December 22, 2016

Sent via email to regs.comments@federalreserve.gov

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

Re: **Docket No. R–1547, RIN 7100 AE–58**
Proposed Rule on Holding Company Involvement with Physical Commodities

Dear Mr. Secretary:

The purpose of this letter is to express strong support for the proposed rule issued by the Board of Governors of the Federal Reserve System ("Board" or "Federal Reserve Board") to create additional safeguards for physical commodity activities at financial holding companies.[1] The Federal Reserve Board is to be commended for tackling important components of this high-risk area.

In addition to supporting the Proposed Rule, this letter respectfully recommends strengthening it by: (1) clarifying and simplifying the definition of "covered physical commodities" by including a short list of the key commodities intended to trigger the higher capital requirements; (2) making it clear that the proposed new safeguards seek to mitigate catastrophic event risks that arise, not only from violating environmental laws, but also from violating safety laws; (3) clarifying regulatory expectations related to insurance; (4) clarifying that the authority to engage in spot market buying and selling of physical commodities does not extend to transactions that are unconnected to any commodity-related financial derivative or financing arrangement; and (5) acknowledging and resolving existing disagreements over the scope of the grandfather clause.

Factual Foundation for the Proposed Rule

The Proposed Rule is the product of several reviews documenting significant risks associated with financial holding companies buying and selling billions of dollars in physical commodities and exercising control over multiple businesses that handle physical commodities.

Special Federal Reserve Review. One key review providing an important factual foundation for the Proposed Rule is a special multi-year inquiry conducted by personnel at the Federal Reserve Bank of New York and the Federal Reserve Board into physical commodity

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[1] "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," rule proposed by the Federal Reserve Board, 80 Fed. Reg. 190, at 67220 (9/30/2016) (hereinafter "Proposed Rule").

activities at U.S. financial holding companies. The review was initiated in the aftermath of the 2008 financial crisis, when one key issue to emerge was the need to identify and mitigate hidden risks posed by unexamined activities at the largest financial holding companies operating in the United States.

In response, in 2009, the Federal Reserve System revamped its risk governance system, replacing its Large Financial Institution section with a new Large Institution Supervision Coordinating Committee (LISCC). The LISCC was staffed with senior Federal Reserve supervisory personnel, economists, quantitative analysts, and other experts who were charged with taking a multidisciplinary approach to identifying and analyzing risks affecting systemically important financial institutions and the global banking system. Among other actions, the LISCC established a Risk Secretariat to identify key risks, set priorities for investigating them, and allocate resources needed for those investigations. In 2009, after weighing various investigative priorities, the Risk Secretariat identified financial holding company involvement with physical commodities as a major emerging risk and approved a special review of those activities.[2]

To conduct the review, the Risk Secretariat authorized formation of a Commodities Team based at the Federal Reserve Bank of New York. Over the following three years, the Commodities Team examined physical commodity activities at multiple financial institutions. The review documented an unprecedented level of financial holding company involvement with energy, metal, and agricultural commodity markets. It also identified and analyzed numerous risks associated with those activities, including operational risks, poor risk management, insufficient capital and insurance, legal risks, and ineffective regulatory safeguards. In 2012, the review produced a written summary of its findings and offered recommendations to reduce the risks associated with financial holding company involvement with physical commodities.[3] The review's recommendations included better reporting and monitoring of physical commodity activities, increased capital requirements, enhanced risk management within financial institutions, and clarification of permissible activities.[4]

Two years later, in 2014, the Federal Reserve Board issued a notice of advanced rulemaking that solicited comments from the public on possible new safeguards to ensure physical commodity activities conducted by financial holding companies were conducted "in a safe and sound manner and consistent with applicable law."[5] The notice generated over 17,000 responses. This Proposed Rule followed two years later.

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[2] For more information about LISCC and the special Federal Reserve review, see "Wall Street Bank Involvement with Physical Commodities," U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 113-501, (11/20-21/2014), Volume 1, at 439-461, https://www.gpo.gov/fdsys/pkg/CHRG-113shrg91522/pdf/CHRG-113shrg91522.pdf.

[3] Id., quoting passages from "Physical Commodity Activities at SIFIs," prepared by the Federal Reserve Bank of New York Commodities Team (10/3/2012), FRB-PSI-200477-510 (sealed exhibit).

[4] Id. at 459-460.

[5] "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities," 79 Fed. Reg. 13, at 3329 (1/21/ 2014).

Section 620 Report. A second factual foundation for the Proposed Rule is a 2016 report prepared by the Federal Reserve Board and other U.S. bank regulators under Section 620 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 620, which was authored by Senators Jeff Merkley and Carl Levin, required federal banking regulators to conduct a study of the activities and investments that banking entities, including financial holding companies, are permitted to undertake. It also directed the regulators to send Congress a report: (i) addressing whether those activities or investments have or could have a negative effect on the safety and soundness of the banking entities or the U.S. financial system, (ii) discussing the appropriateness of the activities or types of investment by banking entities, and (iii) recommending additional restrictions as may be necessary to address risks to safety and soundness arising from the permissible activities or types of investments.

In September 2016, the Federal Reserve Board, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency released a joint Section 620 report.[6] The portion of the report prepared by the Federal Reserve Board included information about financial holding company activities permitted under the Gramm-Leach-Bliley Act as "complementary" to their financial activities, "merchant banking" investments, or authorized under the so-called "grandfather clause" in Section 4(o) of the Act, focusing on physical commodity activities.

In the Section 620 Report, the Federal Reserve Board recommended that, to reduce existing risks in the banking system, Congress repeal both the merchant banking authority and grandfather clause.[7] The Federal Reserve Board explained that repealing both provisions would:

- "better align the activities and investments of, as well as the regulatory and supervisory framework governing, regulated financial institutions and corporate owners of insured depository institutions";
- "create a more level playing field among regulated financial institutions and owners of insured depository institutions";
- "limit the commercial activities of banking entities and, as a result, help to enhance safety and soundness,"
- "minimize the concentration of economic resources by limiting an institution's ability to take on risk associated with commercial activities"; and
- "help ensure the separation of banking and commerce."[8]

In advocating the repeal of both the merchant banking and grandfather provisions, the Federal Reserve Board highlighted the longstanding principle in U.S. banking that banking should be generally separated from other commerce. The Section 620 Report explained:

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[6] "Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act," Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (9/2016), https://occ.gov/news-issuances/news-releases/2016/nr-ia-2016-107a.pdf (hereinafter, "Section 620 Report").

[7] Id. at 28.

[8] Id. at 29.

> That separation [of banking and commerce] is important to ensuring a sound, efficient, and objective banking system that allocates credit and provides services on a fair and equitable basis. The separation also helps to prevent undue economic concentration that can have a disproportionate effect on financial markets, production, and employment if failure occurs.[9]

The Federal Reserve's reaffirmation of the importance of separating banking from commerce is a critical contributing factor to minimizing the risks posed by and to financial holding companies. We commend the Federal Reserve Board for its careful work in the Section 620 Report to identify opportunities to reduce excessive risks in the U.S. financial system, including in connection with physical commodity activities.

Senate Investigation. A third factual foundation for the Proposed Rule is information disclosed by a Senate investigation into physical commodities activities by U.S. banks and financial holding companies. In 2014, the U.S. Senate Permanent Subcommittee on Investigations held hearings and issued a bipartisan staff report examining the risks associated with bank and financial holding company involvement with physical commodities.[10] The investigation was led by Subcommittee Chair Carl Levin (D-Mich.) and Ranking Minority Member John McCain (R-Ariz.). Ms. Bean was the Subcommittee staff director and chief counsel and Mr. Gellasch was senior counsel under Subcommittee Chair Levin. We both worked on the Subcommittee investigation, hearings, and report, as well as helped in the drafting of Section 620 four years earlier.

The hearings and report capped a two-year, bipartisan Subcommittee investigation into how three large U.S. financial holding companies were buying and selling billons of dollars in physical commodities and exercising control over a variety of businesses conducting activities involving physical commodities. Among other matters, the report detailed nine case studies of physical commodity activities undertaken by the three financial institutions. Specifically, at Goldman Sachs, the report presented case studies involving Goldman's ownership and operation of a shell company that bought, sold, and stored physical uranium, while trading uranium-related derivatives; its ownership and operation of two coal mines in Colombia, while trading coal-related derivatives; and its warehousing of multi-billion-dollar aluminum stockpiles at a Goldman-owned warehouse, while trading both physical aluminum and aluminum-related derivatives.

At Morgan Stanley, the report presented case studies involving Morgan Stanley's ownership interests in natural gas pipeline, exploration, production, and processing businesses and in shell companies constructing a compressed natural gas facility, while trading natural gas-

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[9] Id. at 30 (omitting footnote); see also id. at 31.

[10] "Wall Street Bank Involvement with Physical Commodities," U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 113-501, (11/20-21/2014), Volumes 1-2, https://www.gpo.gov/fdsys/pkg/CHRG-113shrg91522/pdf/CHRG-113shrg91522.pdf and https://www.gpo.gov/fdsys/pkg/CHRG-113shrg91653/pdf/CHRG-113shrg91653.pdf, the staff report is reprinted in Volume 1, beginning at 341 (hereinafter "2014 Senate Staff Report").

related derivatives; its operation of a jet fuel supply business; and its ownership and operation of a variety of other physical oil businesses, including oil-related production, storage, supply, and transport facilities involving over 50 million barrels of oil, while also trading physical oil and oil-related derivatives. At JPMorgan Chase, the report presented case studies involving JPMorgan's operation of over two dozen electrical power plants across the country, while selling electricity and trading electricity-related derivatives; its storage and trading of multi-billion-dollar copper stockpiles and plans to operate a copper-based exchange traded fund (ETF), while trading physical copper and copper-related derivatives; and its compliance with regulatory size limits on its physical commodity activities.

The report concluded that those and other physical commodity activities improperly mixed banking with commerce; raised troubling issues involving unfair trading, conflicts of interest, and price manipulation; and created both financial institution and systemic risks.[11]

Like the special Federal Reserve review and the Section 620 Report, the Subcommittee investigation examined the risks associated with physical commodity businesses vulnerable to a low-probability, but high-cost catastrophic event, such as an oil spill or fire, railway crash, nuclear incident, coal mine collapse, or natural gas explosion.[12] The facts suggested that even a single catastrophic event could shake public confidence in a financial institution associated with the catastrophe. Depositors might react to such an event by pulling deposits from an associated bank; creditors might decline to renew lines of credit with that bank or its holding company; counterparties might decline to enter into or demand exit from derivative trades or other transactions; financial institutions might decline to offer financing or impose more expensive terms; or stockholders might sell shares and depress the financial holding company's share price, all of which could trigger a range of financial difficulties. The contagion could also spread beyond the financial holding company and its bank to its larger network, its business partners, and other financial institutions. If the financial holding company were large enough and the catastrophe severe enough, it could even affect the U.S. financial system.

As a consequence, the 2014 Senate Staff Report offered a number of recommendations, supported by both Senator Levin and Senator McCain, to reduce the risks associated with financial holding company involvement with physical commodities.[13]

On November 20 and 21, 2014, the Subcommittee held two days of hearings on its investigation into financial holding companies' physical commodity activities. On the second day, the Honorable Daniel K. Tarullo, Federal Reserve Governor, testified. He discussed the ongoing physical commodity activities at U.S. financial holding companies, their attendant risks, and the Federal Reserve Board's deliberations over strengthening regulatory safeguards to mitigate the risks to the U.S. financial system.

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[11] 2014 Senate Staff Report, at 360-361.

[12] Id. at 507-515, 521- 522, 537-543, 636, 658-659, 667-668, 687-688, 693-694, 704, 727-729, and 754-756.

[13] Id., at 361-363.

Because of their relevance, this letter respectfully requests that the Subcommittee's 2014 hearing record and bipartisan staff report be made a part of the Proposed Rule's administrative record. The materials, which can be found in their entirety online as indicated in footnote 10, and which were previously made part of the Advance Notice of Proposed Rulemaking record,[14] provide a strong factual foundation for the Proposed Rule's new safeguards on physical commodity activities.

Proposed Rule

The Proposed Rule offers important new safeguards to reduce the risks associated with physical commodity activities at financial holding companies. All of the proposed safeguards should be included in the final rule. While Congress also has a role to play in reducing those risks, we urge the Federal Reserve Board to take the steps it needs to in order to meet its statutory obligation to ensure the safe and sound operation of the U.S. financial system.

Stronger Size Limit. One of the most important new safeguards in the Proposed Rule is a stronger prudential limit on the permissible size of a financial holding company's physical commodity holdings. Size limits are a longstanding bank regulatory tool used to curb risks associated with various types of investments. In the case of physical commodities, those risks include the dangers associated with an overconcentration of assets, volatile price swings that can cause sudden losses, and unexpected costs arising from a catastrophic event. An effective size limit can help reduce all of those risks, ensure the safe and sound operation of the financial holding company, and protect U.S. taxpayers from physical commodity activities posing outsized financial, operational, and catastrophic event risks.

The Federal Reserve Board has long imposed a size limit on the physical commodity holdings of financial holding companies, but that limit has not always been respected or effective. The standard practice of the Board, whenever it granted a financial holding company complementary authority to conduct physical commodity activities, was to require the financial holding company to commit to limiting the amount of the relevant physical commodities it would hold at any one time to no more than 5% of its consolidated Tier 1 capital. That commitment was set out in the Federal Reserve order granting the complementary authority. Separate statutory size limits applied to any commodity-related merchant banking or grandfathered activities, and yet another size limit was applied by the Office of the Comptroller of the Currency to physical commodity holdings at any subsidiary national bank.

This uncoordinated and somewhat haphazard collection of different size limits applicable to different activities and different entities within a financial holding company's network of enterprises left regulators with a confusing and often incomplete picture of the firm's physical commodity activities and risks.

In addition, the Senate Subcommittee investigation showed how one financial holding company, JPMorgan Chase, used aggressive interpretations, unintended loopholes, and questionable valuation methodologies to circumvent the effectiveness of the size limit on its

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[14] See the Proposed Rule, at footnote 43.

complementary activities. Its tactics included excluding from its reported holdings billions of dollars in physical commodities held by its subsidiary bank as well as the value of its physical copper stockpiles, oil and gas leases, and power plants.[15] The result was that JPMorgan Chase amassed physical commodity holdings far in excess of its 5% complementary limit, without informing its regulators. In September 2012, for example, JPMorgan held physical commodity assets – excluding gold, silver, and its merchant banking assets – that had a combined market value of $17.4 billion, which at the time equaled nearly 12% of its Tier 1 capital of $148 billion, while informing the Federal Reserve that its physical commodities holdings totaled only $6.6 billion or 4.5% of its Tier 1 capital.[16]

The proposed new size limit would put in place a more effective limit on a financial holding company's physical commodity holdings. First, the size limit would be given the force of law by making it a regulatory requirement rather than a provision in an agency order. Second, while the proposed limit does not set a lower threshold, the proposed Section 225.95 makes it clear that the limit would apply to all types of physical commodities without exception, and it would cover commodities held under any type of legal authority – not just a complementary order – with exceptions for commodities held as a merchant banking investment (which has its own size limit), an insurance company investment, or in satisfaction of a debt. The Proposed Rule is also clear that the new limit would apply to physical commodities held by the financial holding company and all of its subsidiaries, including its subsidiary banks.[17] It would ensure that a financial holding company could no longer exclude the physical commodities held by its national bank when reporting its total holdings to the Federal Reserve.

A stronger size limit offers a cost effective, efficient mechanism to mitigate the risks associated with physical commodity activities. Ongoing risks from environmental and safety mishaps such as oil spills and natural gas explosions establish an ongoing need to limit financial holding company exposure to catastrophic events. Dramatic swings in commodity prices, such as crude oil prices that dropped from more than $100 per barrel to $35 per barrel over the course of a few months, establish an ongoing need to protect financial holding companies from over-investing in assets with unpredictable and volatile value shifts. An effective size limit can mitigate both dangers. The stronger size limit is further supported by a bipartisan recommendation in the 2014 Senate Staff Report urging the Board to take that course of action.[18]

The effectiveness of the strengthened size limit will be further enhanced by another provision in the Proposed Rule. That provision seeks to establish new reporting requirements in a new Schedule HC-W mandating regular public disclosures by financial holding companies of the fair value of their physical commodity holdings, broken down into nine commodity categories.[19] Those public disclosures would provide ongoing, timely information to regulators, holding company risk managers, investors, and the public about the size of the relevant holdings, enabling each of them to monitor changes in those holdings over time.

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[15] See 2014 Senate Staff Report, at 783-784, 788, 792-805, 808-811.
[16] Id. at 783-784, 788, 792-805.
[17] Proposed Rule at 67225-226, 67239 (in Section 225.95(a)-(c)).
[18] 2014 Senate Staff Report, at 361 (Recommendation No. 2).
[19] Proposed Rule, at 67233 (new Schedule HC–W).

Stronger Prohibition on Risky Physical Commodity Activities. A second important new safeguard in the Proposed Rule is a stronger prohibition on financial holding companies "owning, operating, or investing in facilities for the extraction, transportation, storage, or distribution of Commodities" under a grant of complementary authority.[20]

Federal regulators have long used prohibitions on financial institutions engaging in certain types of activities as a way to reduce risk and separate banking from commerce. In the case of physical commodities, the Federal Reserve has long conditioned a grant of complementary authority to conduct those activities on the relevant financial holding company's agreeing to refrain from engaging in activities involving the extraction, transportation, storage, or distribution of physical commodities. As the Proposed Rule explains, a key reason for that prohibition was to prevent a financial holding company from opening itself up to legal liability for environmental or safety mishaps related to its physical commodity activities. Another rationale for the prohibition is that it prevents financial holding companies from engaging in activities that are unrelated to the business of banking.

The Federal Reserve prohibition, while longstanding, has not always been respected or enforced. The Senate Subcommittee investigation uncovered a number of financial holding company activities that seemed to defy the prohibition, yet were allowed to continue for years. The Subcommittee learned, for example, that Goldman was directly involved with the storage and distribution of uranium, after it purchased a company involved in that business, the company's employees left, and Goldman employees took over the company's day-to-day operations.[21] In another instance, Goldman acquired two coal mines in Colombia and involved Goldman employees in key extraction, transportation, and marketing decisions.[22]

The Subcommittee also learned that Morgan Stanley had established three wholly owned shell corporations to build and operate a $355 million compressed natural gas facility in Texas, with plans to transport and distribute the containerized product abroad.[23] Morgan Stanley also owned or operated a variety of oil storage, transport, and distribution businesses, including storage facilities for millions of barrels of crude oil and other fuels; oil exploration, pipeline, shipping, and blending operations; and a jet fuel distribution operation that, among other activities, became the primary fuel supplier for United Airlines.[24] In still another case, the Subcommittee learned that JPMorgan Chase had taken direct ownership interests in multiple electrical power plants across the country, including acquiring 100% of the ownership of three power plants in Florida, Maryland, and Michigan.[25]

In some cases, the facts indicated that those activities had not been fully disclosed to, or were carried out despite concerns expressed by, Federal Reserve regulators. In some cases, after

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[20] Id. at 67226.
[21] 2014 Senate Staff Report, at 502-506.
[22] Id. at 522-525, 528-530, 533-536.
[23] Id. at 639-645.
[24] Id. at 669-683, 694-699, 703, 705.
[25] Id. at 731-733, 737, 742-743.

regulatory inquiries, the financial holding company appeared to switch the legal authority used to justify its physical commodity activities in order to circumvent the complementary authority prohibition. In every case, the financial holding company appeared to have increased its exposure to liability for a catastrophic event.

In the aftermath of the BP disaster[26] and numerous pipeline and railway spills,[27] the extent of the financial and reputational risks associated with such events has only deepened. In addition, as Chiara Trabucchi, an expert in financial economics and environmental risk management, testified before the Senate Subcommittee, the methods used by financial holding companies to shield themselves from legal liability were far from certain to be effective, yet may have led them to dramatically underestimate the magnitude of their potential exposures.[28]

To reinvigorate the prohibition and reduce the risks associated with the specified physical commodity activities, the Proposed Rule would take several steps. First, it would strengthen the prohibition by making it a regulatory requirement rather than a provision in an agency order. Second, it would spell out the prohibited activities in more detail. The revised Section 225.95(d) would state explicitly that a financial holding company engaging in complementary activities "may not own operate, or invest in facilities or vessels for the extraction, transportation, storage, or distribution of physical commodities."[29] Section 225.95(e) would make it clear that the term "operate" includes:

> "(1) participation in the day-to-day management or operations of the facility, (2) participation in management and operational decisions that occur in the ordinary course of the business of the facility, and (3) managing, directing, conducting or providing advice regarding operations having to do with the leakage or disposal of a physical commodity or hazardous waste or involvement in decisions related to the facility's compliance with environmental statutes or regulations …."[30]

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[26] See *In re Oil Spill by Oil Rig Deepwater Horizon in Gulf of Mexico, on April 20, 2010*, 2014 WL 4375933 (E.D. La. Sept. 4, 2014); "BP's 'gross negligence' caused Gulf oil spill, federal judge rules," *Washington Post*, Steve Mufson (9/4/2014), http://www.washingtonpost.com/business/economy/bps-gross-negligence-causedgulf-oil-spill-federal-judge-rules/2014/09/04/3e2b9452-3445-11e4-9e92-0899b306bbea_story.html.

[27] See, e.g., "Calif. gas leak seen as litigation gusher rivaling BP spill," Greenwire, Jeremy P. Jacobs (2/17/2016), http://www.eenews.net/stories/1060032503; "Five Years After Deadly San Bruno Explosion: Are We Safer?" KQED News, Rebecca Bowe and Lisa Pickoff-White (9/8/2015), https://ww2.kqed.org/news/2015/09/08/five-years-after-deadly-san-bruno-explosion-are-we-safer/; "Railroads fight regulators over need for new braking system: Trains full of flammable liquids have crashed 19 times in 6 years," *Washington Post*, Ashley Halsey (12/20/2016), https://www.washingtonpost.com/local/trafficandcommuting/railroads-regulators-clash-over-braking-system-for-trains-carrying-flammable-liquids/2016/12/19/68071650-9ad4-11e6-b3c9-f662adaa0048_story.html?utm_term=.8086434dde68.

[28] 2014 Senate Hearing, at 101-103, 113-114.

[29] The proposed text contains one typographical error: a comma should be added after "own".

[30] Proposed Rule, at 67239 (proposed Section 225.95(e)).

Finally, the Proposed Rule warns that the "proposed list of actions is not meant to be exhaustive," and that every financial holding company would be "expected to take other steps as appropriate to limit the types of actions that potentially could impose environmental liability on the FHC or otherwise suggest that the FHC is unduly involved in the activities of third parties."[31]

Through its explicit language, applicable to all types of physical commodities without exception, the Proposed Rule would strengthen and revitalize the longstanding Federal Reserve prohibition against engaging in risky physical commodity activities unrelated to banking.

At the same time, in one respect, the proposed provision needs strengthening. Currently, the proposed language is narrowly focused on catastrophic events related to environmental hazards, instead of also addressing catastrophes caused by safety violations. Oil fires, natural gas explosions, grain elevator combustion, and railway crashes are examples of catastrophic events that may have little to do with violating environmental statutes, and yet incur significant legal risk, primarily from violating safety requirements. Similar to the liability attached to environmental violations, safety violations may carry significant financial deterrents, such as enhanced damages, penalties for abuses, and civil and criminal liability. Consideration of safety as well as environmental requirements could easily be incorporated into the proposed language. Perhaps the simplest way would be to insert "or safety" after "environmental" in clause (3) so that it reads "the facility's compliance with environmental or safety statutes."

Prohibition of Energy Tolling and Management Agreements. A third new safeguard is the Proposed Rule's proposed retraction of complementary authority for financial holding companies to enter into energy tolling or energy management agreements to operate electrical power plants.[32] Like the prohibition just discussed, curbing those agreements would limit financial holding company involvement with operational activities that heighten catastrophic event liability and deepen entanglement in activities unrelated to the business of banking.

Energy tolling and management agreements necessarily involve financial holding companies in the day-to-day activities of the affected power plants. The resulting operational and management activities not only breach the longstanding U.S. principle against mixing banking with commerce, but also expose the financial holding company to a host of safety and environmental risks specific to the power plant industry. Those risks include fires, explosions, and environmental and safety hazards associated with fuel transport, storage, and use, including issues related to coal ash containment ponds, natural gas pipelines, and nuclear waste storage facilities.[33] Each of those risks increases the financial holding company's potential liability for a catastrophic event.

The Subcommittee's 2014 investigation examined energy tolling and management agreements at several financial holding companies, and developed a detailed case study involving JPMorgan Chase. The case study showed how, from 2008 to 2010, JPMorgan acquired 31 power plants across the country and entered into multiple tolling agreements valued

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[31] Id. at 67226.
[32] Id. at 67231-232.
[33] See 2014 Senate Staff Report, at 727-729.

at more than $2 billion.[34] At the same time, a 2010 Federal Reserve examination noted that JPMorgan's own internal audit team had determined that the firm did not have the technical capability to evaluate its power plants' compliance with federal, state, and industry standards.[35] The Subcommittee also learned that JPMorgan encountered multiple regulatory difficulties over how it was conducting its power plant activities.[36] In one set of disputes, JPMorgan battled state and federal regulators over responding to information requests and ended up suspended for six months from bidding in U.S. energy markets, costing the company potentially millions of dollars. JPMorgan also unsuccessfully fought regulatory efforts to modify the operations of one of its California plants to improve grid reliability. In still another case, to settle charges that some of its plants had manipulated California and Midwest wholesale energy prices, JPMorgan paid a 2013 fine totaling $410 million.

The JPMorgan case study provides ample factual evidence that energy tolling and management agreements can expose financial holding companies to hundreds of millions of dollars in legal liability that would not otherwise apply to a financial institution. Perhaps as a result, JPMorgan has largely ended its energy tolling and management activities and sold its power plant investments. It is not alone. The Proposed Rule states: "Of the five FHCs [financial holding companies] that currently have the authority to engage in either energy management services or energy tolling, at least four have discontinued these activities in the U.S."[37] That means only one U.S. financial holding company is currently engaged in U.S. energy tolling and management activities. The relative paucity of those activities makes it a good time to end financial holding company involvement with operating power plants.

The Proposed Rule indicates that the Federal Reserve Board plans to withdraw the existing authority to participate in energy tolling and management agreements as a complementary activity, after granting holding companies a two-year transition period to exit those agreements.[38] The Proposed Rule justifies its change in policy primarily on the basis of the weak relationship between energy tolling and management agreements and the business of banking. It notes that operating a power plant has virtually nothing to do with trading electricity-related derivatives or issuing credit to a power plant. While sound, that analysis may also want to take note of the catastrophic event liability concerns that also apply to such activities.

In addition, the Proposed Rule may wish to note that ending financial holding company participation in energy tolling and management agreements would be consistent with the Proposed Rule's broader effort to prohibit financial holding company participation in the "operation" of physical commodity distribution facilities, including power plants that distribute electricity.

Reclassification of Copper. Another important reform in the Proposed Rule is a proposal to stop treating copper as "bullion" and a "precious metal," and instead reclassify it as

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[34] Id. at 729.
[35] Id. at 733.
[36] Id. at 745-753.
[37] Proposed Rule, at 67231.
[38] Id. at 67232.

an industrial metal.[39] The proposed change is significant, because both financial holding companies and bank holding companies are currently permitted to buy and sell precious metals, such as gold and silver, without regard to size limits or other physical commodity safeguards. In contrast, industrial metals can only be traded by financial holding companies and then only if the financial holding company has been granted complementary authority, and is subject to both a prudential size limit and other safeguards designed to curb the risks associated with physical commodity activities.

The Federal Reserve first designated copper as a precious metal in 1997, following the lead of the Office of the Comptroller of the Currency (OCC). In response, some bank holding companies as well as some national banks began increasing their physical and financial trading of copper. The Proposed Rule notes that, despite its reclassification by the Federal Reserve and OCC, copper continued to be traded on world financial markets as an industrial metal, valued for its industrial uses rather than as a store of value like gold or silver.[40] The Proposed Rule notes, for example, that copper futures continued to trade copper in industrial-sized lots involving thousands of metric tons versus the troy ounces used in futures for precious metals.[41] The Proposed Rule also notes that the OCC has already undertaken to revise its policy by issuing a proposed rule to reclassify copper as an industrial metal under the National Bank Act.

The Senate Subcommittee investigation provides additional factual support for the proposed change in copper's status, in a case study detailing high-risk copper trading undertaken by JPMorgan Chase.[42] The case study showed that, through its "Global Metals Group," JPMorgan had become an active trader of many types of metal on both physical and financial markets. Its activities included trading physical copper on spot markets and through warrants, as well as trading copper futures, swaps, options, and forwards on financial markets. JPMorgan conducted its copper trades on behalf of itself as well as a number of clients. In addition, the bank provided a variety of copper-related financing arrangements, structured transactions, and hedging transactions. To carry out its activities, the bank built at times a large physical copper inventory, despite volatile copper prices whose "'unpredictable' fluctuations" could dramatically alter its value.[43] In 2010, the bank purchased a global warehouse company, Henry Bath & Sons, that, among other metals, stored billions of dollars in physical copper, including copper belonging to the bank and its clients.

Because it was permitted to treat copper as a precious metal, JPMorgan accumulated enormous copper inventories. From 2010 to 2012, for example, JPMorgan's bank reported holding hundreds of thousands of metric tons whose value peaked at $2.7 billion.[44] Records also showed that, in 2010 alone, JPMorgan held "a significant portion of the physical copper available for trading in the United States" as well as such a huge share of the copper available for trading on the London Metals Exchange (LME) – in the range of 50% to 60% of the available

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[39] Id. at 67232, 67239 (proposed Section 225.28).
[40] Id. at 67232.
[41] Id. at footnote 86.
[42] 2014 Senate Staff Report, at 759-815.
[43] Id. at 760.
[44] Id. at 767-768.

copper – that the LME regulator required it to reduce its holdings.[45] JPMorgan records also showed that, during 2010 and 2011, the bank engaged in multiple outsized copper transactions that, at times, involved more than $1 billion.

At the same time it was amassing physical copper and actively trading in both the financial and physical copper markets, JPMorgan "designed and proposed a copper-backed exchange traded fund (ETF) … to acquire copper, place it in storage, and sell investment securities whose value would be tied to copper prices."[46] JPMorgan proposed that its warehouse affiliate store the copper, and other affiliates buy the copper and sell the ETF securities. Some market analysts attributed a late 2010 surge in copper prices to JPMorgan's buying large amounts of copper in anticipation of its ETF.[47] Offering documents prepared for investors, however, did not specifically disclose the extent of JPMorgan's copper holdings or how it would avoid conflicts of interest when selling copper to the ETF or conducting proprietary trades that might run counter to the interests of ETF investors.[48] When informed of the proposed ETF, a number of industrial copper end-users vigorously opposed its creation, alleging it would "cause artificial supply shortages and higher and more volatile copper prices by removing large amounts of copper from the marketplace for indeterminate amounts of time."[49] Facing that opposition as well as SEC inquiries into various issues, JPMorgan eventually placed the ETF on hold.

The Subcommittee's investigation showed that JPMorgan's physical copper activities were far removed from normal banking activities. Its massive purchases and sales of physical copper often had no apparent relationship to the business of banking, even when defined as trading on financial commodity markets. The activities placed JPMorgan in direct competition with other commodity-related commercial businesses and copper end users. In addition, besides engaging in customer-facing trading, many of its physical copper transactions appeared to be proprietary in nature, seeking to produce profits for JPMorgan.

The transactions also raised a variety of financial risks due to volatile copper prices, JPMorgan's outsized positions, and its engagement in massive transactions. Those risks become apparent when comparing copper prices and JPMorgan's copper activities over several years. As explained in the 2014 Senate Staff Report:[50]

> Over the last decade, copper prices have experienced significant volatility, including "unpredictable" fluctuations, creating price risks for producers and end users. As shown in the chart below, prices per metric ton fell from $8,500 in 2008, to under $3,000 in 2009, and then spiked to over $10,000 in December 2010 and January 2011, reaching all-time highs.

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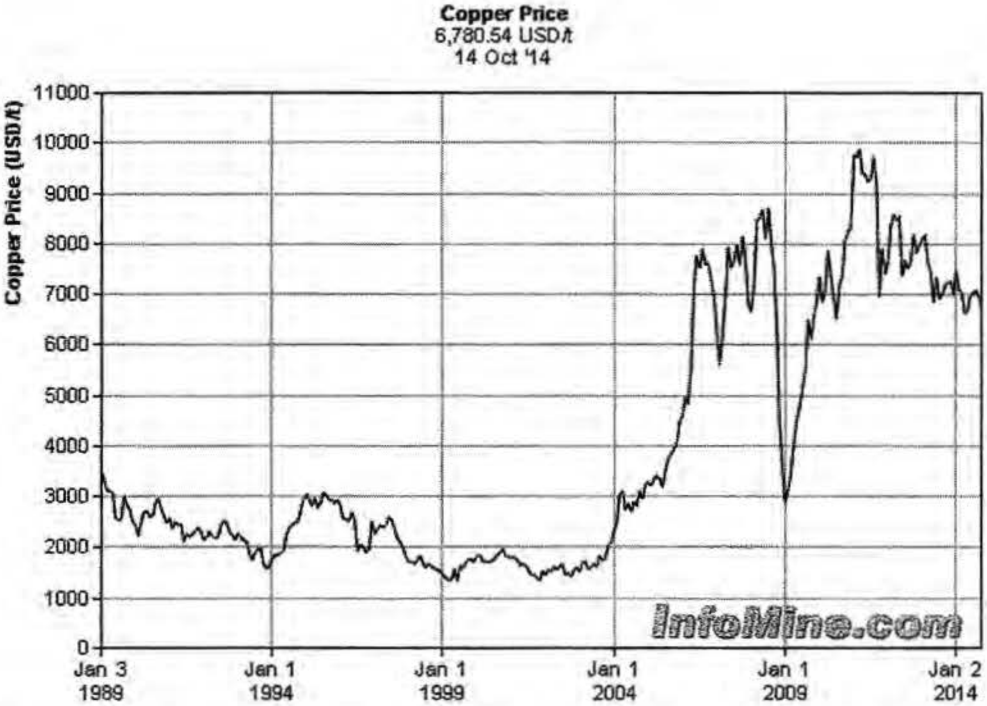
[45] Id. at 767-769.
[46] Id. at 770. See also 771-773.
[47] Id. at 768 and footnote 2338.
[48] See two comment letters filed by Senator Levin with the Securities and Exchange Commission (SEC) related to the proposed ETF, included as hearing exhibits. Id. at 1660-681.
[49] Id. at 763-764.
[50] Id. at 760-761.



Source: "Historical Copper Prices and Price Chart," InfoMine Inc. (10/14/2014), http://www.infomine.com/investment/metal-prices/copper/all/.

Those massive price fluctuations occurred just as JPMorgan was dramatically increasing its copper holdings, exposing the firm to significant price risks. Additionally, because of the unprecedented size of its positions (again, at one point comprising over 50% of all copper available for trading on the LME), the positions posed a significant concentration of risk, not only for JPMorgan, but also for the overall copper market. The Proposed Rule's decision to restrict copper trading to well-capitalized financial holding companies subject to size limits and other prudential safeguards will help alleviate those type of price risks in the future.

The JPMorgan case study, in short, fully supports the proposal to overturn the treatment of copper as bullion and a precious metal, and instead treat it as an industrial metal subject to the same prudential safeguards that currently apply to all other industrial metal activities.

Increased Capital Requirements. One of the most important new safeguards in the Proposed Rule is the application of increased capital requirements to financial holding companies engaged in certain specified physical commodity activities. The proposed increases are both reasonable and necessary to protect financial holding companies and U.S. taxpayers from low-probability but high-cost catastrophic events, such as a major oil spill, natural gas explosion, or nuclear incident. Those types of catastrophic event risks do not normally apply to financial holding companies, and so are not incorporated into the standard capital assessment system. That's why an additional capital charge reflecting the higher risks is both appropriate and necessary. Furthermore, the amount of the proposed capital charges, including the 1,250 percent charge for activities authorized by the grandfather clause, appropriately reflects the outsized risks associated with those activities.

Increased capital requirements are the logical outcome of both the special review conducted by the Federal Reserve, culminating in the 2012 summary document, and by the Senate Subcommittee investigation that produced hearings and the bipartisan 2014 Senate Staff Report. The special Federal Reserve review determined that the financial holding companies conducting physical commodity activities held insufficient capital and insurance to mitigate the risks associated with a related catastrophic event.[51] In its 2012 summary, the review discounted the usefulness of insurance as a risk mitigation strategy, because "[i]nsurance companies reportedly will not insure the full event loss due to their inability to measure the maximum potential loss."[52] The 2012 summary concluded that, in the event of a multi-billion-dollar catastrophic event, insurance alone would not protect a financial holding company from significant costs.[53]

On the issue of capital, the 2012 summary found that, while capital can provide significant loss absorption to protect both financial holding companies and U.S. taxpayers, "current levels of capital appear insufficient to protect against a maximum loss potential."[54] The summary explained that an analysis of four major financial holding companies engaged in physical commodity activities, Bank of America, Goldman Sachs, JPMorgan, and Morgan Stanley, had determined that, even when enhanced with insurance, the four had insufficient capital to cover losses associated with an "extreme loss scenario."[55] A chart prepared in connection with the 2012 summary depicted the total level of capital and insurance coverage at each of the four financial holding companies, compared those totals to estimated costs associated with a an extreme loss event, and concluded that, at each institution, "the potential loss exceed[ed] capital and insurance" by $1 billion to $15 billion.[56] To address that large shortfall, the review summary recommended requiring "higher capital" levels and that the new "capital levels should be aligned to cover maximum potential loss with a buffer."[57]

The 2014 Senate Staff Report provided additional support for the conclusions reached by the Federal Reserve special review. It detailed nine case studies of physical commodity activities at three large financial holding companies, including six that risked catastrophic events.[58] Like the Federal Reserve special review, the Senate Subcommittee investigation expressed concern about insufficient capital and insurance protections to pay for the costs associated with a catastrophic event. The resulting 2014 Senate Staff Report made a bipartisan recommendation urging the Federal Reserve to "establish capital and insurance minimums based on market-prevailing standards to protect against potential losses from catastrophic events in physical commodity activities, and specify the catastrophic event models used by financial

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[51] See id., at 456-458
[52] Id., at 456.
[53] Id. at 457.
[54] Id. at 458.
[55] Id.
[56] Id. at 514.
[57] Id. at 460.
[58] Those case studies examined physical commodity activities involving uranium, coal, natural gas, oil, jet fuel, and electricity. For the sections of the 2014 Senate Staff Report analyzing the catastrophic event risks related to each of those activities, see footnote 12, <u>supra</u>.

holding companies."[59] The proposed new capital requirements represent a reasonable response to that bipartisan recommendation.

One important aspect of the proposal is the decision to assign greater capital requirements to physical commodity activities conducted under the authority of the grandfather clause than would be permitted under an order authorizing complementary activities.[60] Those higher capital requirements are both necessary and appropriate, due to the greater risks associated with activities permitted by the grandfather clause.

Currently, and under the Proposed Rule, complementary activities operate under greater prudential safeguards than grandfathered activities. Complementary activities require prior Federal Reserve approval and operate under a size limit capped at no more than 5% of the financial holding company's consolidated Tier 1 capital. Grandfathered activities require no prior Federal Reserve approval and operate under a much less restrictive size limit of 5% of the financial holding company's total consolidated assets. In addition, financial holding companies are barred from complementary activities that involve the ownership, operation, or investment in facilities or vessels aimed at "the extraction, transportation, storage, or distribution of physical commodities." In contrast, grandfathered activities explicitly permit direct ownership and operation of facilities to "manage, refine, store, extract, transport, or alter" physical commodities.[61] In short, grandfathered physical commodity activities require less regulatory approval, operate under a less restrictive size limit, and can involve higher-risk activities with greater potential for catastrophic event liability. Given those facts, common sense supports the decision of the Proposed Rule to mitigate the greater risks associated with grandfathered physical commodity activities by imposing higher capital requirements on them compared to complementary activities.

The Senate Subcommittee investigation further supports the proposed distinction. The 2014 Senate Staff Report detailed, for example, how Goldman cited the grandfather clause as its authority to own and trade uranium and own and operate two coal mines, activities that would not have been permitted under its complementary authority.[62] Similarly, Morgan Stanley cited the grandfather clause as its authority to own a global network of oil and natural gas storage facilities and pipelines, lease and direct over 100 oil tankers and other ships, and set up and use three shell corporations to construct a compressed natural gas facility.[63] None of those physical commodity activities would have been permitted under its complementary authority.

A second key aspect of the new capital requirements is their application to merchant banking investments that involve physical commodities. Commodity-related merchant banking activities can vary widely; some involve activities similar to those allowed under a complementary order, while others involve higher risk activities like those authorized by the grandfather clause. By law, for example, merchant banking activities can include direct

[59] 2014 Senate Staff Report, at 362.
[60] Proposed Rule, at 67226-227.
[61] Id. at 67227.
[62] 2014 Senate Staff Report, at 426.
[63] Id.

ownership of facilities involved in the storage, transportation and refining of physical commodities.[64] The Senate Subcommittee investigation found that some financial holding companies deliberately used the broader merchant banking authority to circumvent the limits on their complementary authority. For example, the Subcommittee learned that, when the Federal Reserve told JPMorgan that its direct ownership of three power plants was not permitted as a complementary activity, JPMorgan simply reclassified them as merchant banking investments and continued to own them.[65]

The Proposed Rule differentiates the amount of the additional capital charges that must be assessed based upon the riskiness of the activities at issue. Where activities are lower risk and operate under size limits or other prudential safeguards, they would enjoy a lower capital charge than activities that are higher risk and less regulated. In the case of merchant banking activities, the Proposed Rule treats merchant banking activities that parallel complementary activities as generally subject to the same capital requirements that apply to complementary activities, and treat those that go beyond permissible complementary activities as subject to the same capital requirements that apply to grandfathered activities.[66] In that way, the Proposed Rule attempts to ensure that similar physical commodity activities are generally subject to similar capital requirements.

As the Federal Reserve explained in the Section 620 Report, the merchant banking and grandfather authorities ought to be repealed altogether for mixing banking and commerce and generating excessive risks. But until Congress acts, the Federal Reserve must fulfill its statutory obligation to ensure the safety and soundness of the U.S. financial system and protect individual financial institutions and taxpayers from excessive risk. The proposed heightened capital charges would accomplish those objectives.

Clarification of Covered Commodities. The new capital requirements in the Proposed Rule do suffer from one serious weakness that should be remedied: a confusing definition of the term "covered physical commodities." The proposed definition could and should be clarified and simplified to ensure effective application of the new proposed capital requirements.

As currently worded, instead of listing the major types of commodities that trigger the increased capital requirements, the Proposed Rule declares that the new capital requirements apply to "any physical commodity that is, or a component of which is" named in certain federal laws as a "hazardous substance" or "hazardous air pollutant," or is included in the definition of "oil" under still two other federal statutes.[67]

The problem with that approach is that the cited federal laws are highly technical and produce lengthy lists of obscure substances and air pollutants that, themselves, are not traded in commodity markets. At the same time, the referenced statutes and lists fail to explicitly mention any of the major traded commodities other than oil. How financial holding companies are

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[64] Proposed Rule, at 67228.
[65] 2014 Senate Staff Report, at 742-744.
[66] Proposed Rule, at 67228.
[67] Id. at 67236 (proposed Section 217.2).

supposed to determine which of the listed substances and air pollutants are linked to the physical commodities they actually buy and sell is not explained. Perhaps the intent was to cover any physical commodity activity that led to the emission of a listed hazardous substance or pollutant, but that's not what the proposed definition actually says.

In provisions sure to generate additional confusion, the statute listing "hazardous substances" states explicitly that they don't include oil or natural gas, while two other listed statutes do cover oil, and still other parts of the Proposed Rule indicate that the new capital requirements do indeed apply to natural gas commodities. It would be strange if the increased capital requirements did not apply to natural gas commodities, since natural gas is a highly toxic, flammable, and explosive substance whose mishandling can lead to catastrophic events. The same is true of coal, fertilizer, and uranium, yet none of those commodities is explicitly named in the proposed regulatory definition or in the cited federal statutes listing hazardous substances and air pollutants. As a result, the proposed definition makes it very difficult to determine exactly what physical commodities are intended to trigger the increased capital requirements.

In contrast, a later section of the Proposed Rule describing new reporting requirements for financial holding companies engaged in physical commodity activities provides a short, straightforward list of the physical commodities that must be reported on a new form:

(1) Petroleum and petroleum products;
(2) Natural gas;
(3) Natural gas liquids;
(4) Fertilizer;
(5) Propylene;
(6) Coal and coal products;
(7) Uranium; uranium products;
(8) Other covered physical commodities; and
(9) All other physical commodities.[68]

The Proposed Rule states that the first eight categories are intended to reflect the "covered physical commodities" defined elsewhere in the rule.[69] While the eighth category – "other covered physical commodities" – apparently functions as a catchall category and requires further clarification, using this same type of list would greatly clarify and simplify the definition of "covered physical commodities" intended to trigger the new capital requirements. It is respectfully suggested that the definition of "covered physical commodities" be revised to make use of this list and its straightforward format.

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[68] Id. at 67233.

[69] Id. The Proposed Rule states: "The categories of physical commodities listed in items (1)–(8) above are proposed to be defined in a manner consistent with the proposed definition of 'covered physical commodities.' Categories (1)–(7) generally include those covered substances under Federal environmental law. The item 'other covered physical commodities' would include all other covered physical commodities held in inventory that would not be included in items (1)–(7) described above and therefore would reflect those covered substances under relevant state environmental law."

A second problem with the current proposed definition of "covered physical commodities" is its narrow focus on environmental statutes, without any reference to safety-related statutes or regulations, even though safety violations can also give rise to catastrophic event liability. Examples include the 2010 San Bruno natural gas pipeline explosion that subjected the pipeline operator to more than $1 billion in legal liability from federal and state lawsuits focused on safety violations rather than environmental harms;[70] and multiple coal mining safety violations that required Murray Energy to pay more than $13 million in federal safety fines compared to $6 million in environmental fines, both of which are apart from civil lawsuits filed by individual victims of the disaster.[71] The proposed increased capital requirements would provide better protection of the U.S. financial system and of individual institutions if were supported by a definition of covered physical commodities that included physical commodities regulated by environmental or safety laws.

Expanded Public Disclosures. A final set of key reforms in the Proposed Rule is the proposal to expand public disclosures of the physical commodity holdings and activities at specific financial holding companies.

The 2014 Senate Staff Report made the following bipartisan finding: "Federal regulators and the public currently lack key information about financial holding companies' physical commodities activities to form an accurate understanding of the nature and extent of those activities and to protect the markets."[72] The Subcommittee investigation based that finding on evidence indicating that "the availability of public information on financial holding company involvement with physical commodities is almost non-existent."[73] As the Federal Reserve's Commodities Team learned once it began its inquiry, the information made available to regulators isn't much better.

The lack of data has made it difficult for regulators, holding company risk managers, investors, and the public to track the size and nature of a financial holding company's physical commodity holdings and activities, gauge the attendant risks, and measure compliance with size limits and other prudential safeguards. The 2014 Senate Staff Report noted that data on commodity-related merchant banking investments was particularly difficult, since merchant banking activities were often conducted by multiple components within a financial holding company, including a commodities division, infrastructure fund, and other capital funds. The report determined there was even less data available on grandfathered activities.

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[70] See, e.g., "Five Years After Deadly San Bruno Explosion: Are We Safer?" KQED News, Rebecca Bowe and Lisa Pickoff-White (9/8/2015), https://ww2.kqed.org/news/2015/09/08/five-years-after-deadly-san-bruno-explosion-are-we-safer/. On the federal level, the San Bruno explosion violated safety regulations issued by the U.S. Department of Transportation's Pipeline and Hazardous Materials Safety Administration.

[71] See, e.g., "Violation Tracker Parent Company Summary: Murray Energy," 2010-2015, http://violationtracker.goodjobsfirst.org/parent/murray-energy, tracing Mine Safety and Health Administration safety requirements.

[72] 2014 Senate Staff Report, at 361.

[73] Id. at 359.

As a result, the 2014 Senate Staff Report made the following bipartisan recommendation: "The Federal Reserve should strengthen financial holding company disclosure requirements for physical commodities and related businesses in internal and public filings to support effective regulatory oversight, public disclosure, and investor protections, including with respect to commodity-related merchant banking and grandfathered activities."[74]

The new reporting requirements seem well-designed to do just that. A new Schedule HC-W would provide regular public disclosures on, for example, the fair value of a financial holding company's physical commodity holdings, broken down into nine commodity categories as indicated in the list above. The Proposed Rule would also provide regular data on the risk-weighted asset amounts held by a financial holding company for "covered physical commodities," grandfathered "infrastructure assets," and "covered commodity merchant banking investments."[75] One issue, however, is why the rule would include only grandfathered "infrastructure assets"; a better approach would be to include all grandfathered physical commodity holdings, without exception.

The improved commodity-related disclosures represent welcome progress; they would facilitate better regulatory oversight and provide more useful information to investors and the public regarding a financial holding company's physical commodity activities and risks.

Recommended Enhancements

While this letter strongly supports the Proposed Rule, it also respectfully suggests three additional areas in which improved physical commodity-related safeguards are needed.

Clarify Insurance Requirements. First, although the Proposed Rule directly addresses the problem of insufficient capital levels at financial holding companies engaged in physical commodity activities, it fails to clarify any regulatory expectations related to a financial holding company's obligation to acquire related insurance. Insurance is a key risk mitigation strategy at non-financial firms engaging in similar activities, and should play a similar role at financial institutions. Aside from its direct loss mitigation component, insurance provides three indirect benefits. First, the mere process of obtaining relevant insurance often requires the insured party to develop and maintain policies, procedures, and practices that further mitigate its risks. Second, the acquisition of insurance provides an effective, cost-related market discipline. If a financial holding company's risks were excessive compared with similarly-situated firms, then its insurance would likely cost more and encourage an analysis of its activities. Third, a non-financial firm's insurance costs may be significant. If a financial holding company were permitted to engage in a similar activity without similar insurance costs, it would gain an unfair advantage over the non-financial firm, distorting market forces and fair competition. Financial holding companies should not escape these important market forces and limitations on its risks. The final rule would, thus, be enhanced if it were to specify best practices or minimal insurance coverage in connection with a financial holding company's physical commodity activities.

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[74] Id. at 361.

[75] Proposed Rule, at 67233.

Clarify Spot Market Authority. Second, the Proposed Rule indicates that, under a grant of complementary authority, a financial holding company may buy and sell physical commodities in the spot market.[76] As currently worded, the Proposed Rule fails to indicate that those spot market transactions must be undertaken in connection with financial transactions that are a recognized part of the business of banking, such as to settle a commodity-related derivatives transaction or advance a commodity-related financing arrangement. On its face, the buying and selling of physical commodities have no direct connection with taking deposits, making loans, or otherwise engaging in the business of banking, so there is no basis for treating those activities as closely connected to banking. That's why a better approach would be for the Proposed Rule to make clear that the authority to engage in spot market physical commodity transactions extends only to transactions that are directly connected to specific commodity-related financial derivatives or financing arrangements. Better yet would be a clear statement that complementary authority does not extend to a spot market transaction that is unconnected to a specific, commodity-related financial derivative or financing arrangement.

Clarify Scope of Grandfather Clause. Finally, one disappointing and puzzling aspect of the Proposed Rule is its failure to acknowledge or resolve existing disagreements over the scope of the grandfather clause. The grandfather clause was enacted into law over 16 years ago and has been actively invoked since 2008, but the Federal Reserve has yet to provide any definitive guidance on how that clause is intended to operate.

The 2014 Senate Staff Report analyzed the clause's ambiguous wording, its legislative history, and how it was being improperly used to expand the types of commodity activities undertaken by some financial holding companies.[77] The report also urged the Federal Reserve, in a bipartisan recommendation, to clarify the scope of the grandfather clause, in particular by making it clear that it was intended "only to prevent disinvestment of physical commodity activities that were underway in September 1997, and continued to be underway at the time of a company's conversion to a financial holding company."[78]

The Proposed Rule discusses the wording and nature of the grandfather clause,[79] but fails to acknowledge or resolve the ongoing disputes over whether that clause is confined to preventing disinvestments when a company becomes a financial holding company or can also be used to authorize a financial holding company's undertaking physical commodity activities that it never conducted in the past. Rulemakings on physical commodity issues are so rare, that the Federal Reserve should not pass up this opportunity to clarify the ambiguities surrounding the grandfather clause, especially when Goldman Sachs and Morgan Stanley may continue to invoke the clause as authority for them to conduct physical commodity activities that they were not engaged in prior to 1997, and would not otherwise be permitted under their complementary or merchant banking authorities.

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[76] Id. at 67239 (proposed Section 225.95(a) and (b)).
[77] 2014 Senate Staff Report, at 418-429.
[78] Id. at 362.
[79] Proposed Rule, at 67223.

Conclusion

Thank you for this opportunity to comment on the Proposed Rule and for your ongoing efforts to revitalize the separation of banking from commerce and reduce the risks associated with physical commodity activities at U.S. financial holding companies.

Sincerely,

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