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February 21, 2017

Via Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Robert deV. Frierson, Secretary
Docket No. R—1547; RIN 7100 AE-58

Re: 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*

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs") appreciates the opportunity to comment on the notice of proposed rulemaking of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), which would amend risk-based capital requirements and assign additional regulatory requirements and restrictions for financial holding companies ("FHCs") conducting physical commodity trading activities pursuant to the Bank Holding Company Act of 1956 (the "BHC Act").[2]

Goldman Sachs, through its affiliates, has been a participant in the commodities markets, including as a market maker in the commodities and commodity derivatives markets, since 1981. Prior to becoming a bank holding company, Goldman Sachs operated as an investment bank active in securities and commodities. Since then, Goldman Sachs has continued to conduct commodities activities under Section 4(o) of the BHC Act,[3] as well as under other authorities

[1] Goldman Sachs also has participated in the preparation of the comment letters written by the Securities Industry and Financial Markets Association ("SIFMA"), The Clearing House, and the International Swaps and Derivatives Association, Inc., and it supports the comments in those letters.

[2] 81 Fed. Reg. 67,220 (September 30, 2016) (the "Proposal").

[3] Section 4(o), introduced in the Gramm-Leach Bliley Act ("GLBA"), permits bank holding companies ("BHCs") that become FHCs after November 12, 1999 to continue to engage in, or directly or indirectly own or control shares of a company engaged in, activities related to the trading, sale, or investment in

available to FHCs more broadly.[4] Since Section 4(o) was enacted, the Federal Reserve has permitted FHCs on a case-by-case basis to engage in physical commodity trading activity under "complementary authority" introduced by GLBA ("Complementary Authority"),[5] subject to certain conditions. In addition, all FHCs have the ability under merchant banking authority ("Merchant Banking Authority")[6] to make investments, including in commodity infrastructure assets, again subject to certain conditions.

The Proposal would impose heightened risk-based capital requirements on financial transactions associated with physical commodities under Complementary Authority, Section 4(o), and Merchant Banking Authority. With respect to Section 4(o), however, the Proposal would go further, in essence imposing even higher capital requirements on *any* activity a 4(o) FHC conducts under Section 4(o) regardless of whether the commodity or activity is environmentally sensitive. The effect of the Proposal is to make the Section 4(o) authority essentially meaningless because it would impose prohibitive capital charges on activity a 4(o) FHC conducts that would not be permitted under Complementary Authority.

We recognize the Federal Reserve has broad authority to impose capital requirements that take into account, and address, the risk of activities conducted by banking organizations. However, where the proposed capital charges would have an impact on all FHCs' ability to participate in segments of the physical commodities markets, we urge the Federal Reserve to consider the potential impacts on markets and end-users. We also urge the Federal Reserve to reevaluate whether the establishment of the proposed 5 percent of tier 1 capital cap on Section 4(o) activities (the "4(k) Cap Parity Amount") and the capital charge imposed on activities that exceed the cap are sufficiently tied to the risk the activity poses that it justifies a capital charge that effectively prohibits statutorily authorized activity.

I. Changes to the current framework for FHCs' physical commodity activities should consider potential costs to markets and end-users from FHCs' reduced involvement

FHCs perform important functions in the commodities markets, which include enabling end-users to obtain competitive pricing, manage their risks, and face stable, highly regulated and rated counterparties. By assigning additional substantial capital requirements to certain physical commodity activities, the Proposal would decrease FHC participation in these markets. This consequence raises concerns, particularly because the Proposal does not address the value that would be lost by end-users and the market more broadly.

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commodities and underlying physical properties that were not permissible for BHCs to conduct in the United States as of September 30, 1997 if, among other things, the FHC or any subsidiary of the FHC, lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States. *See* 12 U.S.C. § 1843(o); *see also* GLBA, Pub. L. No. 106-102, § 103(a), 113 Stat. 1338, 1349-1350 (1999). FHCs that engage in activities pursuant to Section 4(o) are herein referred to as ("4(o) FHCs").

4 For example, Goldman Sachs may engage in cash-settled or instantaneous transfer-of-title commodity derivative transactions. *See* 12 C.F.R. § 225.28(b)(8)(ii)(B).

5 *See* 12 U.S.C. § 1843(k)(1)(B).

6 *See* 12 U.S.C. § 1843(k)(4)(H).

FHCs are highly stable market participants, as they are subject to multiple regulatory and supervisory regimes in the conduct of these activities, have transparent credit ratings and are market makers and not proprietary traders. FHCs assist both producers and consumers of commodities in transferring risks relating to price exposures by trading in the spot market and conducting market making activities. Customized products also facilitate the ability of end-users to achieve hedging treatment under accounting principles, which is important in allowing them to manage risk without having the unintended consequence of increasing earnings volatility. Additionally, FHCs help clients in resolving mismatches in timing, grade and location between commodity assets and liabilities and in obtaining financing and investment capital. Further, by participating in the widest possible variety of commodities markets and transactions, FHCs acquire more experience in the markets for physical commodities that they may use to better serve its customers and help them manage their risks. By reducing FHCs' activities in the physical commodities markets, the Proposal would cause end-users to rely to a greater degree on non-FHC commodities participants. Although other market participants may provide intermediation services, they are not a perfect substitute for FHCs, and they are generally not market makers because they also trade opportunistically. A gap in these services would increase costs to end-users and has the potential to negatively impact the market as a whole by reducing liquidity, price convergence and transparency, as well as increasing volatility and risk to end-users.

Despite numerous benefits to end-users from FHC participation in the physical commodities markets, the Proposal would assign higher costs for FHCs, particularly 4(o) FHCs, which could ultimately have a direct financial impact on end-users. The Proposal may result in the exit from segments of the commodities markets by some FHCs, which would result in less competition, less innovation, and increased costs to end-users. For those FHCs that remain in those markets, the Proposal may have an adverse effect on their ability to provide competitive pricing terms and conditions when compared with other non-FHC participants in the same markets. In addition, the proposed new, lower 4(k) Cap Parity Amount could result in lower overall aggregate transaction size offerings and reduced product offerings for end-users. Finally, the range of innovative and tailored products available to end-users may decrease, as the incentive to invest in the development of unique transaction structures would decline.

We urge the Federal Reserve to conduct in-depth empirical and qualitative studies to assess these potential impacts and to carefully consider the potential loss in the expertise and availability of physical commodities services by highly regulated and stable FHC counterparties before taking any action that would reduce their participation in these markets.[7]

II. <u>Actions that limit a 4(o) FHC's ability to rely on Section 4(o) should be undertaken cautiously in light of the clear Congressional grant of authority</u>

Congress enacted Section 4(o) to permit FHCs to, among other things, engage in activities related to: (i) the facilitation of business through the trading and sale of commodities and in the underlying physical properties, and (ii) the investment in commodities and in the

7 *See* comment letters submitted by end-users in response to the advanced notice of proposed rulemaking published by the Federal Reserve in January 2014, *available at*: http://www.federalreserve.gov/apps/foia/ViewAllComments.aspx?doc_id=R-1479&doc_ver=1.

underlying physical properties.[8] Given this clear grant of authority and Congressional intent, changes to the risk-based capital framework that effectively reduce or eliminate the purpose of Section 4(o) should not be taken without a clear articulation of the reason such a step is necessary.

In enacting Section 4(o), Congress explicitly acknowledged the importance of the expertise and risk management provided by FHC intermediaries in the physical commodities markets. Indeed, Goldman Sachs's clients, which include many end-users (including corporates and state and local governments), benefit greatly from its market making and intermediation activities. Further, Congress clearly stated that its purpose in enacting Section 4(o) was to not replace banking organizations in these markets, stating that the purpose of Section 4(o) was to "assure[] that a securities firm currently engaged in a broad range of commodities activities as part of its traditional investment banking activities, is <u>not</u> required to divest certain aspects of its business in order to participate in the new authorities granted under the Financial Services Modernization Act."[9]

The Proposal may practically pre-empt Congressional authority by taking action in direct contravention to the language of Section 4(o). First, Section 4(o) grandfathers the scope of traditional investment banks' commodities activities. By applying a 1,250 percent risk weight on a subset of assets, the Proposal would limit the range and volume of physical commodities activity—the very things that Section 4(o) was designed to protect—without action by Congress.[10] Second, Section 4(o) grandfathers the degree of the activity, as reflected in the 5 percent of total consolidated assets cap.[11] By setting a *de facto* 5 percent cap of tier 1 capital on physical commodities activity, as opposed to a cap of 5 percent of total consolidated assets, the Proposal would reduce the ability for 4(o) FHCs to engage in statutorily permitted activities and effectively would override the congressionally authorized 5 percent of total consolidated assets cap. This is despite the fact that the 4(k) Cap Parity Amount, used as a tool to "level the playing field," would be assigned without an apparent analysis of why a 5 percent of tier 1 capital cap is more appropriate than the existing cap established by Congress. Lastly, the proposed 4(k) Cap Parity Amount would not solely apply to "covered physical commodities,"[12] but to <u>all</u> physical commodities (excluding precious metals), notwithstanding that the Proposal only posits that

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8 *See* GLBA §103.

9 Amendment No. 9 by Senator Gramm (Mar. 4, 1999), *available at*: http://www.banking.senate.gov/docs/reports/fsmod99/gramm9.htm (emphasis added). It being understood, however, that regulations that have subsequently been enacted, which appropriately regulate banking institutions, such as the Volcker Rule, required such banking institutions to modify certain business lines.

10 Note that the Federal Reserve, in its September 2016 report pursuant to Section 620 of the Dodd-Frank Act, recommended that Congress take this action. *See* Federal Reserve, FDIC and OCC, *Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act*, pp. 28-31 (September 2016)

11 "[T]he attributed aggregate consolidated assets… are equal to not more than 5 percent of the total consolidated assets of the bank holding company…" GLBA §103.

12 Covered physical commodities refers to environmentally sensitive physical commodities. *See* Proposal, at 67,233 and 67,236.

covered physical commodities raise additional environmental and, consequently, reputational risks.

III. There is a disconnect between the suggested risk of an activity and the risk-based capital charge assigned or cap imposed on the activity

The Federal Reserve has historically used its authority to impose regulatory capital requirements on banking organizations to construct a well-functioning and balanced risk-based capital framework. The Proposal offers some explanation for heightened capital charges, but does not explain the rationale for 300 percent versus 1,250 percent risk weights for the same type of holdings. For example, the Proposal states that "[a]n environmental catastrophe linked to an FHC's physical commodity activities could suddenly and severely undermine public confidence in the FHC… limiting its access to funding markets until the market assesses the extent of the FHC's liability,"[13] but it does not explain why this limited access to funding would only apply to, or would apply to a greater degree to, a 4(o) FHC. Further, no risk-based rationale is provided for the massive capital increase from 300 percent to 1,250 percent for activity that exceeds the 4(k) Cap Parity Amount for the very same commodity holding. This lack of rationale is particularly concerning because the cap is applied to all physical commodities activities, meaning that a substantial inventory of commodities that are not "covered physical commodities" could trigger a 1,250 percent risk weight on a *de minimis* amount of "covered physical commodities" inventory.

As more clearly illustrated in the table below, the Proposal applies differing capital treatment[14] for 4(o) FHCs based on (A) whether (i) a commodity is a "covered physical commodity" that may be held under Complementary Authority (not clearly defined), (ii) a commodity that is not a covered physical commodity and permissible under Complementary Authority, (iii) a covered physical commodity that is not permissible under Complementary Authority or (iv) a commodity that is not a covered physical commodity nor permissible under Complementary Authority and (B) whether the FHC has commodity holdings above or below the 4(k) Cap Parity Amount.[15]

13 *Id* at 67,227.

14 Note that the capital charges discussed in this section are incremental to existing market and operational risk capital charges, and, where relevant, counterparty credit capital charges (collectively, "Existing RWs").

15 *See* Proposal at 67,227-67,228.

	Complementary Authority	Section 4(o) and below 4(k) Cap Parity Amount	Section 4(o) and above 4(k) Cap Parity Amount
Non-Covered Physical Commodities	Existing RWs	Existing RWs	Existing RWs+**1,250%**
Covered Physical Commodities that can be held under Complementary Authority	Existing RWs+**300%**	Existing RWs+**300%**	Existing RWs+**1,250%**
Covered Physical Commodities that can only be held under Section 4(o)	N/A	Existing RWs+**1,250%**	Existing RWs+**1,250%**

These proposed provisions reveal three significant inconsistencies in the application of risk weights:

- First, for a 4(o) FHC, the Proposal would assign a 300 percent risk weight if its commodity holdings are below the 4(k) Cap Parity Amount (and permissible under Complementary Authority); however, if the 4(o) FHC exceeds that threshold, a 1,250 percent risk weight would apply to the very same holdings.

- Second, for non-covered physical commodities held by a 4(o) FHC, no additional risk weight applies, yet if the holdings of the 4(o) FHC exceeds the 4(k) Cap Parity Amount, a risk weight of 1,250 applies to that non-covered physical commodity. In addition to this inconsistency, no additional capital charge would apply for the same commodity holding under Complementary Authority (subject to the 5 percent of tier 1 capital cap).

- Lastly, in calculating the 4(k) Parity Amount, all commodities (excluding precious metals) held by a 4(o) FHC are included, even those that are not covered physical commodities are in scope for the elevated risk weights.[16]

The rationale behind the Proposal's application of risk weights is elusive, as the capital charges do not reflect any change in the intrinsic risk of owning the physical commodities. To illustrate, suppose a FHC enters into a covered commodity derivative contract involving physical delivery to hedge another position, with a contract valued at $500 million. If the derivative transaction involving physical delivery of the covered commodity is conducted by a 4(o) FHC ("FHC A") in excess of its 4(k) Cap Parity Amount, a 1,250 percent risk weight would apply. In this case, FHC A would be required to hold an additional $625 million in order to achieve the minimum ratio to sustain its well-capitalized status. Conversely, if the very same transaction is conducted by another FHC under Complementary Authority ("FHC B"), the Proposal would only apply a 300 percent capital charge to the transaction, and FHC B would be required to hold an additional $150 million. That means that FHC A would effectively be required to hold more

16 *See id.*

than four times the capital for the same activity as FHC B (*e.g.*, \$625 million for FHC A as compared to \$150 million for FHC B), notwithstanding that the risks posed by these holdings are the same. Instead of functioning as a carefully crafted risk-based capital rule, with risk weights that are commensurate to the risks they are designed to mitigate, the Proposal presents a *de facto* prohibition.

Moreover, the same analysis would apply for activities involving commodities that are not covered commodities, for example, if FHC A and FHC B each entered into base metal derivative contracts involving physical delivery, with contracts valued at \$500 million. In this case, FHC A would be required to hold an additional \$625 million, but the Proposal would not apply any additional capital charge to the transaction conducted by FHC B. The result in this case is even more difficult to tie to risks because the Proposal imposes a *de facto* prohibition on the 4(o) FHC for an activity that does not present any heightened environmental risk.

Finally, the Proposal's explanation for imposing the 4(k) Cap Parity Amount is the same as the explanation for tightening the cap on Complementary Authority,[17] that is, the legal and environmental risks that the Proposal states are unique to holding physical commodities. However, without further analysis or evidence it is difficult to understand what would justify a 5 percent of tier 1 capital cap on Section 4(o) activities, or why the cap is not limited to covered physical commodities. There is a difference between a cap imposed by the Federal Reserve on an activity that it has permitted on a discretionary basis, such as the existing cap on activities authorized under Complementary Authority, and a cap imposed on an activity that is permitted up to a limit established by statute. In the latter case, we believe that there needs to be sufficient evidence that the cap is truly necessary as a safety and soundness matter. Again, no rationale is provided to explain why an incremental dollar of activity above the cap results in a 950 percent jump in capital charge.

IV. Other Issues

We also have the following comments on other specific elements of the Proposal:

Scope of Complementary Authority. Currently, under Complementary Authority, a FHC is only permitted to conduct physical commodity trading activities for commodities that have been approved by the Commodity Futures Trading Commission (the "CFTC") for trading on a U.S. futures exchange, or that have been approved in an order. The commodities that have been separately authorized by the Federal Reserve include physical commodities that are not approved for trading in the United States or on certain non-U.S. exchanges, but for which there is a market in financially settled contracts, the physical market for the commodity is liquid, and the commodity is fungible.[18] Additionally, the Federal Reserve separately authorized trading in certain natural gas liquids, oil products and petrochemicals.[19] The lack of clarity regarding the scope of activities under Complementary Authority is problematic; because these commodities were approved only for certain FHCs, not all FHCs with Complementary Authority may trade in

17 *See id.*

18 *See The Royal Bank of Scotland Group plc*, 94 Fed. Res. Bull. C60, C63 (2008).

19 *See id.*

the same commodities, and, as a result, it is unclear whether the Federal Reserve would consider them "permissible" under Complementary Authority. Additionally, for those 4(o) FHCs that plan to continue conducting certain activities under Section 4(o), the ambiguity surrounding activities that are permissible under Complementary Authority creates uncertainty for the assignment of capital charges to Section 4(o) activities. We urge the Federal Reserve to harmonize the permissible physical commodities across all FHCs with Complementary Authority.

Furthermore, Goldman Sachs believes that the basis on which the Federal Reserve authorized FHCs to trade in nickel is equally applicable to physical commodities that are traded on other exchanges, foreign boards of trade, related facilities and platforms that are "highly liquid global markets" and "subject to a regulatory structure comparable to that administered by the CFTC."[20] For example, the contracts traded on the LME are highly liquid, in some cases, with daily notional values of roughly $350 million traded, and are subject to comparable regulatory oversight. Additionally, swaps that are traded over-the-counter but are cleared by U.S. or foreign clearing houses and swaps traded on swap execution facilities exhibit similar properties as LME contracts.

Implementation period. The Proposal would provide a two year transition period following the effective date of the final rule, if adopted, for FHCs to conform their activities to the revised 5 percent of tier 1 capital cap for activities conducted under Complementary Authority,[21] and to wind down their energy management and energy tolling arrangements,[22] but it does not provide a transition period for implementing new risk weights or for 4(o) FHCs to conform their operations to account for the 4(k) Cap Parity Amount. The Federal Reserve generally allows for a conformance period when implementing new rules because it recognizes the burdens associated in applying those rules. Given that the Proposal imposes a *de facto* prohibition on some activities conducted under Section 4(o), 4(o) FHCs will experience greater challenges in implementing the Proposal as compared to other FHCs. Thus, we urge the Federal Reserve to provide an implementation period that is commensurate with these substantial challenges.

Grandfather existing transactions. Congress enacted Section 4(o) in 1999 in order to ensure that banking organizations would "<u>not</u> [be] required to divest"[23] the aspects of their business that involve physical commodities markets, so that end-users and markets could continue to benefit from the expertise that FHCs bring to these markets. As described above, the proposed risk weights and 4(k) Cap Parity Amount will force 4(o) FHCs to reduce the activities they conduct under Section 4(o), and in some cases, to exit the market completely, resulting in a

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20 *Id* at C62. The Federal Reserve requires that there is a liquid and fungible exchange or facility on which the commodities are traded such that the FHC is not exposed to significant additional risks than it would be exposed to in taking and making delivery of a commodity for which derivative contracts have been authorized for trading on a U.S. futures exchange by the CFTC. *See id.*

21 *See* Proposal, at 67,226.

22 *See* Proposal, at 67,232.

23 Amendment No. 9 by Senator Gramm (Mar. 4, 1999), *available at*: http://www.banking.senate.gov/docs/reports/fsmod99/gramm9.htm (emphasis added).

de facto prohibition on these activities. Even if the Federal Reserve implements the Proposal in its current state, we urge the Federal Reserve to grandfather 4(o) FHCs' existing Section 4(o) transactions in deference to the longstanding reliance on this statutorily authorized activity and the reliance interest of 4(o) FHC clients.

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We appreciate the opportunity to comment on the Proposal. We would be pleased to discuss these comments and suggestions with you in more detail and to provide additional information that may be helpful.

Sincerely,

John F.W. Rogers
Executive Vice President and Chief of Staff
The Goldman Sachs Group, Inc.