TrailStone Group
2901 Via Fortuna Drive, #125
Austin, Tx. 78746

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December 22, 2016

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

Re: Comment to 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 (Docket No. R-1547; RIN7100 AE58)

TrailStone Group ("TrailStone") respectfully submits this letter in connection with the Board of Governors of the Federal Reserve System's (the "Board") Notice of Proposed Rulemaking (the "NOPR") regarding the physical commodities activities conducted by financial holding companies ("FHCs").[1] We are submitting this comment because our business both relies on FHC market making functions and regularly transacts with FHC counterparties in physically settled commodity transactions to support our operations.

The NOPR ignores the many benefits that FHCs provide to the physical commodities market, and we remain concerned that the Board has not fully considered the impact additional regulation in this area will have on commodity market liquidity, depth, and transparency. Although we appreciate the Board's continued oversight of the U.S. financial system, we believe that certain aspects of the NOPR will have unintended consequences on our business. We are concerned that the NOPR's new restrictions on the commodity activities of FHCs and their affiliates, in their totality, would fuel market instability for the commodity-related products on which we depend, hamper our ability to compete and threaten higher prices for our business. To ensure continued growth of commodities-based businesses, we respectfully request that the Board reconsider the downstream effects and costs the NOPR may have on market participants and revise the NOPR accordingly.

1. Background on TrailStone

TrailStone is an asset-backed trading and logistics company with in-depth experience in mining, oil and gas investment and finance, energy asset management, energy logistics and trading. We were founded with the belief that significant commercial optimization can be achieved when production assets are paired with storage, transportation and demand.

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[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 "NOPR"].

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Our asset management services enable us to co-operate with producers and consumers to provide certainty, continuity and stability for their energy requirements. This includes investing directly in asset ownership, partnership or lease in the delivery system of commodities, focusing in particular on power plants, processing plants, refineries, shipping, rail, pipeline and transmission capacity, terminals and storage. For example, our acquisition of US Oil and Refining Company, based in Tacoma, Washington, requires the use of numerous hedging and other commodities-based derivatives products to successfully leverage the benefits of an oil refinery with best-in-class rail, pipe, marine and truck logistics in the Pacific Northwest.

Our physical trading, logistics, and optimization services help to address the physical, financial and risk management aspects of our ventures in the energy, metals and agricultural commodities markets. In gas and power this means managing price and volume risk on very short timescales on a continuous basis.

2. The NOPR Will Reduce Market Depth

We are concerned that the NOPR would further decrease overall market depth. Increased regulatory burdens and scrutiny on the activities of FHCs have prompted a reduction in the number of banks willing to transact in physical commodities.[2] 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 NOPR would further fuel the exodus of FHC counterparties within the financial markets due to: (1) increased risk weighting for Section 4(o) FHCs and (2) the restriction of Section 4(k) complementary authority.

The NOPR would effectively push out FHC market-makers by rendering Section 4(o) uneconomical. The risk weighting assigned by the Board to physical commodities held by FHCs exclusively under Section 4(o) authority is punitive and is an overreaction to the risks it seeks to address. In particular, we are concerned that a 1,250% risk weighting for these Section 4(o) exposures would needlessly force FHCs to retain more in total capital than the actual value or risk of the exposure in order to meet well-capitalized status. A $100 million Section 4(o) asset would require the FHC to hold $125 million in total capital to maintain a 10% Total Capital/RWA ratio. Rather than reducing systemic risk, the NOPR has been designed to push FHCs out of the market by rendering Section 4(o) impractical and uneconomical and force FHCs to rely on more restrictive Section 4(k) authority.

Compounding this problem is the fact that the NOPR would further limit FHCs' ability to rely on Section 4(k) complementary authority. Assets held under Section 4(k) would be further limited in total asset size and assigned a 300% risk weighting. Currently, an FHC's national bank subsidiary can hold physical commodities in amount equal to 5% of its total notional value of its derivatives in that particular commodity. The NOPR

[2] The Advanced Notice of Proposed Rulemaking notes that 14 FHCs are currently authorized to engage in physical commodities activities, either under Section 4(k) or Section 4(o) of the BHCA. *See* 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).

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would limit an FHC's derivatives activities by now counting it towards the 5% of Tier 1 Capital that the Board has imposed under Section 4(k).

The practical implications of the NOPR and the real possibility of a market with limited FHCs would adversely affect TrailStone by reducing the number of sophisticated parties in which we rely on to efficiently hedge, finance and otherwise transact within the commodities market.

3. The NOPR Will Reduce Liquidity, Price Convergence and Market Solutions.

As a market participant in physical commodities and commodity-based derivatives, we wish to emphasize that efficient markets require depth, competence and narrow pricing spreads. We are registered and active in most North American and European commodity exchanges, and in accessing these markets we are deeply active in both physical and financial trading. Although we engage in many transactions similar to FHCs, we rely on FHCs to serve as market makers. We are concerned that, especially in the markets for highly-customized commodity products, a retreat by FHC affiliates will lead to greater market illiquidity, greater price variation and a reduction in market solutions.

A. The NOPR Will Reduce Liquidity

The current participation of FHCs and their affiliates as market-makers in physical commodities increases the liquidity of the market, reduces bid and ask pricing, increases the overall volume of commodities products, and reduces price volatility. By facilitating the exchange of physical commodities, FHCs help to stabilize commercial growth by providing a mechanism in which businesses can manage their short- and long-term inventory needs. The NOPR, however, would drastically reduce an FHC's ability to provide such services by increasing funding costs and limiting their reliance on Section 4(k). As FHC affiliates are frequently the most knowledgeable, most willing and most equipped participants to enter into market-necessary customized trades, we will likely experience a drastic reduction in the volume and variety of commodities-based products.

B. The NOPR Will Reduce Price Convergence

As market participants and operators of physical commodity ventures, we rely on accurate and efficient pricing of physical commodities. Unlike other financial products, commodity instruments are directly related to the physical product itself. Under the current regulatory authority of Section 4(o) and Section 4(k), the volume of commodities-based transactions by FHCs help to reduce any inefficiency in the market by better converging prices of the financial instrument and the correlating physical commodity.

The NOPR, however, ignores this critical function and instead would increase price differentiation between the physical and financial asset. This would have a noticeable impact to companies, like us, that deal in both physical commodities and their associated financial instruments. Moreover, the elimination of FHC involvement within this market would subject us and end-users to increased risks due to price differences and market arbitrage.

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C. <u>The NOPR Will Reduce Market Solutions</u>

Although many have posited that non-bank counterparties can fill any vacuum, only FHCs can provide practical market solutions to transparency, bid/ask pricing, and the tenor in which market participants need. We believe that non-bank counterparties will be unable to replace FHCs in their entirety.

In particular, we would note that many non-bank institutions, when compared to FHCs, lack the capital necessary to engage in large trades; do not provide the economies of scale and cost-savings; tend to focus on niche areas of the commodities market (e.g., dealing only in certain commodities); cannot provide a one-stop financing and hedging solution; are relatively less sophisticated; and most importantly, will likely only engage in this space to meet their discrete needs.

In contrast, FHCs are sophisticated institutions that serve as critical intermediaries with interests in both the buy and sell side of the commodities market. Among other benefits, FHCs are large enough to operate across the market, provide depth and transparency to less opaque commodities (e.g., coal), are better equipped to tailor products to individual companies, provide financing solutions for commodity rich businesses, and provide an economical venue in which to hedge commodities risks. For example, our affiliate, Talon Energy, relies on lien-based derivatives contracts to hedge their commercial risks. Under these arrangements, Talon Energy is able to effectively manage its commercial risks by posting physical commodities, in lieu of cash, as collateral to its hedging activities. Without the use of physical commodities as collateral, Talon, would be unable to effectively manage risk, due to the quantum and cost of cash-collateral requirements.

4. Conclusion

For the foregoing reasons, imposing additional restrictions or limitations on the physical commodity activities of FHC affiliates would be harmful to market participants 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.

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Thank you for your consideration of our comments to the Board's NOPR. We look forward to working with the Board as it continues to consider this important issue.

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Please contact Troy Martin if you have any questions or if you would like to discuss our comments in more detail.

Respectfully submitted,

Troy Martin
Senior Partner & Chief Operating Officer
TrailStone Group