other products involve more customization. An example of this involves an agricultural cooperative that utilizes natural gas at a particular location as fuel or propylene to package its perishable foods that it procures from suppliers at prevailing spot prices. The cooperative may seek to protect itself against an increase in commodity prices by entering into a cash-settled swap with an FHC intermediary. Because market physically-settled natural gas in the relevant location or propylene contracts is more liquid than that for financially-settled swaps, the FHC may manage the risk on its commitment to the cooperative by purchasing the commodity, making arrangements to store it and then selling the stored inventory at prevailing spot prices as the swap with the cooperative comes to settlement.

Liquidity Efficiency. FHCs utilize their expertise in assessing credit risk, valuing assets and managing price risks by offering end-users facilities to hedge commodity risks that are secured by company assets rather than requiring the posting of cash margin. In these facilities, the FHC looks to the company's assets as a basis for its credit assessment in the same manner as a secured lender determines to make a loan. Companies that qualify for the "end-user exemption" from clearing and margin requirements that Congress included as part of the Dodd-Frank Act Title VII reforms for derivatives would not be able to avail themselves of its benefits in many instances were they not provided with arrangements of this type by FHCs.[20] Just as secured lenders provide credit based on a broad range of collateral, so too has Goldman Sachs structured secured hedging facilities based on assets ranging from an airline's aircraft to a manufacturer's property, plants and equipment.

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[20] Pub. L. 111-203, 124 Stat. 1376, § 723 (codified at 7 U.S.C. § 2(h)(7)). Notably, one condition to the availability of the end-user exemption is that the swap be entered into for the purpose of hedging commercial risk, such as commodity price exposures. 7 U.S.C. § 2(h)(7)(A)(ii).

Basis Risk Management. A primary means by which FHCs provide hedges and liquidity to end-users is through the effective management of the relationship between different grades of commodities and commodities at different locations. By participating in these distinct but related markets, FHCs are able to source commodities at favorable prices and arrange for them to be transported to end-users to provide cost-efficient supplies. Having access to these markets also facilitates the ability of FHCs to provide cost-effective financial hedges for end-users.

In many instances we enter into transactions that combine financial and physical products that achieve more than one client objective. Thus, for example, it is not uncommon for us to enter into a transaction that provides a hedge against price exposures while serving as a source of supply to the client.

3. Diversification Benefit

Participation by FHCs in commodity intermediation activities and merchant banking activities provides sources of revenues that may be diversified from other sources. The Federal Reserve has long recognized that such diversification can enhance a banking organization's ability to withstand economic cycles that affect individual lines of business and that the ability to generate increased revenue from a range of products and services can enhance overall capital strength.

C. The Absence of Effective Alternative Intermediaries

Restricting FHCs' ability to participate in the physical commodities markets as intermediaries would limit their ability to provide these arrangements to their clients, thereby reducing the economic benefits that accrue to corporate producers and consumers of commodities as well as to consumers and the economy more broadly. The impact of the exclusion of FHCs from these markets (or the placement of significant limits on their involvement) would be felt all the more acutely because of the absence of effective alternative providers of these intermediary services.

Although other market participants may provide intermediation services from time to time, their role is notably different from that of FHCs. The most obvious alternative is trading houses, which participate in commodities markets by sourcing, storing and delivering physical commodities for other participants. Trading houses typically do not act as market makers on a consistent or ongoing basis; instead they transact in commodities markets to earn a return on their own assets. This model differs substantially from that of FHCs, which are subject to the Volcker Rule[21] and therefore are only permitted to trade financial instruments in these markets as part of market-making, risk-mitigating hedging and underwriting activities.

FHCs differ from trading houses and other non-bank organizations in several other important ways. First, FHCs are subject to comprehensive regulation and stringent prudential oversight. Second, because FHCs have developed an infrastructure and capability to provide multiple financial services, they are able to offer clients more economical terms than providers that offer a more limited set of services. Third, clients regard FHCs as better capitalized and more financially stable counterparties. Fourth, by entering into

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[21] 12 U.S.C. § 1851; *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (Jan. 31, 2014).

commodity transactions with FHCs that serve as counterparties on hedges in other asset classes (such as currencies and interest rates), credit exposures are subject to reduction through netting both bilaterally and across the financial system more generally. Finally, clients expect their providers of financial services to be able to provide commodity intermediation services in combination with other products, such as hedges for currency or interest rate risk, as well as loans and financial advisory services.

D. Risk Avoidance, Mitigation and Management Relating to Our Intermediation Activities

The ANPR raises a number of potential risks that FHCs could face with respect to physical commodity activities, with a significant focus on risk from environmental events.[22] Goldman Sachs respectfully submits that the ANPR improperly characterizes these risks and the ability of an FHC to manage them. We believe that environmental risks associated with intermediation activities are limited and can be managed through the utilization of a risk management program that is based on the primary laws that provide allocation of environmental liabilities. This risk management program, and an FHC's adherence to it, are subject to assessment and review through the Federal Reserve supervisory process.

The ANPR also highlights reputational risk as well as the risk of market contagion and tail risk.[23] These risks are not unique to an FHC's physical commodities activities. They should be addressed in the context of physical commodities activities in the same ways that an FHC addresses these risks in its core financial activities. Moreover, we believe the risk of market contagion in regards to commodities is in fact small, given that any one environmental incident is unlikely to coincide with similar events involving other FHCs.

In connection with both our commodity intermediation activities and our merchant banking activities, we maintain an integrated risk management program of policies, procedures, diligence practices, governance arrangements, approval processes and insurance coverage designed to enable us to identify, avoid or otherwise mitigate potential risks associated with these activities. For this purpose, we consider risk both from a liability and reputational point of view. We believe that our program is appropriate to limit the risks posed by these activities. At the same time, we recognize the need to re-evaluate the strength and sufficiency of our program periodically and as events or new activities dictate. For example, the occurrence of a significant incident involving commodities has and would cause us to re-examine our policies and procedures.

As an example, the Deepwater Horizon spill prompted Goldman Sachs to evaluate ways in which we could enhance our approach to evaluating risks associated with potential investments and physical commodities activities. After conducting a thorough review, we concluded that it would be beneficial to adopt a formalized approach to ensure consistency across the various business divisions that engage in these activities. This resulted in the establishment of the Physical Commodity Review Committee ("PCRC") in 2010. The PCRC is responsible for evaluating new activities and investments involving physical commodities from the standpoint of potential risks and for proactively identifying industry developments that

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[22] 79 Fed. Reg. at 3331–33.

[23] *Id.*

may inform our approach with respect to new or existing activities. Annex A contains a more detailed description of the PCRC, which we regard as an integral component of our risk management program, and other aspects of this program.

The fact that we have not been involved in significant events of the type described in the ANPR has not diminished our vigilance with respect to potential risks of these activities. Indeed, in considering the issues raised by the ANPR, we determined to further enhance certain features of our program by broadening the scope of our vendor reviews and reinforcing our emergency management procedures to provide additional insulation against potential liabilities. We discuss these initiatives further in Section II.E.

1. Addressing Risk from Environmental Events

The ANPR lists a number of catastrophic events involving commodities that, for the reasons discussed below, bear little relation to the intermediation activities that FHCs currently conduct. In order to review the potential risks that may be associated with commodity intermediation activities, it is necessary to examine the activities actually involved in intermediation in the context of the potential liabilities that exist under applicable law. Potential liabilities may arise from:

<u>Owner/Operator Liability</u>. The Joint Memorandum of Law sets out in detail the law with respect to the allocation of liability for environmental damages. As a general proposition, this law is based on the common sense notion that the parties that are in the best position to prevent damages are the parties that will be liable for damages should they arise. Thus, whether under the Oil Pollution Act, the Comprehensive Environmental Response, Compensation and Liability Act (the "CERCLA"), the Clean Water Act or other similar laws, the general approach under applicable law is that ***owners and operators***[24] ***of <u>facilities</u>*** that are involved in an environmental problem will be liable for any resulting damages.[25] FHCs do not own or operate such facilities as part of their intermediation activities. Rather, they merely own ***<u>commodities</u>*** and arrange for storage and transport of them with independently managed operators. As such, FHC

[24] 42 U.S.C. § 9607(a) (imposing CERCLA liability on an owner or operator of a facility or vessel). Under CERCLA, "owner or operator" means: "(i) in the case of a vessel, any person owning, operating, or chartering by demise, such vessel [a demise charter is a particular type of arrangement under which the chartering party assumes responsibilities typically associated with the ownership of the vessel], (ii) in the case of an onshore facility or an offshore facility, any person owning or operating such facility, and (iii) in the case of any facility, title or control of which was conveyed due to bankruptcy, foreclosure, tax delinquency, abandonment, or similar means to a unit of State or local government, any person who owned, operated, or otherwise controlled activities at such facility immediately beforehand. Such term does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility." *Id.* § 9601(20)(A).

[25] *See, e.g.*, *United States* v. *Bestfoods*, 524 U.S. 51, 66–67 (1998) ("[A]n operator is simply someone who directs the workings of, manages, or conducts the affairs of a facility. To sharpen the definition for purposes of CERCLA's concern with environmental contamination, an operator must manage, direct, or conduct operations specifically related to pollution, that is, operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations.").

intermediaries do not assume and are not subject to the liability that attaches to owners and operators of facilities, unless an FHC itself is found to have caused or contributed to the incident.[26]

"Deemed Operator" Status. Although the owners and operators of facilities from which environmentally sensitive substances are released may be held responsible for adverse consequences to the environment arising therefrom, under certain environmental laws, it is possible that an entity other than the owner or operator of a facility may be held liable as an "operator" because of its specific conduct with respect to the facility. This can occur when the entity or its personnel become so integrally involved in the day-to-day operations of the facility as to be indistinguishable from the actual operator in regard to environmental activities or decision-making, subjecting the entity to the risk of being designated a "deemed operator." Market participants, including FHCs, are cognizant of this risk and develop policies and procedures of the type that we have adopted as part of our risk management program, and that we are currently in the process of expanding to ensure that they do not engage in the type of facility-controlling conduct that could make them susceptible to designation as a deemed operator.

Entrustment of Commodities. As noted in the Joint Memorandum of Law, a party that knowingly entrusts a hazardous material to an incompetent operator may be held liable based on a theory developed in a line of state tort cases.[27] It is possible that such a theory could be applied against the owner of a commodity that knowingly engages an incompetent transportation or storage facility operator. We believe that our approach of applying appropriately tailored vendor selection criteria, which we are in the process of expanding, is an effective mitigant against this risk.

2. *Risk Mitigation*

We maintain an integrated risk management program for our commodity intermediation and merchant banking activities, which is described in greater detail in Annex A. We maintain this program as a matter of sound corporate governance. At the same time, the program also provides a means of avoiding potential liability based on well-settled principles of law described above.

Avoiding Operator Status. First, we do not own or operate storage or transportation facilities as part of our intermediation activities. Second, under our policies, firm personnel are prohibited from becoming involved in the operation of such facilities in a way that could result in our being designated a "deemed operator." As part of these policies, we maintain "emergency or event response" policies and procedures that are designed to address a situation in which a commodity that we own becomes involved in an accident, which we are in the process of expanding. These policies and procedures provide standing protocols to facilitate internal and external communications, without allowing our personnel to become involved in the actual management of the incident in a way that could raise deemed operator risk.

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[26] The orders authorizing Complementary Commodities Activities recognize the significance of the owner/operator standard by specifically prohibiting FHCs from using complementary authority as a basis for owning or operating infrastructure assets. *See, e.g.*, *The Royal Bank of Scotland Group plc*, 94 Fed. Res. Bull. C60, C64 (2008).

[27] Joint Memorandum of Law at 29.

Selecting Qualified Operators. It is wholly appropriate—and not inconsistent with the policies designed to prevent a commodity owner from being designated a "deemed operator"—for a commodity owner to conduct diligence on the vendors that store or transport the owner's commodities. As part of our framework, we maintain policies and procedures establishing baseline requirements for engaging any vendor that provides a service to Goldman Sachs. For vendors that may store or transport commodities we own as an intermediary, we have additional procedures to assess operator qualifications. Among the factors we consider are the operator's safety record, regulatory status, financial condition and insurance. Applying these procedures has two benefits. First, it provides us with confidence that the operator has the requisite expertise and capabilities to safely handle, store or transport our commodities. Second, it provides a basis to defeat claims that we knowingly entrusted our commodities to an incompetent operator.

Importantly, our vendor selection program is designed to be tailored to the particular facts of the proposed vendor engagement. Among the factors we use to calibrate the scope of our vendor diligence are the particular nature of the commodity and the terms of the storage or transportation arrangement. Thus, we take the appropriate steps of conducting more thorough diligence in situations when a vendor dedicates facilities to our exclusive use for a period of time than when our commodities are commingled with those of other customers.

We have again reviewed our policies and procedures for vendor management in the context of responding to the ANPR. In doing so, we have determined to strengthen our policies in the following ways:

- We are broadening the scope of selection criteria that we apply to operators of storage and transportation facilities, and
- We are enhancing our "emergency management" protocols to reinforce prohibitions on our personnel involving themselves in the management of accidents involving commodities that we own.

On-Going Review. In light of the dynamic nature of the considerations that may affect the risks associated with our activities, including acting as a commodities intermediary or making merchant banking investments, we revisit and review the sufficiency and strength of our integrated risk management program. We do this both on a regular periodic basis and as new events (such as changes in law) or new activities (such as entering new lines of business or expanding a line of business into a new jurisdiction) dictate. Based on our review of such analyses, we evaluate measures that we could take to mitigate particular risks that are identified. We may determine to limit particular activities or take special risk-mitigating measures beyond those that we would otherwise apply in the normal course. This review and decision-making process is part of our firm's normal risk management process and is subject to the oversight of the firm's board of directors.

3. Reputational Risk

The ANPR suggests that even in the absence of legal liability, public confidence in an FHC or its subsidiary insured depository institution could suffer, perhaps significantly, with potential consequences for its access to the funding markets in the event that the FHC is involved in an environmental event.[28] FHCs have experience managing reputational risk as it arises in other contexts, including in the consumer-facing businesses that are far larger in scale and that have demonstrated considerably greater reputational risk than the commodities business. These issues have not affected FHCs' access to funding markets.

We endeavor to be pro-active in our approach to potential reputational issues, as evidenced, for example, by our establishment of the PCRC, discussed above. Of course, no matter how robust its procedures and how well settled the applicable law may be, it is always possible that an FHC intermediary would face the risk of litigation in particular instances. In these situations, it is possible that particular facts and circumstances could lead an FHC to choose to settle a claim even in the absence of legal liability. However, we do not believe that an FHC would agree to a settlement so large that it would endanger the firm's safety and soundness. Further, we believe that clients and providers of funding are able to distinguish unanticipated liabilities from the underlying financial wherewithal of an FHC.

In this context, we believe that it is important to note that Goldman Sachs has demonstrated a commitment to promoting sound environmental stewardship and a focus on potential reputational aspects of our activities. To this end, the firm has developed a comprehensive approach to address the environmental, social and governance issues that are raised in our businesses and by our firm as an organization. Our approach to these matters is described further in Annex B.

4. Market Contagion and Tail Risk

The ANPR raises the specter of the financial crisis in its discussion of recent events that have prompted reconsideration of physical commodities activities; it points to the dangers of market contagion and underappreciated tail risk as lessons learned from the financial crisis.[29] In the context of physical commodity activities, however, these concerns seem misplaced. An environmental incident affecting the commodities owned by an individual FHC typically would be an idiosyncratic event rather than an event that would "spread" to commodities owned by other FHCs. For example, an oil spill in one area and relating to one FHC would not affect other oil holdings and thus would not be similar to a significant downturn in an asset, such as housing, that is held widely throughout the financial system.

Moreover, in light of the nature of intermediation activities and the manner in which such liability is generally allocated under applicable law, we believe it is unlikely that an FHC would be found liable as an owner/operator for a catastrophic event. Furthermore, the steps that we and other FHCs take to mitigate reputational risk and the rational limits we would put on any settlement, as discussed above, also limit the effect on us of a catastrophic event. As a result, the likelihood that an environmental catastrophe would threaten to bring down an FHC and destabilize other FHCs is remote.

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[28] 79 Fed. Reg. at 3333.

[29] *Id.* at 3331–33.

5. Other Risk Mitigants

Beyond our risk management program, comprehensive insurance programs serve as an important component of protection against the risks associated with physical commodity activities. We insure against risk from our physical commodity activities by maintaining loss, damage and theft and liability insurance. Liability limits are largely based on availability in the insurance market on commercially reasonable terms, premium costs, loss history and the relative exposure and limits in comparison to peer insured parties. FHCs may also require parties they engage to store or transport commodities to carry adequate insurance[30] and, when possible, to stipulate that the FHC be named as an additional insured on the third-party policy. We have maintained a robust insurance program for risks associated with physical commodity activities. In this regard, we note that on a premium dollar per coverage basis, our commodities liability insurance is among the most cost-efficient of all the insurance maintained by Goldman Sachs—which is indicative of the insurance underwriters' view that the risks they are underwriting are quite low.

Despite these significant safeguards, some residual risk does remain. Residual risk may arise from operational failure to adhere to the established risk management structure, limits on available insurance and changes to the legal framework, potentially with retroactive effect. This type of residual risk again is common to many (if not all) activities in which an FHC engages and demonstrates the importance of FHCs proactively reviewing the sufficiency of their risk management programs.

6. Existing Federal Reserve Requirements That Limit Risks Relating to Intermediation Activities

The Federal Reserve monitors and assesses FHCs' physical commodity activities through its supervisory and examination authority. As a baseline, banking organizations are legally required to conduct their activities safely and soundly, and the Federal Reserve has authority to ensure that banking organizations do so. This general requirement provides the Federal Reserve with broad discretion in determining whether the manner in which a banking organization conducts its activities poses undue risk to the organization.

The Federal Reserve also has more precise tools to assist with the evaluation of an FHC's physical commodity activities. In particular:

- FHCs are subject to comprehensive risk management program requirements.[31] The Federal Reserve requires FHCs to establish and maintain policies for monitoring, measuring and controlling the legal, reputational and environmental risks involved with commodities activities, specifically. Compliance with these requirements and this guidance is subject to the review of the Federal Reserve, which can require improvements and remediation as necessary.

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30 *Id.* at 3330 n.7.

31 Supervision and Regulation Letter SR 08-8, *Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles* (Oct. 16, 2008) ("SR 08-8").

- FHCs are required to have "adequate safeguards and controls to limit their exposure to potential environmental liability."[32] Policies and procedures must be in place to mitigate exposure, including through ongoing review of existing activities.[33]

Taken together, these tools provide a baseline for an FHC to ensure that its physical commodity activities can be conducted on a safe and sound basis. They also provide the Federal Reserve with a means of reviewing and evaluating an FHC's ability to manage the risks associated with its physical commodities activities.

7. Other Non-Environmental Considerations, Concentration and Material Conflicts

We note that the ANPR raises questions with respect to non-environmental considerations of commodities activities, including with respect to potential conflicts of interest and undue concentration of resources. We believe that intermediation and merchant banking activities do not present unique risks that are not otherwise addressed by the policies and procedures that we and other FHCs maintain to ensure the appropriateness of our participation in these markets, as well as by the regulations governing such participation. At the same time, we understand that others have expressed generalized concerns with regard to these issues, and we intend to respond as a firm or as part of an industry submission to specific concerns identified by commenters as part of this ANPR process.

E. Recommendations with Respect to Intermediation Activities

In light of the established legal principles regarding liability under environmental law for owners/operators and the doctrine of corporate separateness, we believe that the following standards help protect an FHC from potential liability from its intermediation activities related to physical commodities. Accordingly, we recommend that the Federal Reserve consider incorporating into guidance the standards below as measures that should be taken to address the risks posed by such activities. Specific requirements developed by the Federal Reserve that reflect the standards below may also serve as a useful guide to supervisory staff in determining whether an FHC's risk management framework is sufficient to address the risks posed by its activities in this area. We believe that this targeted approach is the most effective means of reducing and mitigating the potential risks that are relevant to commodity intermediation activities.

FHCs engaged in physical commodity intermediation activities should:

- prohibit participation in the operational decision-making that is the province of the owner or operator of facilities in which commodities are stored or transported,[34]

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[32] Bank Holding Company Supervision Manual § 2010.5.4.

[33] *Id.* § 2010.5.

[34] This may include storage facilities (such as tanks) and transportation facilities (such as ships and pipelines).

- require appropriate diligence prior to selecting facilities or operators used to store or transport commodities calibrated to take into account the specific nature of such arrangements,
- require the design and maintenance of contingency policies designed to prevent FHC personnel from becoming involved in the management of an environmental accident, and
- review the sufficiency of policies and procedures on both operational risk and reputational risk grounds, periodically and as warranted by new developments and activities.

III. MERCHANT BANKING

Our merchant banking investments offer a valued source of capital for many companies, are a key part of our business and fulfill an expected function for a global FHC. Although commodity-related merchant banking investments can pose certain risks, we believe these risks are mitigated by the limitations in Section 4(k)(4)(H) of the BHC Act and the risk management policies and practices that we have developed over time. Moreover, we believe that the grant of authority under the Gramm-Leach-Blilely Act (the "GLB Act") to make merchant banking investments reflects a considered Congressional determination regarding the benefits and risks associated with such investments. A significant increase in the restrictions on merchant banking activities would upset the careful balance struck by Congress and would make it difficult for us to continue making merchant banking investments in a way that is helpful to the businesses in which we invest and is profitable to us. As noted, however, we have identified one area relating to routine management where we believe that an additional safeguard may be appropriate.

A. Benefits of Merchant Banking

Our merchant banking investments fund vital growth opportunities for businesses and catalyze innovation. The basic premise underlying our merchant banking activity is to provide capital support and financial expertise to enterprises that we identify as having economic potential and sound management teams capable of growing their businesses.

Our background and experience as a financial institution enables us to make capital available in different layers of a company's capital structure—senior secured debt, mezzanine and/or subordinated debt, and common and/or preferred equity—as appropriate and thereby provide bespoke financing that simultaneously addresses a particular company's needs and protects our investment interests. Moreover, our diverse capabilities across a variety of transaction types allow us to take both a flexible and a customized approach to each investment opportunity depending on market conditions, industries and geographies and including build-ups, strategic capital investments, structured transactions and growth capital investments.

Portfolio companies often deploy the new capital we invest on operational improvements, technological innovations, strategic repositioning and other fundamental enterprise enhancements aimed at increasing productivity, expanding capacity, improving efficiency and reducing costs. The value of merchant banking investments is not driven by "financial engineering" or short-term cost cutting but rather by providing the capital needed to improve operations and the financial expertise to develop a long-term strategic vision for growth.[35] There are many examples of improvements and economic growth that are a direct result of investments and commitment of financial expertise and resources to companies engaged in businesses across a range of industries and sectors, including in the physical commodities arena.

B. Risk Management

The GLB Act, which imposes limitations on an FHC's ability to manage merchant banking investments in non-financial companies, together with the Federal Reserve's regulation and oversight, provide significant safeguards to mitigate the risks associated with merchant banking investments in companies active in physical commodities. In addition to these statutory and regulatory mandates, we have developed our own robust risk-assessment and management policies and practices, both formal and informal, to identify, evaluate and manage the risks arising from our merchant banking activities, which are consistently and vigorously applied and tested to ensure that appropriate precautions are taken both at the inception of an investment, whether in the physical commodities space or otherwise, and throughout its life.

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[35] We are not aware of studies of FHCs' merchant banking investments specifically, but as to private equity investing more generally, recent research indicates that annual EBITDA growth in North American private equity-backed companies exited between 2010 and 2012 was 11.8%, significantly above the 5.5% rate achieved by comparable public companies. *See* Ernst & Young, LLP, *Clear Direction, Focused Vision. How Do Private Equity Investors Create Value? A Study of 2011-12 North American Exits* 5 (2013), http://www.ey.com/Publication/vwLUAssets/EY_-_Private_equity_value_creation_in_North_America/$FILE/EY-Clear-direction-focused-vision.pdf.

Most post-1980s empirical work finds that private equity investments are associated with significant operating and productivity improvements. *See, e.g.*, Viral V. Achayra et al., *Corporate Governance and Value Creation: Evidence from Private Equity* (2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1324016; Quentin Boucly, David Sraer & David Thesmar, *Do Leveraged Buyouts Appropriate Working Rents? Evidence from French Data* (HEC, Paris, Working Paper, 2008); Douglas Cumming, Donald Siegel & Mike Wright, *Private Equity, Leveraged Buyouts and Governance*, 13 J. Corp. Fin. 439 (2007); Richard Harris, Donald S. Siegel & Mike Wright, *Assessing the Impact of Management Buyout on Economic Efficiency: Plant-Level Evidence from the United Kingdom*, 87 Rev. Econ. & Stat. 148 (2005).

A World Economic Forum report reviewed large-sample studies to analyze the impact of private equity over the past several decades on a global basis and found that, in the first two years after private-equity acquisitions, productivity at the acquired company grew on average by about two percentage points more than at comparable, non-private equity held firms. Steven J. Davis et al., *Private Equity, Jobs and Productivity*, in *Globalization of Alternative Investments Working Papers Volume 2: The Global Economic Impact of Private Equity Report* (World Econ. F., Working Paper, 2009).

Another study of seventy large companies acquired from 2002 to 2005 by major US private equity firms, including twenty-one manufacturing and forty-nine services and other non-manufacturing companies, found that their combined sales increased at an average annual rate that was 77% faster than the rate of annual sales for all U.S. companies over the same period. Robert J. Shapiro & Nam D. Pham, *The Impact of Private Equity Acquisitions and Operations on Capital Spending, Sales, Productivity, and Employment*, Sonecon (2009), http://www.sonecon.com/docs/studies/Private_Equity_Capital_Spending_Sales_Jobs-January2009.pdf.

1. Corporate Separateness and the Limited Liability of Shareholders

The principles of corporate separateness (in this case, between the FHC and its portfolio company) and the limited liability of shareholders significantly limit the risks for FHCs that invest in companies active in physical commodities under Merchant Banking Authority. As discussed in greater detail in the Trade Organization Letter and the accompanying Joint Memorandum of Law, it is generally accepted that a corporation is an entity distinct from its shareholders, with its own separate rights and liabilities, provided that proper corporate separateness is maintained.

The statutory and regulatory requirements governing merchant banking activities help ensure that a merchant banking portfolio company is recognized as a separate corporate entity, consistent with the doctrine of corporate separateness and limited liability. Specifically, pursuant to the terms of Section 4(k)(4)(H) of the BHC Act, in order to qualify under Merchant Banking Authority (i) an investment must be a bona fide merchant banking investment, i.e., the FHC must be making the merchant banking investment for the purpose of generating an investment return and not with a view to generating revenues from the operation of the portfolio company[36] and (ii) the investing FHC must not engage in routine management of its portfolio company, except in limited circumstances.[37] Thus, in order to make a merchant banking investment in a company active in physical commodities, Goldman Sachs must adhere to the requirements of Section 4(k)(4)(H) both at the time of investment and on an ongoing basis. Compliance with these requirements also helps maintain the corporate separateness between an FHC and a portfolio company and, taken together with our risk management framework described in this letter, provide an effective regulatory framework to safeguard against the risk of veil-piercing or statutory environmental liability and otherwise protect the firm from liability for portfolio company risk.

In addition to the safeguards reflected in the GLB Act and Regulation Y, the Federal Reserve has provided supervisory guidance over the years[38] focused on issues such as: (i) maintenance of policies and procedures to ensure corporate separateness; (ii) oversight by the board of directors and senior management of risks related to merchant banking; (iii) management of the investment process (including policies, limits and procedures, investment analysis and approvals, investment risk ratings, periodic reviews, and valuation, accounting and exit strategies); and (iv) internal controls. In establishing the investment and risk management practices, policies and procedures to which all merchant banking investments are subject, we have carefully implemented and adhered to the guidelines established by the Federal Reserve to ensure not only compliance with the regulatory requirements but also protection of our banking enterprise from risk (whether financial or reputational).

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[36] 12 U.S.C. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(b).

[37] 12 U.S.C. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171.

[38] *See, e.g.*, Supervision and Regulation Letter 00-9, *Supervisory Guidance on Equity Investment and Merchant Banking Activities* at 4 (June 22, 2000) (" Supervisory Letter SR 00-9"); Supervision and Regulation Letter 08-8, *Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles* (Oct. 16, 2008); Federal Reserve Bank Holding Company Supervision Manual §§ 2124.0, 3909.0.

2. Management of Other Merchant Banking Risks

Beyond the risk of corporate veil-piercing, the ANPR also cites legal, environmental, reputational, market, credit and concentration risk from merchant banking activities.[39] These are the same risks that FHCs face in other contexts, including traditional bank activities such as lending, and, as such, FHCs have the ability to manage them in similar ways.

Over time, Goldman Sachs has developed considerable experience and risk-assessment policies and practices, both formal and informal, to identify, analyze and consider the risks associated with an investment opportunity. These policies and practices include: (1) rigorous due diligence of each investment opportunity, (2) multi-stage senior level review of and oversight over business opportunities and (3) as described in the context of veil piercing above, the appropriate corporate structuring of investments. These policies and practices are continually reviewed, tested and adjusted to ensure that appropriate measures are taken at the inception of an investment and throughout its term until divestment.

We believe that our control framework reflects current industry best practices. That said, business risks change as do their associated regulatory mandates. To address such shifts, we evaluate and enhance the adequacy of our controls on a regular basis to ensure that they remain robust, effective and current with the business and regulatory landscapes within which our control framework operates. Moreover, our practices and policies are subject to both routine and periodic examination by the Federal Reserve.

The Federal Reserve specifically examines FHCs' policies, procedures and systems to ensure that they are designed to maintain corporate separateness between the FHC and its portfolio companies and to protect the FHC and its depository institution subsidiaries from legal liability for such companies' operations and obligations.[40] This examination approach has allowed the Federal Reserve to tailor its supervision to particular circumstances and to ensure that corporate separateness is maintained and that effective risk management frameworks are in place. In addition, it enables the Federal Reserve to oversee the operative effectiveness of the safeguards that have been implemented and provides an objective check on the adequacy and efficacy of our policies and procedures relating to merchant banking investments.

C. Potential Revisions to the Current Merchant Banking Rule

The Federal Reserve has identified several potential areas for enhancement with respect to merchant banking activities: restrictions on routine management, holding period limitations, capital requirements and reporting requirements.[41] Although we do believe it is appropriate for the Federal Reserve to provide guidance on the need to consider liability arising from merchant banking investments related to physical commodities, we do not think that changes to holding periods, capital or reporting requirements are necessary to protect FHCs from environmental liability.

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[39] 79 Fed. Reg. at 3335.

[40] Bank Holding Company Supervision Manual § 3907.0.7.1. *See also* Supervision and Regulation Letter SR 00-9, *Supervisory Guidance on Equity Investment and Merchant Banking Activities*, 11, 14 (June 22, 2000) ("SR 00-9").

[41] 79 Fed. Reg. at 3335.

1. Routine Management

We believe that the existing restrictions on routine management of a portfolio company are an important mechanism by which FHCs can limit the risk of being subject to indirect liability based on a veil-piercing theory and direct liability based on a "deemed operator" theory. In the course of considering our policies in connection with our response to the ANPR, we have, however, identified one area in which the current routine management restrictions can be further enhanced to provide greater protection to an FHC. We propose this enhancement in connection with the limited exemption that allows FHC personnel to become involved in the day-to-day management of a merchant banking subsidiary when necessary in order for the FHC to protect the value on its investment.[42]

We believe that this exception is important to enable the FHC to deal with unanticipated exigent circumstances involving a portfolio company (such as the departure of a chief executive officer or senior management). Because the exemption comes into effect only in rare situations, there apparently has not been an incident in which the exercise of this limited exception has created or resulted in liability for an FHC. Nonetheless, it is an area that potentially could become a source of liability for an FHC, and thus we believe the Federal Reserve can and should enhance protections to FHCs in such a situation without undermining FHCs' ability to deal with unanticipated circumstances in ways that do not present liability risks.

To address this potential risk, we recommend that the Federal Reserve provide guidance on the limitations on routine management by restricting an FHC from assuming responsibility for environmental decision-making or exercising day-to-day control over facility operations with environmental effects at the portfolio company. We are similarly revising our policies so that in an exigent circumstance where we are allowed to exercise routine management of a portfolio company, we would engage qualified third parties to assume front-line decision-making responsibility with respect to environmental matters. These third parties would generally be professional management firms with relevant industry experience that would act pursuant to a contractual arrangement with the portfolio company or the shareholder.

2. Holding Periods

The Federal Reserve and the Department of the Treasury ("Treasury") adopted a holding period to implement the requirement of the GLB Act that merchant banking investments may be held "for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities."[43] Unduly constraining the holding period for merchant banking investments to a lesser period of time would be contrary to the Congressional intent that FHCs be permitted to conduct this activity

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[42] 12 U.S.C. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171(e).

[43] 12 U.S.C. § 1843(k)(4)(H)(iii). This has been implemented by requiring divestment within ten years, with possible extensions beyond that period under certain circumstances and with Federal Reserve approval. 12 C.F.R. § 225.172. This limit was based on research indicating that most merchant banking investments mature within this timeframe.

in a financially viable manner.[44] In developing the holding periods, the Federal Reserve and Treasury evaluated the Federal Reserve's experience supervising the equity investments of bank holding companies and sought input from securities firms that made merchant banking investments.[45] On that basis, they determined that although the average holding period for these entities generally was less than ten years, a ten-year holding period may be necessary to enable the sale or disposition of some investments "on a reasonable basis consistent with the financial viability of the activities."

Merchant banking investments, particularly those in start-up companies or companies undergoing a restructuring, may take some time before they become profitable, meaning that shorter holding periods would make it more difficult for FHCs to realize a return on their investment. Even more established companies are subject to the normal fluctuations of the business cycle. Indeed, reducing the holding periods might actually increase the risks to an FHC by reducing its opportunity to dispose of the investment on a financially viable basis. Shorter holding periods would increase the risk that the FHC would be forced to sell its investment at an inopportune time, given either the financial condition of the company or the state of the markets generally. FHCs might be less willing to make merchant banking investments, particularly in start-ups or reorganizing companies, out of a concern that they might be forced to exit their investments at a loss after reaching the end of the holding period. Moreover, reducing the holding period would do little to mitigate the risks of merchant banking investments in entities engaged in physical commodities activities during the lifetime of the investment—it would merely reduce the window of time in which such an event could occur. There would be no risk reduction from an FHC exiting such an investment to comply with a shorter holding period only to make another similar investment. The risks of investing are better addressed through careful corporate structure and adherence to the policies and procedures in the risk management framework.

3. *Capital Requirements*

As discussed in the Trade Organizations Letter, FHCs are already subject to strict capital requirements, including capital requirements for equity exposures that were comprehensively revised as part of the U.S. rule implementing Basel III, and the capital position of major U.S. FHCs has become much stronger in recent years. Furthermore, there does not appear to be any empirical evidence that FHCs have suffered any material losses, much less any catastrophic losses from any tail-risk event related to environmental liability, arising from their merchant banking investments in non-financial companies engaged in commodities-related activities. Under the Basel II Framework and under the U.S. Basel III final rule for advanced approaches banking organizations, respectively, banking organizations must calculate risk-weighted assets for operational risk. The U.S. advanced approaches banking organizations that have

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[44] Sen. Rep. No. 106-44, at 9 (1999) (noting, for example, that certain merchant banking investments may need to be held for a period of time to realize their potential value and directing the Federal Reserve to "not impose arbitrary or unduly restrictive limitations on the holding period for such investments"); *Merchant Banking Regulations Pursuant to the Gramm-Leach-Bliley Act of 1999: Hearing Before the Subcomm. on Fin. Insts. & the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urban Affairs*, 106th Cong. 11 (2000) (statement of Sen. Robert F. Bennett) (stating that "Congress was painstakingly careful in constructing and passing [the GLB Act]" and that "one of Congress' main objectives was to limit the development of unduly burdensome regulation").

[45] *Bank Holding Companies and Change in Bank Control*, 66 Fed. Reg. 8466, 8473–74 (Jan. 31, 2001).

completed and those that are still in the midst of their parallel runs have had to calculate operational risk charges based on internal and external loss event data for years. Yet the publicly available data on operational loss events since 2006 do not support the concern expressed in the ANPR with respect to catastrophic losses from tail risk. These increased capital requirements coupled with the other risk mitigants discussed above that lessen the likelihood of an FHC incurring material losses from a merchant banking investment should make it unnecessary to impose higher capital requirements on merchant banking activities.

4. Reporting

For the reasons provided in the Trade Organizations Letter, we believe that the current reporting and disclosure requirements are adequate to provide sufficient information to the Federal Reserve to assist it with its supervisory duties and to investors and the general public to allow for effective market discipline.

IV. CONCLUSION

In sum, we believe that the role that FHCs play as intermediaries in commodities markets and in the merchant banking context provides significant benefits to our clients, the markets and the broader economy. While we recognize that there are potential risks associated with these activities, we believe they are not significantly different from risks associated with other financial activities. We believe that such risks are capable of being managed through an appropriate framework subject to appropriate regulatory oversight.

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We appreciate your consideration of our comments and suggestions. We would be pleased to discuss these comments and suggestions with you in more detail and to provide additional information that may be helpful.

Sincerely,

John F.W. Rogers
Executive Vice President and Chief of Staff
The Goldman Sachs Group, Inc.

Annex A: ***Goldman Sachs's Risk Management Program***

Goldman Sachs maintains an integrated risk management program to address the potential risks associated with its commodities intermediary and merchant banking activities. This program involves several elements, including:

Governance: Goldman Sachs maintains a matrix of corporate governance arrangements to set the standards for the activities and investments and to evaluate such activities and investments at the time they are proposed and thereafter periodically and as circumstances warrant. These corporate governance arrangements are ultimately subject to the oversight of the Board of Directors of The Goldman Sachs Group. Among the committees involved in these arrangements on a firmwide or divisional basis are:

- Acquisition and Disposition Review Committee
- Client and Business Standards Committee
- New Activity Committee
- Operational Risk Committee
- Physical Commodity Review Committee
- Investment Policy Committee
- Risk Committee
- Investment Committees within Merchant Banking, Goldman Sachs Asset Management and the Special Situations Group

Members of these committees are among the most experienced professionals of our firm, with substantial participation by professionals who serve in a "control" capacity, including individuals from Controllers, Operations, Corporate Treasury, Tax, Compliance and Legal.

Physical Commodity Review Committee: A key component of our governance structure in this context is the Physical Commodity Review Committee ("PCRC"), which was established in 2010. The PCRC is chaired by one of the firm's most senior operations professionals and is composed of professionals with a range of experience, including environmental engineering expertise. The PCRC has approval authority over new physical commodity activities or investments of 10% or more of a company's equity or in respect of which one or more firm employees will serve as director. Importantly, PCRC review is conducted for activities and investments made by any division of the firm. The PCRC is a cross-divisional, firmwide governance committee responsible for maintaining a consistent approach to evaluating risks associated with the firm's activities in physical commodities that may have an impact on the environment, human health and safety.

While the PCRC does not engage in any direct operational management of firm activities or investments, it does set the standards that the firm seeks to ensure are being observed by portfolio companies with respect to environmental, health and safety matters. The PCRC is the firm's primary organization monitoring developments that may have a bearing on activities and investments involving physical commodities (including changes in law, regulation and industry practices) with a view toward ensuring that firm activities and investments are consistent with "best practices" to the extent possible. The PCRC reports on its activities to the Firmwide New Activity Committee. In addition, the Chair of the PCRC meets with The Goldman Sachs Group Board of Directors periodically.

Policies and Procedures: The firm maintains and is currently enhancing various policies and procedures that are applicable to its commodities intermediation and merchant banking activities. These include:

- Policies designed to ensure that the firm is not at risk of being a "deemed operator" of commodity transport or storage facilities
- Merchant banking policies
- Vendor and facility vetting policies
- Policies to promote the legal separateness of the firm and merchant banking portfolio companies

Investment Due Diligence/Structure: We conduct thorough due diligence before making merchant banking investments. Among the items that we examine in particular is the commitment of management to meeting high standards with regard to environmental, health and safety ("EHS") issues, the company's EHS track record and its insurance coverage. Our oversight continues over the life of the investments, with regular reviews of investments that are conducted on a scheduled basis or as called for by particular circumstances. Moreover, we generally structure our merchant banking investments to ensure that (1) the investment is made, and the portfolio company's activities occur, through a legal entity separate from Goldman Sachs and with limited liability, (2) third parties, including customers and suppliers, understand that they are dealing with separate entities, (3) the portfolio company is adequately capitalized to run its business and (4) we do not engage in the routine operation of the company's business other than pursuant to the limited exception provided by the merchant banking rule, as described further in this letter.

Investment Committee Review: Each merchant banking investment is subject to a review and approval process conducted by the specific investment committee governing the relevant business line. These committees are comprised of the senior professionals within the sponsoring business unit and representative from various control functions.

Insurance: Goldman Sachs maintains several comprehensive insurance programs dedicated to its activities as a commodities intermediary that are designed to address the full scope of activities in which the firm engages. We review and recalibrate these programs annually to reflect the particular exposures, value at risk, peer analysis, market capacity and cost for the relevant inventories being insured. Additionally, inventory values are regularly monitored and compared to the insurance limits. Liability limits are generally based on the maximum capacity available on commercially reasonable terms. Since 2011, the firm's insurance group has maintained a program that provides the firm and its affiliates with contingent, third-party environmental/pollution liability coverage for risks that could emanate from either physical trading activities or investing activities.

Ongoing Review: The firm reviews the strength and sufficiency of its integrated risk management program periodically and as events or new activities dictate.

Annex B: *Goldman Sachs's Environmental Risk Management*

Goldman Sachs takes a comprehensive approach to managing environmental risk in relation to our business activities. As part of our evaluation of client assignments and opportunities advisory, financing and investing teams consider environmental, social and governance ("ESG") issues in the normal course of their due diligence.

Our Environmental Markets Group ("EMG"), which is part of the firm's Executive Office and reports into the Office of the Chairman, assists deal teams in evaluating transactions that may have potential environmental sensitivities by conducting independent reviews and, as appropriate, identifying mitigants and opportunities to reduce the risk. The Business Intelligence Group, a group within our Legal Division that takes a broad view of risk including legal, regulatory, governance and social risks, works closely on the ESG transaction review. In certain cases, including merchant banking investments, Corporate Environmental Management, an in-house team of environmental consultants with strong technical expertise, also conducts due diligence in relation to potential environmental, health and safety issues.

Key findings are reviewed by relevant committees (notably including the PCRC), which consider potential reputational risks in addition to financial, business and legal considerations. As appropriate, transactions that have potential environmental risks are discussed with key leaders in the firm to determine the appropriate course of action. In certain instances, the firm determines not to pursue a particular assignment or opportunity.

In addition to assisting deal teams with transaction reviews, EMG provides due diligence guidelines to teams and conducts annual training for new hires. Due diligence guidelines include fourteen industry sectors and sub-sectors. EMG also maintains relationships and engages with external stakeholders, including environmental non-governmental organizations, to remain current on emerging environmental sensitivities and campaigns and to share our prudent approach to environmental issues.