ISDA® Safe, Efficient Markets

February 17, 2017

Submitted Electronically

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments (Docket No. R-1547, RIN 7100 AE-58)

Dear Mr. Frierson:

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] appreciates the opportunity to submit these comments with respect to the notice of proposed rulemaking published by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") (the "**Proposal**")[2] relating to physical commodity activities engaged in by banking organizations. As the trade association for the global derivatives market, ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivatives products, including end-users.

ISDA is concerned that the Proposal does not provide an analysis of the market impacts in the physical commodity markets and related financial markets that would result if the Proposal is implemented. We believe that the Federal Reserve should conduct a rigorous analysis of these market impacts prior to implementing any final rule. In addition, ISDA believes that the Proposal provides insufficient justification or empirical support for

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1 Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 67 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and depositories, as well as law firms, accounting firms and other service providers. Additional information on ISDA is available at www.isda.org.

2 *Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments*, 81 Fed. Reg. 67,220 (Sept. 30, 2016).

imposing restrictions on, or otherwise limiting, covered physical commodity activities of banking organizations.[3] Consistent with the comments ISDA provided on the Federal Reserve's advanced notice of proposed rulemaking (the "**ANPR**") with respect to physical commodity activities of financial holding companies ("**FHCs**"),[4] ISDA is concerned that the limitations and restrictions in the Proposal on the ability of banking organizations to engage in certain activities relating to physical commodities may have negative effects on the physical and financial commodities markets, including less liquid and efficient markets, greater volatility and higher costs for end-users and consumers.

As discussed in more detail in this letter, in addition to ISDA's general concerns regarding the lack of consideration of the market effects of the Proposal and the insufficient justifications for the limitations and restrictions provided in the Proposal, we respectfully request that the Federal Reserve implement the following changes in any final rule:

- The Federal Reserve should not impose a capital charge on covered physical commodity assets and activities in the absence of any analysis demonstrating that these activities actually pose additional risk.
- The Federal Reserve should not revise the cap that currently applies to the total value of physical commodities that an FHC is permitted to hold under "complementary" authority under Section 4(k)(1)(B) of the Bank Holding Company Act of 1956, as amended (the "**BHC Act**").
- The Federal Reserve should not rescind the previous authorizations of FHCs to engage in energy management services and energy tolling activities without making the proper determinations.
- The Federal Reserve should not implement the restrictions on copper activities engaged in by bank holding companies ("**BHCs**") absent a compelling justification.
- The reporting provisions of the Proposal should be limited in light of concerns regarding competitive harm, and any reports on physical commodity activities that are required should be afforded confidential treatment.

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3 For reference, we have provided, as an Appendix to this letter, an overview of the authority of banking organizations to engage in physical commodity activities.

4 *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities*, 79 Fed. Reg. 3,329 (Jan. 21, 2014). ISDA's comment letter on the ANPR is available at the following link: https://www.federalreserve.gov/SECRS/2014/April/20140424/R-1479/R-1479_040814_112254_567506723573_1.pdf.

I. The Proposal does not analyze the impacts on the physical and financial commodity markets that may result from imposing the proposed limitations and does not provide a compelling justification for curtailing participation by banking organizations in these markets.

The Proposal does not provide an analysis of the effects of limiting the involvement of banking organizations in physical commodity activities on the relevant markets, including on end-users and consumers of physical commodities. As a general matter, the Federal Reserve should not implement changes in regulations and policy absent a compelling justification. In particular, as ISDA noted in a recent comment letter to the Office of the Comptroller of the Currency (the "**OCC**"),[5] in a recent case, the Supreme Court stated that "one basic procedural requirement of administrative rulemaking is that an agency must give adequate reasons for its decisions."[6] The Supreme Court further noted that "an agency must be cognizant that longstanding policies may have 'engendered serious reliance interests that must be taken into account.'"[7] We do not believe that the Proposal meets these procedural requirements because the Federal Reserve provides insufficient justification for imposing additional restrictions on the participation of banking organizations in physical commodity markets and does not consider adequately the market effects that may result if the Proposal is implemented.

As one potential justification, the Federal Reserve states that there are legal, reputational and financial risks associated with physical commodity trading activities and focuses in particular on potential liability associated with environmental catastrophes. However, the Proposal provides no empirical support or analysis for these positions and does not cite any instance in which this type of liability was imposed on a banking organization or where a banking organization suffered material financial losses with respect to these activities. ISDA is not aware of any such instances that would justify the limitations and restrictions provided in the Proposal.

We believe that it is important to undertake a complete and rigorous analysis of the market impacts of the Proposal before implementation of any final rule, which would include an analysis, on both an historical and forward-looking basis, of the performance of physical and financial commodity markets without participation from banking organizations and a quantitative and qualitative assessment of all related direct and indirect costs and benefits of the Proposal. ISDA is concerned that the Proposal, if implemented, has the potential to affect adversely both the physical and financial commodity markets based on the unique role that banking organizations play in these markets, including higher costs and credit risk for end-users, increased volatility in physical and financial markets and a reduction in consumer choice. Banking

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[5] The comment letter is available at the following link: https://www.regulations.gov/document?D=OCC-2016-0022-0005.

[6] Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117, 2120 (2016).

[7] *Id.* (quoting FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009)).

organizations provide important services to the physical and financial markets that are unlikely to be replicated by other market participants in the event that banking organizations are forced to curtail their physical commodity activities due to the adoption of the Proposal. For example, as discussed in ISDA's comment letter on the ANPR,[8] banking organizations provide liquidity by making prices in commodities and taking on the role of market maker. Banking organizations also permit market participants to hedge exposure to physical commodity prices at attractive pricing. In contrast, end-user counterparties generally enter into transactions to accommodate their own business needs and not to accommodate counterparty demand. Therefore, end-users are generally less willing and able to engage in market making and related activities, including making two-way markets. If the Proposal were implemented, banking organizations may have limited capacity to enter into physical transactions with commercial parties, which are necessary for end-user entities to engage in hedging and related activities and are unlikely to be provided by other market participants. We also believe that many market participants would prefer to trade with regulated banking organizations than with other non-bank firms that are subject to less robust regulatory requirements. In addition, the Proposal may correspondingly impair the ability of banking organizations to participate in financial transactions with respect to physical commodities, in light of the inherent relationship between the physical and financial markets.

Similarly, commercial entities need to have access to liquidity in order to engage in necessary physical distribution of commodities and to execute hedging strategies in connection with the distribution of physical commodities. In the current markets, banking organizations provide liquidity and make two-way markets for market participants. However, if liquidity in these physical and financial markets is reduced, it may become more expensive and risky for commercial entities to operate their businesses. We are concerned that this could result in increases in volatility in commodity markets and, ultimately, higher costs to consumers.

In addition, certain end-users, in particular commercial energy firms, rely on financing from banking organizations for storage tank and pipeline construction, as well as refinery offtake transactions, that could become subject to limitations under the Proposal. For example, an inventory financing transaction in which the FHC temporarily takes title to the physical commodity upfront (for resale to the counterparty at a later point in time) would become subject to higher capital requirements under the Proposal. These heightened capital requirements may result in a reduction in the capacity for banking organizations to provide these services to end-users and may lead to higher prices in light of these constraints. We believe that this could have negative effects on energy firms, commodity markets and consumers.

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[8] *See supra* fn. 4.

II. The Federal Reserve should not impose a capital charge on covered physical commodity assets and activities in the absence of any analysis demonstrating that these activities actually pose additional risk.

The Proposal would impose higher risk weights on covered physical commodity assets and activities of an FHC under "complementary" authority and grandfather authority under Section 4(o) of the BHC Act. Under the Proposal, a "covered physical commodity" is defined as any physical commodity that is, or a component of which is, specifically named in certain Federal statutes, in particular: (i) the Comprehensive Environmental Response, Compensation, and Liability Act; (ii) the Oil Pollution Act; (iii) the Clean Water Act; and (iv) the Clean Air Act.[9]

The Proposal provides insufficient justification for imposing these higher risk weights and in particular does not ground the particular risk weights assigned for covered physical commodity assets and activities in the actual risks of these activities. The Federal Reserve has clear statutory authority to impose regulatory capital requirements on banking organizations.[10] However, in addition to establishing minimum capital requirements, a key focus of this authority is to "address the *risks* that the activities of [banking organizations] pose, not only to the institution engaging in the activity, but to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity" (emphasis added).[11] The Federal Reserve does not explain why it selected the particular risk weights for covered physical commodity assets and activities in the Proposal, other than provide general assertions about the risks that it believes are posed by these assets and activities. As one example, the Proposal would impose a 1,250 percent risk weight on physical commodities held by an FHC pursuant to Section 4(o) of the BHC Act held in excess of the 5 percent of tier 1 capital cap, even though the very same commodity, if it is treated as a covered physical commodity, would receive a 300 percent risk weight if held by an FHC pursuant to "complementary" authority. The Proposal does not explain this discrepancy in capital treatment or provide a justification for imposing drastically different risk weights for the same physical commodity.

In addition to the risk weights that would be imposed by the Proposal, the Federal Reserve states in the preamble to the Proposal that the increase in capital requirements on covered physical commodity activities, as a result of the Proposal, "would be in addition to any existing capital requirements relating to market risk or operational risk applicable

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9 A covered physical commodity would also include any physical commodity in a state statute or regulation that makes a party (other than a governmental entity or fund) responsible for removal or remediation efforts related to the unauthorized release of the substance or costs incurred as a result of the unauthorized release.

10 *See, e.g.*, 12 U.S.C. § 3907(a).

11 Dodd-Frank, Pub. L. No. 111-203, § 171(b)(7), 124 Stat. 1376, 1438 (2010).

to assets associated with physical commodity activities of an FHC."[12] Under the Federal Reserve's current risk-based capital regulations, all exposures to physical commodities are "covered positions" under the market risk rules and therefore are subject to risk-based capital requirements under the market risk rules, whether or not the exposures arise from "trading positions."[13] However, the Proposal does not propose an amendment to the definition of "covered position" in the market risk rules that would exclude covered physical commodity assets that would be subject to capital requirements in the Proposal and states that the capital requirements in the Proposal are in addition to market risk capital requirements. If the intended (though unstated) result of the Proposal is for capital requirements on these covered physical commodity assets to be subject to capital requirements under the market risk rules <u>in addition to</u> the more stringent risk-based capital requirements, this would effectively require greater than dollar-for-dollar capital for certain physical commodity positions. We are not aware of any precedent for imposing this level of capital requirements on any position and do not believe there would be any basis for imposing greater than dollar-for-dollar capital requirements. If implemented as proposed, the stringency of these capital requirements may make certain physical commodity activities economically impractical for FHCs and could drive FHCs out of some of these businesses altogether, which we believe is a decision that should be made by Congress.

III. The Federal Reserve should not revise the cap that currently applies to the total value of physical commodities that an FHC is permitted to hold under "complementary" authority under Section 4(k)(1)(B) of the BHC Act.

The Proposal would reduce the cap of 5 percent of tier 1 capital that current applies to the total value of physical commodities that an FHC is permitted to hold pursuant to "complementary" authority by generally requiring an FHC to include <u>all</u> physical commodity holdings of the FHC and its subsidiaries – including its depository institution subsidiaries – held pursuant to any other authority, subject to limited exceptions.

We are concerned that this cap may place further restrictions on activities of FHCs in physical and financial commodity markets and do not believe that it would be appropriate for the Federal Reserve to implement this limitation absent a compelling justification. The Federal Reserve does not provide any rationale in the Proposal for imposing tighter limits on activities conducted pursuant to complementary authority, other than a general and unsubstantiated concern for the various risks that it believes may arise from these activities. We respectfully request that the Federal Reserve undertake an analysis of the market effects of imposing this restriction on the relevant physical and financial commodity markets prior to implementation of any final rule.

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[12] 81 Fed. Reg. at 67,226.

[13] *See* 12 C.F.R. § 217.202 (defining "covered position" for purposes of the market risk rules as, among other things, a commodity position, whether or not the position is a trading asset or trading liability. A "commodity position" is defined under the market risk rules as a position for which price risk arises from changes in the price of a commodity. *See id.*

IV. The Federal Reserve should not rescind the previous authorizations of FHCs to engage in energy management services and energy tolling activities without making the proper determinations.

We believe that the Federal Reserve should not rescind the previous authorizations for certain FHCs to engage in energy management services and energy tolling activities pursuant to "complementary" authority and instead should harmonize this authority to permit all FHCs permitted to engage in physical commodity activities to engage in energy management services and energy tolling.[14] ISDA believes that these activities continue to be "complementary" to financial activities that are permissible for an FHC, which the Federal Reserve specifically found in its orders approving these activities. The findings in prior Federal Reserve orders that these activities enable FHCs to gain additional information about physical commodity markets and to engage in related financial activities with clients are still as valid today as when the orders were issued. Moreover, we understand that the majority of the agreements governing the provision of these services by an FHC expressly clarify that the FHC does not "control" the facility for which it serves as energy manager. We do not believe there is a valid justification for prohibiting FHCs from providing these services to power plants when an FHC may provide similar physical commodity trading services under complementary authority and the mere fact that certain FHCs have discontinued energy tolling and energy management services is an insufficient basis for rescinding its prior authorizations. Moreover, the Federal Reserve did not make a finding in the Proposal (or otherwise) that these activities pose undue risk to the safety and soundness of depository institutions or the financial system generally, which is the standard provided in the BHC Act for authorizing "complementary" activities.

V. The Federal Reserve should not implement the restrictions on copper activities engaged in by bank holding companies ("BHCs") absent a compelling justification.

The Proposal would remove copper from the list of metals that BHCs are permitted to buy, sell and store for their own accounts and for the accounts of others without limit and would also remove copper from the list of metals with respect to which a BHC may enter into derivative contracts that require taking delivery of the underlying metal as principal, in each case pursuant to Section 4(c)(8) of the BHC Act and the Federal Reserve's Regulation Y. Therefore, if the Proposal is implemented, these activities related to copper would require FHC status and "complementary" authority.

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[14] As described in prior Federal Reserve orders, energy tolling refers to entering into tolling agreements with power plant owners pursuant to which the FHC would pay the plant owner a fixed periodic payment that compensates the owner for fixed costs and, in return, the FHC would receive the right to all or part of the plant's power output. Energy management services refer to providing transactional and advisory services to power plant owners, in particular through acting as financial intermediary for the owner and substituting the credit and liquidity of the FHC for those of the owner to facilitate the owner's purchase of fuel and sale of power. *See, e.g.*, *The Royal Bank of Scotland Group plc*, 94 Fed. Res. Bull. C60 (2008).

BHCs are generally permitted to buy, sell and store precious metals (including gold, silver, platinum and palladium) and enter into derivative contracts that require taking delivery of metals as principal. The Federal Reserve cited as justification for removing copper from this list of metals that copper has been most commonly used as a base or industrial metal and not as a store of value.

However, the Proposal does not discuss the impact of these proposed revisions on the physical and copper financial markets and does not provide a compelling justification for these restrictions. Similar to the points raised in ISDA's comment letter on the OCC's proposal relating to copper, the Federal Reserve has not identified any risk factors with respect to transactions in copper that would warrant this change in market practice and has not identified any meaningful changes in the structure of nature of the copper markets.[15] The Proposal also does not address how the limitations that would be imposed on BHC involvement would affect the physical and financial copper markets, including any effects on end-users and consumers. We believe that it is important for the Federal Reserve to conduct an analysis of the effects on the copper markets of imposing this limitation, which should be analyzed in the context of the recent rulemaking from the OCC that repeals the authority of national banks and federal savings associations to participate in the copper markets.[16]

VI. The reporting provisions of the Proposal should be limited in light of concerns regarding competitive harm, and any reports on physical commodity activities that are required should be afforded confidential treatment.

The Proposal would require FHCs to produce detailed reports on physical commodity holdings and activities by modifying the Federal Reserve's FR Y-9C. These reports would include, among other things, a public report of the total fair value of certain categories of physical commodities held in inventory by the FHC and the total fair value of commodities owned by the FHC pursuant to "complementary" authority and grandfather authority.

ISDA believes that requiring FHCs to produce public reports with detailed information on physical commodity activities may raise certain competitive concerns. In particular, this type of granular information may be used by other market participants to engage in front running of physical commodity positions held by FHCs or other behavior that would be detrimental to the business strategies of FHCs in these markets.

In light of these concerns, we do not believe that it is appropriate to require that reports of physical commodity holdings and activities be publicly reported because this may disclose the confidential business strategy of the particular FHC. We appreciate that the Proposal provides the ability to request confidential treatment, but to the extent any

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[15] The comments submitted by ISDA on the OCC proposal can be accessed at the following link: https://www.regulations.gov/document?D=OCC-2016-0022-0005.

[16] *See* Industrial and Commercial Metals, 81 Fed. Reg. 96,353 (Dec. 30, 2016).

submission is required, we would request that it be given confidential treatment as a matter of rule (and not subject to regulatory discretion).

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ISDA appreciates the opportunity to provide these comments. If we may provide further information, please do not hesitate to contact the undersigned or ISDA's Head of U.S. Public Policy, Chris Young (cyoung@isda.org).

Sincerely,

Steven Kennedy
Global Head of Public Policy

cc: Board of Governors of the Federal Reserve System
Vanessa Davis and Kevin Tran, Supervisory Financial Analysts;
Will Giles, Counsel;
Constance Horsley, Assistant Director;
Elizabeth MacDonald, Manager;
Laurie Schaffer, Associate General Counsel;
Michael Waldron, Special Counsel;
Mary Watkins, Attorney

APPENDIX

Overview of Authority of Banking Organizations to engage in Physical Commodity Activities

1. <u>General BHC authority</u>

- BHCs and their subsidiaries, including BHCs that are not eligible for FHC status, are permitted to engage in certain physical commodity activities, in particular under the authority to engage in activities that are "so closely related to banking as to be a proper incident thereto" provided in Section 4(c)(8) of the BHC Act.

- Under Section 4(c)(8) of the BHC Act and the Federal Reserve's Regulation Y, BHCs are permitted to:

  1. buy, sell or hold precious metals (including gold, silver, platinum and palladium);

  2. participate as a principal in cash-settled derivative contracts based on commodities; and

  3. trade in commodity derivatives that allow for physical settlement under certain circumstances.[17]

2. <u>"Complementary" authority</u>

- The Federal Reserve has authorized certain BHCs that are FHCs to, on a case-by-case basis, engage in three different types of physical commodity activities pursuant to "complementary" authority under Section 4(k)(1)(B) of the BHC Act, enacted in the Gramm-Leach Bliley Act (the "**GLB Act**"),[18] subject to certain prudential limitations:

  1. Physical commodity trading, specifically the purchase and sale of commodities in the spot market and taking and making delivery of physical commodities to settle commodity derivatives;

  2. Energy tolling, pursuant to which the FHC provides fixed, periodic payments to power plant owners to compensate the owners for its fixed costs in exchange for the right to all or part of the plant's power output; and

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17 12 C.F.R. § 225.28(b)(8).

18 Pub. L. 106-102 (1999).

3. Energy management services, in which the FHC provides transaction and advisory services to power plant owners.

- Prudential limitations with respect to activities conducted under complementary authority include:

  1. A limitation on the aggregate market value of commodities held under physical commodity trading and energy tolling to no more than 5 percent of the tier 1 capital of the FHC;

  2. A cap on energy management services of no more than 5 percent of an FHC's consolidated operating revenues;

  3. Limiting physical commodity trading authority to only physical commodities approved by the CFTC for trading on a U.S. futures exchange unless specifically excluded by the Board or commodities the Board otherwise approves;[19] and

  4. A prohibition on an FHC owning, operating or investing in facilities that extract, transport, store or alter commodities and a requirement to hire third-party contractors to store, transport and otherwise handle the physical commodities that are reputable.

3. "Grandfather" authority

- The GLB Act permitted a company that was not a BHC prior to and becomes an FHC after November 12, 1999 to continue to engage in activities relating to the trading, sale or investment in commodities and commodity-related facilities that were not permissible for BHCs as of September 30, 1997, if the company was engaged in the U.S. in any such activities as of September 30, 1997, pursuant to Section 4(o) of the BHC Act.[20]

- Section 4(o) of the BHC Act permits "grandfathered" firms to engage in a broader range of activities than firms that are limited to "complementary" authority and are generally not subject to the prudential limitations that are applicable in respect of "complementary" authority. The two limitations imposed by Section 4(o) are:

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19 The Federal Reserve has also permitted FHCs to take and make physical delivery of a non-CFTC-approved commodity if the FHC demonstrated that (i) there is a market in financially-settled contracts on that commodity; (ii) the commodity is fungible; (iii) the commodity is liquid; and (iv) the FHC has in place trading limits that address concentration risk and overall exposure. *See, e.g.*, The Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60 (2008) (the "*RBS Order*").

20 Two firms are permitted to rely on Section 4(o) authority: Goldman Sachs and Morgan Stanley.

1. The activities are limited to no more than 5 percent of the total consolidated assets of the FHC; and

2. The FHC is prohibited from cross-marketing the services of its subsidiary depository institution(s) and subsidiary(ies) engaged in activities under Section 4(o) authority.

4. Merchant banking investments

- The GLB Act permits FHCs to engage in merchant banking activities, pursuant to which an FHC may invest in nonfinancial companies as part of a bona fide securities underwriting or merchant or investment banking activity, which may be made in any type of ownership interest and in any type of nonfinancial company, pursuant to Section 4(k)(4)(H) of the BHC Act.

- The GLB Act and implementing regulations promulgated by the Federal Reserve in Regulation Y impose certain prudential limitations on merchant banking authority, including that:

    1. An FHC is generally prohibited from engaging in routine management or operation of the portfolio company; and

    2. The FHC generally may not hold investments under merchant banking authority for more than ten years.