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Via electronic submission

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

Re: Notice of Proposed Rulemaking – 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:

I appreciate this opportunity to comment on the Notice of Proposed Rulemaking (“NPR”) referenced above. In my scholarly capacity, I have examined the legal basis for, the policy implications of, and the principal regulatory concerns in connection with the expansion of large U.S. financial holding companies (“FHCs”) into the purely commercial businesses of trading, producing, processing, storing, transporting, and marketing physical commodities.¹ I have testified in the U.S. Senate on these matters in July 2013 and November 2014. In April 2014, I submitted comments on the Advanced Notice of Proposed Rulemaking (“ANPR”) on the same subject.

To begin with, I would like to commend the Board of Governors of the Federal Reserve System (the “Board”) for tackling the critically important task of regulating, in a more targeted and coherent manner, FHCs’ activities involving physical commodities. As I have extensively argued before, such activities, especially when conducted on a large scale, implicate a number of public

¹ See, Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265 (2013); Saule T. Omarova, *Beyond Finance: Permissible Commercial Activities of U.S. Financial Holding Companies*, in AN UNFINISHED MISSION: MAKING WALL STREET WORK FOR US, A REPORT BY AMERICANS FOR FINANCIAL REFORM & THE ROOSEVELT INSTITUTE, ED. BY MIKE KONCZAL & MARCUS STANLEY (2013).

policy concerns underlying U.S. banking laws and regulations.² These include concerns about the safety and soundness of financial institutions and systemic risk associated with their commercial activities, potential leakage of the public subsidy beyond the banking sector, market integrity and consumer protection, and excessive concentration of economic and political power in the hands of financial conglomerates. In addition, there are serious reasons to doubt the actual capacity of large FHCs and financial regulators to monitor and effectively control potential risks posed by these activities – which raises a number of policy issues under the general rubric of “governability.”

In November 2014, the U.S. Senate Permanent Subcommittee on Investigations released a comprehensive report detailing and discussing many instances of risky, inefficient, and abusive behavior on the part of U.S. FHCs in the course of their physical commodities activities.³ The report provides ample evidence that the policy concerns listed above are not mere abstractions: they give expression to very real problems and dysfunctions in U.S. financial markets and economy at large. It is, therefore, a matter of utmost public importance that the Board, as the umbrella regulator of U.S. FHCs, address all of these concerns explicitly, effectively, and comprehensively.

The Board’s present rulemaking initiative is a welcome – and long overdue – step in the right direction. I urge the Board to bring that important effort to its full fruition. To that end, I respectfully recommend strengthening the substance and ultimate risk-reducing potential of the proposed rulemaking (“Proposed Rule”) by

- (1) expanding the scope of “covered physical commodities” subject to the Proposed Rule’s conditions, restrictions, and prohibitions;
- (2) clarifying and tightening restrictions on FHCs’ “complementary” authority to conduct physical commodities operations;
- (3) narrowing the scope of permissible “grandfathered” commodity assets and activities under Section 4(o) of the Bank Holding Company Act of 1956 (the “BHCA”); and
- (4) mandating more detailed and comprehensive quantitative and qualitative disclosures of FHCs’ physical commodity activities and assets.

Each of these recommendations is briefly elaborated below.

A. The scope of “covered physical commodities” should be expanded

One of the principal shortcomings of the Proposed Rule is the artificially narrow scope of the proposed definition of a “covered physical commodity,” which is limited to a short list of certain

² For a detailed discussion of each of these policy concerns, see sources cited *supra* note 1.

³ See, U.S. Senate Permanent Subcommittee on Investigations, “Wall Street Bank Involvement with Physical Commodities: Vols. 1-2” (Nov. 2014), available at <https://www.hsgac.senate.gov/subcommittees/investigations/hearings/wall-street-bank-involvement-with-physical-commodities-day-one>.

hazardous substances that carry “the greatest potential liability” under specific Federal environmental laws.⁴ As a result of this narrow definitional choice, many of the key substantive provisions of the Proposed Rule – including the proposed capital surcharges on commodities assets – apply only to a fraction of FHCs’ present and future commodities operations.

This approach reflects the Board’s primary focus on potential safety-and-soundness risks posed by FHCs’ physical commodity operations prone to environmental accidents. While it is a critically important risk that must be addressed by the Board, narrowing the scope of “covered physical commodities” in this manner unnecessarily limits the practical impact of the Proposed Rule. There is no principled reason for not applying special capital surcharges or other regulatory constraints to FHCs’ activities involving industrial metals (such as, e.g., copper or aluminum), agricultural commodities, electricity, or any other physical commodity that serves as a productive input or a consumption staple. In fact, markets for some of these “non-hazardous” commodities have already experienced the distortive effects of large FHCs’ operations, including artificial disruptions in supply and unjustified increases in wholesale and consumer prices.⁵ Thus, in order to impose effective regulatory controls on the entire spectrum of systemically relevant risks posed by banking organizations’ physical commodities activities, the Proposed Rule’s key operative provisions should explicitly apply to all physical commodities.

B. Restrictions on FHCs’ “complementary” authority to conduct physical commodities operations should be clarified and strengthened

I support the Proposed Rule’s stated intent to codify and strengthen the long-standing regulatory prohibitions on owning, operating and investing in facilities for transportation, storage, or distribution of commodities as activities “complementary” to FHCs’ permissible financial activities. To the extent, however, that the Proposed Rule seeks to ensure that FHCs are not found to “operate” any entity for the purposes of Federal and state environmental laws, the scope of its prohibitions remains indefensibly narrow.

To impose effective limits on FHCs’ complementary powers, the Proposed Rule should contain broader prohibitions on FHCs’ ability to manage, direct, conduct, or provide advice regarding business operations of entities engaged in physical commodities business. These prohibitions should not be limited to the narrow band of “management and operational decisions” related to the relevant entity’s compliance with environmental laws and regulations. To keep FHCs out of the risky commodities logistics business, the Board should address directly the ever-present

⁴ The NPR specifically refers to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”), the Oil Pollution Act of 1990 (“OPA”), and the Clean Water Act (“CWA”).

⁵ See e.g., U.S. Senate Permanent Subcommittee on Investigations, *supra* note 3, Vol. 1, at 201-268 (analyzing Goldman Sachs’ activities in the aluminum market); 374-435 (analyzing JPMorgan’s activities involving electricity and copper).

potential for replication of direct “ownership and operation” through contractual means⁶ and/or through provision by FHCs’ of strategic business and financial advice to ostensibly independent commodities firms. Limiting FHCs’ practical ability to control or significantly influence the conduct of business by companies that transport, process, and distribute physical commodities is critical not only for the Proposed Rule’s stated purpose of shielding FHCs’ from environmental liability but also – and far more importantly – for the purposes of safeguarding the integrity of the financial markets and the underlying commodity markets.⁷ The Proposed Rule should explicitly reflect that fundamental understanding.

C. The scope of permissible “grandfathered” commodity assets and activities under Section 4(o) of the BHCA should be expressly limited

The Proposed Rule should clarify and limit the scope of the special “grandfather” authority in Section 4(o) of the BHCA. Given the plain language and legislative history of this provision, as well as the overall structure and purposes of the U.S. bank holding company regulation, it would be entirely reasonable and consistent with the public interest to interpret Section 4(o) as allowing relevant FHCs to continue conducting only those physical commodities activities and owning only those physical commodity assets they conducted or owned prior to September 30, 1997.

D. FHCs’ physical commodities activities should be subject to more detailed and comprehensive quantitative and qualitative disclosure requirements

Lack of transparency and inadequate public data collection with respect to FHCs’ physical commodities activities significantly undermine the Board’s and other government agencies’ ability to monitor, regulate, and supervise such activities. The Proposed Rule correctly seeks to remedy this problem by requiring more detailed disclosures of the fair market value of FHCs’ physical commodity inventories and certain other information. However, to provide regulators and the American public with a fuller picture of FHCs’ role in, use of, and impact on physical commodities markets, the Proposed Rule should establish a more comprehensive and rigorous system of mandatory quantitative and qualitative disclosure of FHCs’ physical commodities activities.

In particular, the Board should require each FHC to provide a detailed qualitative narrative of the entire complex of its operations and assets involving, or related to, physical commodities. As part of this narrative, FHCs should be required to identify and discuss specific organizational, informational, and financial links and inter-dependencies between their specific physical commodities businesses and other business activities they conduct or seek to conduct (including

⁶ Such contractual means include various exclusive or nearly exclusive arrangements (such as, e.g., supply-and-offtake agreements) that give an FHC *de facto* control over an ostensibly independent commodity firm’s productive inputs or output, and thus functionally replicate ownership of that firm’s facilities by the FHC.

⁷ For a detailed articulation of the nature and significance of the public interest in safeguarding the integrity of the nation’s financial and commodity markets, avoiding or minimizing conflicts of interest on the part of financial institutions engaged in physical commodity businesses, and preventing excessive concentrations of economic and political power in the hands of *de facto* financial-industrial conglomerates, see sources cited *supra* note 1.

commodity derivatives activities). On a commodity-by-commodity basis, each FHC should be required to disclose and discuss how big or how important a player it is in the market for such commodity, who its major clients and competitors are, what other business dealings it has or plans to have with such clients and competitors, whether or not it is also active in any adjacent or related market, and how it finances those activities. These are just a few examples of enhanced disclosure requirements the Board should mandate for all FHCs conducting physical commodities activities.⁸

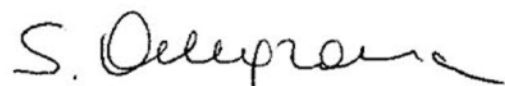
It is critical that any mandatory disclosure requirements under the Proposed Rule explicitly apply to and encompass FHCs' physical commodity assets and activities held or conducted pursuant to their merchant banking authority. The putative operational difficulty of collecting information from portfolio companies is not a sufficient excuse for denying the Board and other regulators a meaningful look into this potentially significant part of FHCs' commodities businesses. Forcing FHCs' managers to keep better track of, and publicly account for, FHCs' business and financial relationships with portfolio companies would improve both the quality of FHCs' internal management and the effectiveness of supervisory assessment of their compliance with the statutory and regulatory restrictions on FHC-permissible merchant banking activities.

* * *

In conclusion, I would like to reiterate my enthusiastic support for the Board's rulemaking effort and its resolve to reduce the risks posed by FHCs' involvement in physical commodity markets.

I hope you find my letter helpful. Please feel free to contact me if you have additional questions.

Sincerely,



⁸ It should be left to the Board's discretion to decide which types of information provided by individual FHCs pursuant to these disclosure requirements would be made publicly available and which would be kept confidential.