National Association of Corporate Treasurers
11130 Sunrise Valley Drive – Suite 350
Reston, VA 20191
www.nact.org

February 20, 2017

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

Via Agency Website

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; RIN7100 AE58]***

The undersigned end-user companies ("End-Users") and associations representing end-users are pleased to respond to the request for comments by the Board of Governors of the Federal Reserve System (the "Board") on its Notice of Proposed Rulemaking relating to the physical commodities activities conducted by financial holding companies (the "Proposed Rule").[1]

I. Introduction

End-users employ physical commodities and commodity-based derivatives to manage risks related to their global commercial activities. Our use of derivatives limits risk – rather than creating it. Hence, we implore the Board to be careful not to make it more difficult or more expensive for us to achieve risk-mitigation through the careful use of commodities-related derivatives. Although we appreciate the Board's continued oversight of the U.S. financial system, we believe that certain aspects of the Proposed Rule will have unintended consequences on our ability to efficiently and effectively manage risk.

We are very concerned that the Proposed Rule's new restrictions on the commodity activities of financial holding companies ("FHCs") and their affiliates will artificially restrict competition in

[1] Notice of Proposed Rulemaking, *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. 67220 (Sept. 30, 2016) [hereinafter the "Proposed Rule"].

and sap innovation and creativity from these markets while fueling market instability. We also fear that reduced competition will result in lessened market liquidity and higher prices for the commodities and commodity-related products on which we depend, hampering our ability to compete and threatening higher prices for our customers. In addition, we believe that any new restrictions or onerous conditions on FHCs will benefit unregulated market participants, heighten the risk of abusive market practices, and increase risk in the financial markets. Risk-reduction in these markets contributes significantly to our continued growth, as well as the health and stability of the real-world economy. This in turn contributes to continued growth, additional jobs, and the success of Main Street America.

II. The Proposed Rule Threatens Increased Risks and Costs for End-Users and the Financial Markets

As end-users of physical commodities and commodity-derivatives, we wish to emphasize that, like markets generally, the commodities markets benefit from robust competition. As previously noted in the Advanced Notice of Proposed Rulemaking, 14 FHCs are currently authorized to engage in physical commodities activities, either under Section 4(k) or Section 4(o) of the BHCA.[2] These FHCs are sophisticated participants in the commodities markets, and, with respect to commodity derivative activities, have engaged in cash-settled derivatives transactions well before physical trading activities were approved for FHCs in 2003. As a result, these FHC participants have substantial market knowledge, and they use their expertise to tailor commodity products efficiently to customer needs, including our specific needs. FHC market expertise is particularly important in the case of physically settled OTC derivative contracts, which are essential to our hedging strategy.

A. The Proposed Rule would increase market concentration

Increased regulation and scrutiny on the activities of FHCs have prompted a reduction in the number of banks willing to transact in this space. Indeed, since the Financial Crisis, there has been a pullback by banks in the United States from the commodities markets: JPMorgan Chase, Barclays, and Deutsche Bank, for example, have all reduced their commodities activities. The Proposed Rule would further fuel the exodus of end-user counterparties and further concentrate risk within the financial markets. In particular, we would point to two aspects of the Proposed Rule that would push FHCs out of the commodities business: (1) increased risk weighting for Section 4(o) and Section 4(k) FHCs and (2) the restriction of Section 4(k) complementary authority.

The punitive risk weighting assigned by the Board to physical commodities held by FHCs under Section 4(o) authority is unwarranted and unjustified. For example, under the Proposed Rule, if an FHC held $500 million in Section 4(o) exclusive assets, those assets would be subject to the 1,250% risk-weighting and the FHC would be required to hold $625 million in total capital

[2] Advance Notice of Proposed Rulemaking, *Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities*, 79 Fed. Reg. 3329 (Jan. 21, 2014).

against the assets in order to remain well-capitalized (i.e., the minimum well-capitalized calculations would convert the assets into risk-weighted assets of $6.25 billion, thus requiring $625 million in total capital for a 10% Total Capital/RWA ratio). By means of comparison, the 1,250% risk-weighting, the highest risk-weighting that can be assigned to an asset, was designed for only the riskiest of bank exposures (e.g., securitization exposures, where an FHC is not able to demonstrate a comprehensive understanding of the potential losses that could result from a default on the securitization). Rather than reducing systemic risk, the Proposed Rule fails to justify the use of such punitive risk-weightings and, instead, appears to be designed to push still more FHCs out of the market and force Section 4(o) reliant FHCs to be engaged only in activities that are eligible under the more restrictive Section 4(k) authority.

However, FHCs will likely find little relief under complementary authority provided under Section 4(k) in order to continue to hold physical commodities. To further push out FHCs from commodities activities, the Proposed Rule imposes additional restrictions on Section 4(k). Under the National Bank Act, an FHCs national bank subsidiary can hold physical commodities in an amount equal to 5% of its total notional value of its derivatives in that particular commodity. The Proposed Rule would limit an FHCs derivatives activities by now counting it towards the 5% ofTier 1 capital that the Board has imposed under Section 4(k).

The Board itself has noted that FHC involvement in physical commodities has declined since the Financial Crisis. The Proposed Rule would further exacerbate this problem by making physical commodities activities under both Section 4(o) and Section 4(k) commercially inviable, which would effectively push FHCs out ofthe market and increase market concentration in a handful of less-resilient and less-supervised institutions, who offer a less-sophisticated and less-customized array of products. Commercial end-users rely on large institutions, such as FHCs, to efficiently manage costs and their commercial risks. Market concentration in less-sophisticated or less-resilient institutions, however, has the potential to restrict competition and increases prices for Main Street America.

B. The Proposed Rule ignores the benefits FHCs provide to end-users

As an end-user of commodities derivatives, we rely on sophisticated counterparties that understand our unique commercial risks. Moreover, the size and stability of FHCs, coupled with their ability to deal in physical commodities, offer economies of scale that allow for highly tailored and affordable derivatives products. The Proposed Rule would undermine such synergies and add additional challenges to companies that serve the real-world economy.

We are concerned that, especially in the markets for customized commodity products, a retreat by FHC affiliates will lead to greater market illiquidity and higher prices. To the detriment of end-users, these FHCs would not be able to maintain their critical intermediary roles in the commodities markets. The lack of competition—with a resulting concentration of risk—would almost assuredly increase costs for end-users as they search for new intermediaries with which to transact.

Market liquidity would suffer because FHC affiliates are frequently the most knowledgeable participants and the most willing to enter into customized trades, and there are few potential new market entrants who can replace them. In particular, end-users would likely find non-bank counterparties to be unable to enter into long-term transactions or to offer a range of financial solutions, as certain products essential to end-user operations are generally only available from banks. Additionally, reducing the number of market participants threatens higher prices because end-users like us will have fewer firms from which to request price quotations. If reduced market liquidity harms our ability to hedge our commodity risks, our overall financial performance will suffer.

In addition, the lack of true competition in the markets in which we operate will lead to higher prices for the physical commodities we use and higher overall costs for our commodity-based derivatives transactions. Both we and our customers will be harmed by these higher market prices. We will be required to allocate more of our capital to paying the remaining market participants for needed products and services, and not be able to use capital for more efficient purposes such as investing in our business infrastructure. Restricting the ability of FHCs to engage in physical commodity activities, therefore, likely would produce "decreased or unfair competition," and an "undue concentration of resources" in the remaining participants in the commodities markets, and thereby result in a loss of market efficiency.[3]

C. The Proposed Rule opens the door to unregulated market participants and ignores the general stability FHCs afford the financial markets

With the continued exodus of FHCs from the commodity-based derivatives market, we will likely find ourselves having to transact with less-resilient and less-regulated non-bank counterparties, who offer a less-sophisticated and less-customized array of products, and who are often located outside the United States.[4] Many end-users will be forced to construct their own hedge of forward prices by committing to more costly and riskier fixed-price, long-term purchase contracts with a non-bank commodity supplier. Under the Proposed Rule, the non-bank commodity supplier would be forced to bear both the supply and price risks—under current practice, FHCs serve as intermediaries and temper price risks by entering into separate commodity-based derivatives. The additional risks that would be borne by non-bank commodity suppliers are of particular concern to end-users, as these entities could well be privately owned companies with no obligation under law or regulation to disclose details of their financial

---

[3] Under Section 4(k) of the BHC Act, the Board, in determining whether an activity is complementary to a financial activity, is to determine whether performance of the activity by the FHC may reasonably be expected to produce public benefits, "such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the U.S. banking or financial system." 12 U.S.C. § 1843(j)(2).

[4] With the departure of bank counterparties from the U.S. market, many less regulated non-bank firms have stepped in to fill the gap: Mercuria Energy Group, Noble Group, Glencore, Cargill, Louis Dreyfus, Castleton Commodities International, Vitol, and Trafigura.

condition. For example, a foreign commodity supplier's operations and creditworthiness might not be regulated, or may be, but inadequately so.

In contrast, not only are the FHC affiliates that engage in commodities activities subject to comprehensive consolidated supervision, but the FHCs themselves are among the most highly regulated FHCs in the world. The supervision and regulation of globally systemically significant financial institutions have increased markedly both in the United States and abroad since the Financial Crisis. In addition, under both Section 4(k) and Section 4(o) of the BHCA, physical commodities activities are subject to hard limits on the size of those activities—they may not grow beyond 5 percent of the FHCs consolidated Tier 1 capital or consolidated assets, depending on the legal authority.

In our view, the current overall regulatory scheme affecting the largest FHCs—heightened prudential regulation combined with the size limits mentioned above—is a better protection against the risks of "interconnectedness" and contagion than anything that exists in the unregulated space. The most obvious alternative providers of physical commodities services, the largest commodity firms, are undiversified businesses. It is far more likely that a "tail risk" event affecting the commodities industry would call into question the stability of firms highly concentrated in that industry, rather than diversified financial institutions where commodities activities are only one of many business lines. As a result, restricting FHC legal authority would result in less well-capitalized, less well-rated and less financially transparent commodities market participants.

D. End-user start-ups will suffer the most adverse effects.

The Proposed Rule also has the potential to stifle innovation and growth among end-user start-ups. Typically, financing arrangements for new and growing end-users are structured so that bank lenders, such as FHCs, have a security interest in the end-users' pledged assets. The physical commodities and equity held by end-users serve as the cornerstone to their financing and risk mitigation solutions. The Proposed Rule would disrupt such arrangements, increase costs, and curtail growth for these end-users.

The exodus of FHCs from commodities activities will force end-user start-ups to find risk mitigation solutions with non-bank counterparties. This is problematic because these end-users rely heavily on security-based financing, and to implement hedging strategies with non-bank counterparties, end-user start-ups would have to undergo costly renegotiations with their bank lenders to allow for the non-bank counterparty to join in the pledge of assets. The subsequent dilution of the end-user's asset coverage ratio—a metric used in financing arrangements for start-up companies—as a result of the inclusion of the non-bank counterparty, would result in less favorable lending terms and a possible decrease in the end-user's credit rating. In contrast, larger end-users with higher credit standings typically do not have to satisfy an asset coverage test, but rather are judged on their cash flow coverage. As a result, end-user start-ups would disproportionately bear the downstream burdens of the Proposed Rule.

Restrictions on FHC participation may also stifle end-user start-ups due to a possible increase in demand for cash collateral. For the FHCs that choose to remain in commodities markets, the Proposed Rule would likely force them to offset additional funding requirements with cash-based collateral. As new and growing end-users are typically illiquid, a shift from commodities-based to cash-based collateral could cripple their ability to economically manage risk. Capital that could otherwise be reinvested into end-user growth and innovation would instead be diverted to cover commercial risks.

The Proposed Rule's effective reallocation of capital during the infancy of a business unnecessarily creates a new problem for the end-user start-up by forcing it to choose between growth or risk management; a needless problem when currently the use of commodities-based collateral allows end-users to accomplish both. To encourage real-world growth, the Board must consider the downstream effects the Proposed Rule would have on end-users.

III. Conclusion

For the foregoing reasons, imposing additional restrictions or limitations on the physical commodity activities of FHC affiliates would be harmful to end-users and should be reconsidered. We would urge the Board not to proceed with further rulemaking and to maintain the conditions that currently apply to FHC commodity activities.

* * * * *

We appreciate the opportunity to provide comments on the Board's Proposed Rule and look forward to working with the Board as it continues to consider this important issue. We also appreciate the Board's efforts to implement requirements that serve to strengthen the derivatives markets without unduly burdening end-users and the economy at large.

Thank you for your consideration of these very important issues to commercial end-users. Please contact Michael Bopp at 202-955-8256 or at mbopp@gibsondunn.com if you have any questions or if you would like to discuss our comments in more detail.

Respectfully submitted,

Thomas C. Deas, Jr.
Chairman
National Association of Corporate Treasurers

End-User Companies & Trade Associations

Accuride Corporation

Air Products and Chemicals, Inc.

American Investment Council

Ball Corporation

The Boeing Company

BP

FMC Corporation

General Electric Company

Harley-Davidson, Inc.

The Hershey Company

Honeywell International

National Association of Corporate Treasurers

NextEra Energy Resources LLC

Northern Virginia Electric Cooperative

Orbital ATK, Inc.

Southwest Airlines Co.