

STATEMENT OF  
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BEFORE THE  
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER  
PROTECTION

HEARINGS ON:

“EXAMINING FINANCIAL HOLDING COMPANIES: SHOULD BANKS CONTROL  
POWER PLANTS, WAREHOUSES, AND OIL REFINERIES”

JULY 23, 2013

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**I. Introduction**

Chairman Brown, Ranking Member Toomey, members of the Subcommittee:

My name is Randall Guynn, and I am a partner and head of the Financial Institutions Group of Davis Polk & Wardwell LLP.<sup>1</sup> Thank you for your invitation to testify at this important hearing.

My testimony will describe the laws and regulations that currently permit insured banks, bank holding companies, financial holding companies and their nonbank affiliates to engage as principal in futures, forwards and other commodities contracts and in owning or controlling physical or intangible commodities or related facilities, including electric power plants, commodities warehouses and oil refineries. These financial institutions are permitted to engage in commodities activities to meet the needs of

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<sup>1</sup> My practice focuses on providing bank regulatory advice and advising on M&A and capital markets transactions when the target or issuer is a banking organization or other financial institution. My clients include many of the largest U.S. and non-U.S. banks, a number of regional, mid-size and community banks, and certain financial industry trade associations.

customers, increase customer choice, increase competition, act as more effective intermediaries between producers and end-users, provide increased liquidity to the markets and lower prices to consumers, and increase the diversification of the revenue streams and exposures of these financial institutions. All things being equal, increased diversification of activities reduces risk, preserves capital and should help an institution improve its financial condition over time.

As you will see, insured banks are the most limited in what they are permitted to do, are not permitted to take delivery of physical commodities and generally are not permitted to control related facilities such as power plants, commodities warehouses or oil refineries. Only separately incorporated, capitalized and insulated nonbank affiliates are permitted to exercise broader powers, and even they are subject to significant limits in doing so. These nonbank affiliates are granted broader powers because they are not eligible for federal deposit insurance and do not have access to the Federal Reserve's discount window.<sup>2</sup> In addition, other federal laws, including Sections 23A and 23B of the Federal Reserve Act,<sup>3</sup> prevent insured banks from passing on the funding advantages of deposit insurance or giving their nonbank affiliates access to the discount window. These other laws also insulate insured banks against the risks of a nonbank affiliate's commodities and other nonbanking activities.

Even the powers of these nonbank affiliates, however, are subject to significant limits. Bank holding companies that do not qualify as financial holding companies, and their nonbank affiliates, are subject to the most severe limits. Subject to certain very

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<sup>2</sup> Deposit insurance and access to the Federal Reserve's discount window are often referred to as the federal safety net.

<sup>3</sup> 12 U.S.C. § 371c.

narrow exceptions, they are not permitted to buy, sell or make or take delivery of physical or intangible commodities or control related facilities.

Moreover, even financial holding companies and their nonbank affiliates must generally show that physical commodities activities are complementary to permissible financial activities, such as entering into futures, forwards or other commodities contracts, before being permitted to engage in such physical commodities activities. They must also show that their exercise of these powers does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. They are prohibited from trading in physical commodities unless a derivative contract has been authorized for trading on a futures exchange by the Commodity Futures Trading Commission or they otherwise demonstrate that the particular commodity is sufficiently fungible and liquid. They are generally prohibited from owning or controlling the day-to-day operations of processing, storage, transportation or other physical or intangible commodities facilities, including electric power plants, commodities warehouses and oil refineries. They may, however, temporarily own or control companies that operate such facilities pursuant to the merchant banking power, the temporary exception for acquiring companies substantially engaged in financial activities or the exception for acquisitions in satisfaction of a debt previously contracted in good faith. Finally, their physical commodities activities are subject to a variety of conditions and limitations. These include appropriate risk management requirements, oversight by the Federal Reserve and other regulators, and volume limitations.

Financial holding companies whose commodities activities are grandfathered under Section 4(o) of the Bank Holding Company Act are generally permitted to engage

in trading, sale or investment in physical commodities activities and related facilities, but only subject to certain conditions and limitations. These conditions and limitations include appropriate risk management requirements, oversight by the Federal Reserve and other regulators, and volume limitations.

All of these financial holding companies and their bank and nonbank affiliates are subject to generally applicable laws and regulations that govern these activities. For example, they must conduct their commodities activities in compliance with all applicable antitrust, securities, futures and energy laws. These include the orders, rules and regulations of the government agencies, exchanges and self-regulatory organizations responsible for implementing and enforcing those laws, including the U.S. Department of Justice, the Federal Trade Commission, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Energy Regulatory Commission, the National Futures Association, the CME Group, Intercontinental Exchange and the London Metal Exchange.

My testimony will also describe the extent to which banks, bank holding companies, their nonbank affiliates and other nonbank financial institutions were permitted to act as principal – and were major players – in the commodities markets before the Gramm Leach Bliley Act of 1999, the Glass-Steagall Act of 1933 or even the National Bank Act of 1863. In fact, there has been a close relationship between banking and commodities since ancient times as well as in this country for most of the past 200 years shows that both the grandfathering provision in Section 4(o) of the Bank Holding Company Act and the complementary powers orders that permit certain non-grandfathered financial holding companies to engage in trading physical and energy

commodities were only incremental expansions of traditional banking powers, not the sort of radical departure some of argued.

I will then discuss whether commodities activities, as currently permitted by the law, are inconsistent with the principle of keeping banking and commerce separate. Finally, I will address whether insured banks or their nonbanking affiliates, including financial holding companies, should be prohibited from engaging in commodities activities or at least from controlling related facilities.

## **II. Current State of the Law**

The National Bank Act expressly permits national banks to engage in the “business of banking,” as well as all activities that are “incidental” to that business.<sup>4</sup> Although the National Bank Act does not define the business of banking, it provides a list of activities that are included within that term, including “buying and selling exchange, coin, and bullion”<sup>5</sup> – that is, trading in precious metals and other commodities that function as money or monetary substitutes. In *NationsBank v. VALIC*, the Supreme Court held that the business of banking is not limited to the list of activities in the National Bank Act:

“We expressly hold that the ‘business of banking’ is not limited to the enumerated powers in §24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated. The exercise of the Comptroller’s discretion, however, must be kept within reasonable bounds. Ventures distant from dealing in financial investment instruments – for example, operating a general travel agency – may exceed those bounds.”<sup>6</sup>

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<sup>4</sup> 12 U.S.C. § 24(Seventh).

<sup>5</sup> *Id.*

<sup>6</sup> 513 U.S. 251, 258-259 note 2 (1995).

In a series of orders and interpretive letters issued over time, the Office of the Comptroller of the Currency (“OCC”) has defined the range of activities that fall within the business of banking or that are incidental to it. Among the activities that the OCC has defined as bank-permissible are acting as principal or agent in connection with a wide range of derivative contracts, including commodities contracts, as long as certain risk-management and other conditions are satisfied.<sup>7</sup> National banks are generally not permitted to take delivery of any underlying physical or intangible commodities and generally are not permitted to control related facilities such as power plants, commodities warehouses or oil refineries. They may, however, acquire temporary ownership or control of companies that operate such facilities in satisfaction of a debt previously contracted in good faith for a maximum of ten years.<sup>8</sup>

Section 4(c)(8) of the Bank Holding Company Act of 1956 (“BHC Act”) similarly authorizes bank holding companies and their nonbank affiliates to engage in activities that are determined by the Board of Governors of the Federal Reserve System (“Federal Reserve Board” or “Board”) “to be so closely related to banking as to be a proper incident thereto.”<sup>9</sup> In a series of orders eventually codified in Section 225.28(b)(8) of the Board’s Regulation Y, the Federal Reserve Board has determined that engaging as principal in a wide range of derivative contracts, including commodities contracts, is

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<sup>7</sup> See Comptroller of the Currency, Administrator of National Banks, *Activities Permissible for a National Bank, Cumulative*, at 57-64 (2011 Annual Edition, Apr. 2012).

<sup>8</sup> See 12 USC 24(Seventh) (incidental powers clause); OCC Interpretive Letter No. 643, reprinted in Fed. Banking L. Rep. (CCH) ¶ 83, 551 (July 1, 1992); OCC Interpretive Letter No. 511, reprinted in [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,213 (June 20, 1990); OCC Interpretive Letter No. 1007 (September 7, 2004); See also *Activities Permissible for a National Bank*, supra note 7, at 86.

<sup>9</sup> 12 U.S.C. §1843(c)(8).

“closely related to banking” as long as certain risk-management and other conditions are satisfied.<sup>10</sup> Subject to certain very narrow exceptions, Regulation Y does not permit bank holding companies or their nonbank affiliates to take or make delivery of physical or intangible commodities as a closely-related-to-banking activity.<sup>11</sup> Nor are bank holding companies permitted to acquire control of related facilities, except temporarily in satisfaction of a debt previously contracted in good faith for a maximum of ten years.<sup>12</sup>

Section 4(k)(1) of the BHC Act, which was added in 1999 by the Gramm Leach Bliley Act (“GLB Act”), expressly permits bank holding companies that qualify as financial holding companies, as well as their nonbank affiliates, to engage in activities that are “financial in nature,” “incidental” to a financial activity or “complementary” to a financial activity if certain conditions are satisfied.<sup>13</sup> Among the conditions that apply to engaging in a complementary activity is that such activity can be and is conducted in a manner that does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.<sup>14</sup>

Section 4(k)(4)(F) expressly defines financial activities for this purpose as including all of the closely-related-to-banking activities in Section 225.28 of Regulation

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<sup>10</sup> 12 C.F.R. § 225.28(b)(8). *See also* Randall D. Guynn, Luigi L. De Ghenghi & Margaret E. Tahyar, *Foreign Banks as U.S. Financial Holding Companies*, in *REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES*, § 10:4[9][a] (6<sup>th</sup> ed. 2012); Melanie L. Fein, *FEDERAL BANK HOLDING COMPANY LAW* §18.07 (3<sup>rd</sup> ed. 2011)

<sup>11</sup> *See* 12 C.F.R. § 225.28(b)(8).

<sup>12</sup> 12 U.S.C. § 1843(c)(2); C.F.R. §225.22(d)(1).

<sup>13</sup> 12 U.S.C. § 1843(k)(1).

<sup>14</sup> *Id.* § 1843(k)(1)(B).

Y, including the commodities activities described above.<sup>15</sup> Thus, Section 4(k)(4)(F) codified the Federal Reserve Board’s regulation as a matter of binding statutory law.

In a series of orders issued to specific institutions after passage of the GLB Act, the Federal Reserve Board determined that purchasing or selling a wide range of physical or intangible commodities, including oil, natural gas, electric power, emissions allowances, agricultural products, metals and certain other nonfinancial commodities in the spot markets or to take or make delivery of such physical or intangible commodities pursuant to commodities contracts, is “complementary” to the financial activity of acting as principal with respect to commodity contracts, subject to certain conditions.<sup>16</sup> Among the conditions applicable to this authority is that the commodities activities be limited to commodities that are sufficiently fungible and liquid.<sup>17</sup> To ensure that they are, the Board has generally required financial holding companies requesting these expanded powers to limit their physical commodities activities to commodities for which a derivative contract has been authorized for trading on a futures exchange by the CFTC or which the Board has specifically determined to be sufficiently fungible and liquid.<sup>18</sup>

Complementary authority does not provide a basis for financial holding companies to own or control the day-to-day operations of processing, storage, transportation or other physical or intangible commodities facilities, including electric power plants, commodities warehouses and oil refineries. They may, however,

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<sup>15</sup> Id. § 1843(k)(4)(F).

<sup>16</sup> See, e.g., *Citigroup*, 89 Fed. Res. Bull. 508 (2003); *JPMorgan Chase & Co.*, 92 Fed. Res. Bull. C57 (2006); *Royal Bank of Scotland Group*, 94 Fed. Res. Bul. C60 (2008). See also Guynn, De Ghenghi & Tahyar, *supra* note 10, §10:4[9][a].

<sup>17</sup> See, e.g., *Royal Bank of Scotland Group*, *supra* note 16.

<sup>18</sup> See, e.g., *id.*



temporarily own or control companies that operate such facilities pursuant to the merchant banking power, the temporary exception for acquiring companies engaged in nonfinancial activities, or in satisfaction of a debt previously contracted in good faith, which are discussed more fully below.

In approving the applications of certain financial holding companies to engage in physical commodities activities, the Board also determined that the activities would satisfy the requirement that they be conducted in a manner that does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally if they were conducted subject to certain conditions. These conditions include appropriate risk management requirements, oversight by the Federal Reserve and other regulators, and a volume limit on the extent to which balance sheet resources may be dedicated to these activities.<sup>19</sup>

Finally, the Board found that permitting physical commodities activities would likely produce public benefits in the form of increasing customer choice, competition and market efficiency.<sup>20</sup> These activities almost certainly also produce public benefits in the form of providing increased liquidity to the markets and lower prices to consumers, and increasing the diversification of the revenue streams and exposures of these financial institutions. All things being equal, increased diversification of activities reduces risk, preserves capital and should help an institution improve its financial condition over time. Another important benefit of allowing financial holding companies to own inventory in

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<sup>19</sup> See, e.g., Citigroup, supra note 16; JPMorgan Chase & Co., supra note 16; Royal Bank of Scotland Group, supra note 16.

<sup>20</sup> See, e.g., *id.*

physical commodities is that this permits them to finance the inventory for customers, such as airlines and refiners.

The merchant banking power is contained in Section 4(k)(4)(H) of the BHC Act.<sup>21</sup> It permits all financial holding companies and their nonbank affiliates to make temporary investments in any company that is engaged in nonfinancial activities or mixed financial and nonfinancial activities, subject to certain conditions.<sup>22</sup> Such nonbanking activities would include investing in physical commodities or related facilities. The most important conditions on the merchant banking power are that such investments in nonfinancial companies must be made as part of a bona fide underwriting or merchant or investment banking purpose and generally must be divested within 10 years, and the financial holding company must not be involved in the routine management of the portfolio company, except temporarily if necessary to preserve the value of the investment.<sup>23</sup>

Financial holding companies are also permitted, under a separate authority, to acquire temporary control of any company that is engaged in both financial and nonfinancial activities, provided that the company is “substantially engaged” in financial activities and the company conforms, terminates or divests any nonfinancial activities within two years.<sup>24</sup> A company is deemed to be “substantially engaged” in financial activities if at least 85% of its revenues and 85% of its assets are attributable to financial

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<sup>21</sup> 12 U.S.C. 1843(k)(4)(H).

<sup>22</sup> *See id.*

<sup>23</sup> See 12 U.S.C. §1843(k)(4)(H); 12 C.F.R. §§ 225.171, 225.172.

<sup>24</sup> 12 C.F.R. § 225.85(a)(3).

activities.<sup>25</sup> Like other bank holding companies, financial holding companies and their nonbank affiliates are also permitted to acquire temporary control of a company that controls physical commodities or related facilities in satisfaction of a debt previously contracted in good faith for a maximum of ten years.<sup>26</sup>

Finally, Section 4(o) of the BHC Act, which was also added in 1999 by the GLB Act, contains a permanent grandfathering provision for institutions that were engaged in any commodities activities as of September 30, 1997, were not bank holding companies when the GLB Act was signed into law, but subsequently become bank and financial holding companies.<sup>27</sup> Section 4(o) expressly permits any qualifying financial holding company 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 commodities and underlying physical properties,”<sup>28</sup> provided that not more than 5% of the qualifying company’s consolidated assets are attributable to such commodities or underlying physical properties.<sup>29</sup> Unlike other grandfathering provisions such as Section 4(n) of the BHC Act,<sup>30</sup> Section 4(o) does not have a time limit. Thus, it is a permanent exemption from the general requirement for a new bank holding company to conform its activities to

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<sup>25</sup> *Id.* § 225.85(a)(3)(ii).

<sup>26</sup> 12 C.F.R. §225.22(d)(1).

<sup>27</sup> 12 U.S.C. §1843(o).

<sup>28</sup> *Id.* (emphasis added).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* §1843(n).

the restrictions on nonbanking activities otherwise contained in Section 4 of the BHC Act within five years of becoming a bank holding company.<sup>31</sup>

Section 4(o) was one of several provisions in the GLB Act that were designed to ensure that the GLB Act would be a “two-way street” for commercial banks and investment banks, making it just as easy for an investment bank with a major commodities business to affiliate with an insured bank as it is for an insured bank to affiliate with a securities underwriting and dealing firm.<sup>32</sup> The legislative history stated that the activities described in Section 4(o) should be construed broadly and to include at a minimum the ownership and operation of properties and facilities required to extract, process, store and transport commodities.<sup>33</sup> It also explained that the purpose of Section 4(o) was to ensure that:

“a securities firm currently engaged in a broad range of commodities activities as part of its traditional investment banking activities, is not required to divest certain aspects of its business in order to participate in the new authorities granted under the [GLB Act].”<sup>34</sup>

All of these financial holding companies and their bank and nonbank affiliates are subject to generally applicable laws and regulations that govern these activities. For example, they must conduct their commodities activities in compliance with all

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<sup>31</sup> See *id.* §1843(a)(2) (providing a transition period of 2-5 years for new bank holding companies to conform their activities to the nonbanking activities restrictions in the BHC Act).

<sup>32</sup> See, e.g., Cong. Rec. H3141 (daily ed. May 13, 1998) (statement of Rep. Dingell) (“H.R. 10 . . . does nothing to hurt the banks. It expands the range of allowable banking activities . . . . It creates, insofar as humanly possible, a fair two-way street for all players.”).

<sup>33</sup> See, e.g., H.R. Rep. No. 104-127, pt. 1, at 97 (May 18, 1995) (“The Committee intends that activities relating to the trading, sale or investment in commodities and underlying physical properties **shall be construed broadly** and shall include owning and operating properties and facilities required to extract, process, store and transport commodities.”) (Emphasis added.)

<sup>34</sup> Amendment No. 9 by Senator Gramm (Mar. 4, 1999), available at <http://banking.senate.gov/docs/reports/fsmod99/gramm9.htm>.

applicable antitrust, securities, futures and energy laws. These include the orders, rules and regulations of the government agencies, exchanges and self-regulatory organizations responsible for implementing and enforcing those laws, including the U.S. Department of Justice, the Federal Trade Commission, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Energy Regulatory Commission, the National Futures Association, the CME Group, Intercontinental Exchange and the London Metal Exchange.

### **III. Commodities Activities Before the GLB Act**

Two of the most vocal critics of allowing financial holding companies and their bank and nonbank affiliates to continue to buy and sell physical and energy commodities are Professor Saule Omarova of the University of North Carolina Law School and Mr. Joshua Rosner, managing director of Graham Fisher & Co. In a widely circulated draft article, Professor Omarova has asserted that U.S. financial holding companies somehow waged a “quiet transformation” to become “global merchants of physical commodities” during that period.<sup>35</sup> To Professor Omarova, this mixing of banking and commodities activities is a radical departure from the past and not an incremental expansion of traditional banking and nonbanking powers. She characterizes it as a serious breach of the “legal wall designed to keep them out of any non-financial business”<sup>36</sup> and “effectively nullifies the foundational principle of separation of banking from

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<sup>35</sup> See, e.g., Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, at 4 (draft of Nov. 24, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2180647](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647).

<sup>36</sup> *Id.*

commerce.”<sup>37</sup> She argues that these physical and energy commodities activities “threaten to undermine the fundamental policy objectives . . . [of] ensuring the safety and soundness of the U.S. banking system, maintaining a fair and efficient flow of credit in the economy, protecting market integrity, and preventing excessive concentration of economic power.”<sup>38</sup> According to Professor Omarova, unless these activities are prohibited or severely curbed, financial holding companies will be exposed to a variety of new and excessive risks, engage in anticompetitive behavior and even threaten “American democracy.”<sup>39</sup> She sums up the implication of her argument as follows: “If there are good reasons to believe that extreme power breeds extreme abuses, the ongoing expansion of large FHCs into physical commodities and energy business warrants serious concern.”<sup>40</sup>

Mr. Rosner has expressed similar views. As reported in the *Huffington Post*, Mr. Rosner has stated that “[i]f banks own storage, distribution, transmission or generating assets, they have the ability to manipulate prices for the benefit of their own balance sheet, to the disadvantage of the public interest, which is why they were prohibited from such activities after the Great Depression to the passage of Gramm-Leach-Bliley in 1999.”<sup>41</sup> Professor Omarova and Mr. Rosner also reportedly told the *Huffington Post* that traders at banks that own physical commodities business have a natural incentive to use

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<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 5.

<sup>40</sup> *Id.*

<sup>41</sup> Shahien Nasiripourshahien & Zach Carterzach, *Beer Brewers Blast Wall Street Banks over Aluminum Business Amid Congressional Scrutiny*, HUFFINGTON POST (July 16, 2013).

inside knowledge gleaned from their co-workers to reap profits from trades of derivatives tied to the underlying commodities.<sup>42</sup>

Not only does Professor Omarova's law review article reflect a deep distrust of the motives and behavior of financial holding companies and their employees, but she has also reportedly been severely critical about the Federal Reserve Board's lack of transparency about the commodities activities of these firms. According to the *Huffington Post*, Professor Omarova has said that "[t]he Fed has absolutely not been transparent" and that "[t]he Fed is like the Kremlin: They do their magic and then tell people like me to go away."<sup>43</sup>

Before addressing whether today's commodities activities are inconsistent with the principle of keeping banking separate from commerce and whether there is sufficient evidence to justify prohibiting or severely curbing these powers, let me first straighten out a few historical facts about the relationship between banking and physical commodities activities. First, there has been a close relationship between banking and physical commodities since the dawn of history. The essence of banking is the creation of money through the maturity transformation process. By funding themselves with demand or other short-term deposits or other liabilities (including the issuance of paper currency) and then making medium- to long-term loans, commercial banks participate in the money and credit creation processes.

Physical commodities such as grain, salt, shells and pieces of wood were among the first forms of money in ancient Mesopotamia, Egypt, China, Korea, Japan, North

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<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

America, Ethiopia, and Oceana, and some of these commodities continued to be used as money until quite recently in certain places.<sup>44</sup> While not as durable as gold or silver, or as reliable and easy to move as coins, paper or electronic money issued by commercial banks, these physical commodities nevertheless had the essential characteristics that made them an efficient medium of exchange and store of value (i.e., money) – fungibility, divisibility and relative liquidity. These ancient forms of money made trading much more efficient than in a barter economy where non-fungible and non-divisible goods and services are exchanged.

Second, the modern history of banking (and money) began with grain merchants in Lombardy creating markets in grain and other commodities, financing crops, holding gold (another commodity) of others for settlement of their grain transactions and trading in gold while it was on deposit.<sup>45</sup>

Third, U.S. banks and other financial institutions were major players in the commodities markets during the 19<sup>th</sup> century. National banks were expressly permitted to trade in gold, silver and other precious metals commodities. Many of the major U.S. merchant banks of the 19<sup>th</sup> century started as dry goods and commodity traders, which expanded into banking in somewhat similar ways and for somewhat similar reasons as their Lombard predecessors from centuries earlier.<sup>46</sup> These commodity traders turned

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<sup>44</sup> *See, e.g.*, Catherin Eagleton & Jonathan Williams, *MONEY: A HISTORY* at 18, 22, 135, 155-156, 196-197, 200 (The British Museum Press 2006) (grain used as money in ancient Mesopotamia and Egypt, as well as China, Korea and Japan; salt used as money in Ethiopia and China; shells and pieces of wood used in China, North America and Oceana). According to Milton Friedman, cigarettes were used as money in Germany after World War II. Milton Friedman, *MONEY MISCHIEF* at 14 (1992).

<sup>45</sup> *See, e.g.*, Charles P. Kindleberger, *A FINANCIAL HISTORY OF WESTERN EUROPE* (1984).

<sup>46</sup> *See, e.g.*, Vincent P. Carosso, *INVESTMENT BANKING IN AMERICA: A HISTORY* (1970); Bray Hammond, *BANKS AND POLITICS IN AMERICA: FROM THE REVOLUTION TO THE CIVIL WAR* (1957).



bankers include Lazard Brothers and Brown Brothers.<sup>47</sup> The private banking partnership of J. Pierpont Morgan, Sr. engaged in wholesale or merchant banking, which included the buying and selling of physical commodities and related facilities. To take just one famous example, a trust controlled by J.P. Morgan purchased Andrew Carnegie's steel company in 1901 and combined it with other steel companies to form U.S. Steel.<sup>48</sup> Pig iron and steel were the most important commodities of the day, just as important then as energy is today.<sup>49</sup> In short, U.S. banks and other financial institutions were actively involved in the commodities markets before the Glass-Steagall Act of 1933 or even the National Bank Act of 1863.

Fourth, the Glass-Steagall Act did not prohibit or otherwise limit banks from engaging in commodities activities or affiliating with commodities firms. It only prohibited banks from dealing in securities or having affiliates that were principally engaged in underwriting or dealing of corporate debt and equity securities.<sup>50</sup>

Fifth, while the BHC Act limited the authority of bank holding companies and their nonbank affiliates to engage in commodities activities or to own or control commodities firms, U.S. banks, bank holding companies and investment banks were not entirely locked out of the physical or energy commodities markets before the GLB Act in 1999. The National Bank Act continued to permit national banks to buy and sell gold,

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<sup>47</sup> *See id.*

<sup>48</sup> *See* Ron Chernow, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE* 82-24 (1990).

<sup>49</sup> *See, e.g.,* Milton Friedman and Anna Jacobson Schwartz, *A MONETARY HISTORY OF THE UNITED STATES, 1867-1960* (1963) (using statistics of pig iron to estimate the growth or contraction of the economy during the Great Depression).

<sup>50</sup> *See* Banking Act of 1933, §§ 16, 20.

silver and other precious metals. More importantly, Goldman Sachs, Morgan Stanley and various other investment banks emerged as major players in the physical commodities in the 1980s,<sup>51</sup> nearly twenty years before passage of the GLB Act and nearly thirty years before Goldman Sachs and Morgan Stanley became bank holding companies.

Since then, financial institutions have assumed key roles in satisfying customer needs, offering services that enable more cost-effective commodity price hedging and secured financing for a broad range of participants in the commodities sector. In fact, reducing financial institution participation in the commodities sector would likely reduce liquidity on exchanges and in over-the-counter markets, and even the availability of some commodities hedging, financing and other intermediation services. A retrenchment could lead to increased prices and greater price volatility, among other consequences.<sup>52</sup>

Moreover, these investment banks had a strong track record of conducting these commodities activities in an efficient, profitable, fair, responsible, and safe and sound manner, without any material violations of applicable laws or regulations or losses as a result of natural catastrophes. I am not aware of any evidence that their activities undermined the safety or soundness of the U.S. financial system, resulted in an unfair or inefficient flow of credit, involved any material anticompetitive behavior or insider

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<sup>51</sup> For example, Goldman Sachs acquired commodities trading firm J. Aron & Co. in 1981, and that same year, the commodities trading firm Phibro Corporation acquired Salomon Brothers to form Phibro-Salomon Inc. In 1984, Morgan Stanley formed the Natural Gas Clearinghouse with law firm Akin Gump and Transco Energy, and in 1985, Morgan Stanley expanded commodities coverage from metals options to oil markets. *Changing Landscape*: Energyrisk.com, July 2009 (at 26). Prior to the financial institutions' arrival, the commodities markets were best described, according to Henrik Wareborn, head of commodities trading at Natixis, as a shadowy place dominated by physical merchants and cartels, which was opened up and transformed thanks to the entry of European banks and U.S. investment banks. *Insight: Banks struggle to adapt or survive in commodities*: Reuters, November 5, 2012.

<sup>52</sup> *Comments on Volcker Rule Regulations Regarding Energy Commodities*, submitted by IHS Inc., February 2012, at 7-9.

trading, or otherwise resulted in other harmful effects on the financial system or the wider economy, much less threatened the end of American democracy.

Indeed, their significant involvement and strong risk-management record in conducting commodities activities was almost certainly one of the reasons why Section 4(o) was considered to be such an acceptable and important way to ensure that the GLB Act would provide a “two-way” street of opportunities to investment banks as well as commercial banks. It also was almost certainly one of the reasons why the Federal Reserve Board determined that physical and energy commodities could be traded by non-grandfathered financial holding companies as a complement to their existing financial activities, that such activities would produce public benefits that outweighed their potential adverse effects and that they could otherwise be conducted in a manner that would not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.<sup>53</sup>

In short, the close relationship between banking and commodities activities since ancient times as well as in this country for most of the past 200 years shows that both Section 4(o) of the BHC Act and the complementary powers orders that permit certain non-grandfathered financial holding companies to engage in trading physical and energy commodities were only incremental expansions of traditional banking powers rather than a radical departure as Professor Omarova has argued. While electricity and oil are modern commodities, they are not fundamentally different from the traditional bank-

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<sup>53</sup> See, e.g., Citigroup, *supra* note 16, JPMorgan Chase & Co., *supra* note 16; Royal Bank of Scotland, *supra* note 16.

eligible commodities such as gold and silver in the sense that they are fungible, divisible and relatively liquid.

#### **IV. The Principle of Keeping Banking and Commerce Separate**

The principle of keeping banking separate from commerce can be a useful way to simplify the otherwise complex U.S. banking laws. Certainly, the basic structure of the National Bank Act and the BHC Act reflects this general principle. But this general principle is not a binding legal rule and does not create an impermeable wall, and reasonable people can disagree as to where the line is and should be drawn.

For example, Professor Omarova argues that the current commodities powers of the grandfathered and non-grandfathered financial holding companies are radically inconsistent with this principle.<sup>54</sup> Yet former Representative James Leach, who has long been one of the most vociferous and consistent champions of the separation between banking and commerce,<sup>55</sup> does not believe that the merchant banking power or the physical commodities power under either the complementary power orders or Section 4(o) of the BHC Act are inconsistent with this principle.<sup>56</sup> Thus, he defended the general principle in words that are strikingly similar to those used by Professor Omarova in her forthcoming article:

“[T]here are few broad principles that could hurriedly be legislated, which could in shorter order change the fabric of American democracy as well as

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<sup>54</sup> See Omarova, *supra* note 35, at 4.

<sup>55</sup> See, e.g., James A. Leach, *The Mixing of Banking and Commerce*, in Proceedings of the 43<sup>rd</sup> Annual Conference on Banking Structure and Competition, Federal Reserve Bank of Chicago (May 2007).

<sup>56</sup> See, e.g., James Leach, *Regulatory Reform: Did Gramm-Leach-Bliley contribute to the crisis?*, *Northwestern Financial Review* (Oct.15, 2008).

the economy, than adoption of a new radical approach to this issue [i.e., mixing commerce and banking].”<sup>57</sup>

Yet, he said this about its application to the GLB Act:

“Fortunately, despite the active advocacy of many in Congress and early-on support of the Treasury and partial support in the Fed (both later reconsidered), the commerce and banking breach did not occur.”<sup>58</sup>

I agree with former Congressman Leach that the merchant banking power and the physical commodities powers under either the complementary powers orders or Section 4(o) of the BHC Act are fully consistent with the historic principle of keeping banking separate from commerce. The merchant banking power permits nonbank affiliates of insured banks to engage in the traditional financial activity of providing capital to small and medium-sized companies, without becoming involved in the routine day-to-day management of these companies and with a clear fixed time horizon. The physical commodities power is only an incremental expansion of the physical commodities powers that banks or their nonbank affiliates have exercised in this country for more than 200 years. If the authority to buy and sell electricity or oil is relatively new, it is probably because they are relatively modern commodities. In addition, it was only relatively recently that that futures contracts in these commodities have been authorized for trading on a futures exchange by the CFTC or otherwise become sufficiently fungible and liquid. Once they satisfied these criteria, however, it was natural that the Federal Reserve would permit trading in them as a complement to the financial activity of trading in their related derivative contracts.

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<sup>57</sup> See supra note 55.

<sup>58</sup> See supra note 56.

## V. Should Existing Commodities Powers be Repealed or Scaled Back?

Professor Omarova has argued that the existing commodities powers of financial holding companies should be repealed or severely scaled back to be consistent with her concept of the “foundational principle” of the separation of banking from commerce. She has said that “[t]here is a particular urgency to focusing” on whether financial holding companies should be allowed to continue engaging in physical and energy commodities activities since Goldman Sachs and Morgan Stanley are “approaching the end of their five-year grace period during which they must either divest their impermissible commercial businesses or find legal authority under the [BHC Act] for keeping them. In the fall of 2013, the Board will have to determine whether these firms may continue their existing commodities operations and, if so, under what conditions.”<sup>59</sup>

Before addressing this argument on the merits, let me explain why there is no urgency at all to this issue, at least not for the reason Professor Omarova gives. Goldman Sachs and Morgan Stanley are indeed approaching the end of the five-year transition period for conforming their activities to the activities restrictions in the BHC Act. But that deadline is irrelevant to the grandfathered commodities activities of Goldman Sachs and Morgan Stanley because the grandfathering provisions of Section 4(o) of the BHC Act have no time limit and do not provide the Federal Reserve Board with the discretion to limit their effect.

Professor Omarova’s argument that the existing commodities powers of the financial holding companies should be repealed or scaled back is based on seven basic predictions:

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<sup>59</sup> See Omarova, *supra* note 35, at 7.

- Otherwise, financial holding companies will continue to face a variety of new and excessive risks that will threaten the safety and soundness of the U.S. financial system.
- The fair and efficient flow of credit in the economy will be threatened.
- Market integrity will be at risk.
- Financial holding companies have or will continue to gain and may abuse market power.
- Traders at financial holding companies will use inside information to engage in illegal insider trading.
- American democracy will be at risk.

The Congress that included Section 4(o) in the GLB Act clearly had a different view of the benefits and risks of commodities activities than Professor Omarova. That Congress said that the grandfathered activities “shall” be broadly construed,<sup>60</sup> and that the purpose of the permanent grandfathering provision was to allow qualifying financial holding companies to continue engaging in commodities activities as long as certain conditions were satisfied.<sup>61</sup> The Federal Reserve that issued the complementary powers orders also had a very different view of the benefits and risks of permitting financial holding companies and their nonbank affiliates to buy and sell physical and energy commodities. The Federal Reserve Board, applying the standard in the BHC Act, found that the public benefits from those activities in terms of increased customer choice and increased competition outweighed their risks, provided they were conducted in

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<sup>60</sup> See supra note 33.

<sup>61</sup> See supra note 34.

accordance with certain limitations and conditions discussed in Section II of this testimony.

This Subcommittee should not take action to repeal or curb the existing commodities powers of financial holding companies, including any temporary or permanent authority to own companies that control electric power plants, commodities warehouses or oil refineries, unless and until critics provide substantial evidence that such powers cannot be exercised without creating a substantial risk to the safety or soundness of depository institutions or the financial system generally. It should not be enough for critics to merely provide speculative assertions of potential adverse consequences. Nor should this Subcommittee take action to repeal or cut back on those powers solely because certain financial institutions or their employees may from time to time violate any generally applicable laws or regulations that govern commodities activities, such as applicable antitrust, securities, futures or energy laws. There is currently no reason to believe that such laws and regulations, and the vigilant actions of the government agencies, exchanges and self-regulatory organizations responsible for implementing and enforcing those laws, would not be sufficient to deter or remedy any such compliance issues. Nor is there reason to believe that such issues would never occur if these types of assets were owned only by entities not subject to comprehensive federal regulation, as all bank holding companies are.

## **VI. Conclusion**

In conclusion, insured banks, bank holding companies, financial holding companies and their nonbank affiliates are currently permitted to engage as principal in futures, forwards and other commodities contracts and, in some cases, owning or



controlling physical or intangible commodities or related facilities, including electric power plants, commodities warehouses and oil refineries, subject to certain conditions. Both Congress and the Federal Reserve have previously found that the public benefits of these activities outweigh their potential adverse effects. This Subcommittee should not take action to repeal or curb those powers unless and until critics provide substantial evidence that such powers cannot be exercised without creating a substantial risk to the safety or soundness of depository institutions or the financial system generally.