The Fed's Physical Commodities ANPR

April 28, 2014

Introduction

On January 21, 2014, the Federal Reserve published an Advance Notice of Proposed Rulemaking (ANPR) announcing that it had commenced a review of the authority of U.S. and foreign financial holding companies (FHCs) to engage in physical commodities activities under the Bank Holding Company Act of 1956 (BHC Act).

According to the ANPR, the activities under review are physical commodities activities that have previously been permitted by the Federal Reserve as a complement to otherwise permissible financial activities, merchant banking investments in portfolio companies engaged in commodities activities, and grandfathered physical commodities activities.

The ANPR invited public comment on whether the public benefits of physical commodities activities continue to outweigh their potential risks in light of recent developments related to environmentally sensitive commodities, such as oil, natural gas and nuclear power. In particular, it asked whether the "tail risks" associated with environmentally sensitive commodities expose FHCs to risks that can result in the sort of market contagion that occurred during the financial crisis of 2008. It also asked whether physical commodities activities continue to be complementary to one or more permissible financial activities in light of recent announcements by certain FHCs to sell or scale back their physical commodities businesses. Finally, the ANPR invited public comment on whether the permitted physical commodities activities involve conflicts of interest, anticompetitive behavior or other potential adverse effects that are not adequately addressed by existing law. The Federal Reserve said that it would consider these public comments in its review of the physical commodities authority of FHCs.

The deadline for comments was April 16, 2014.

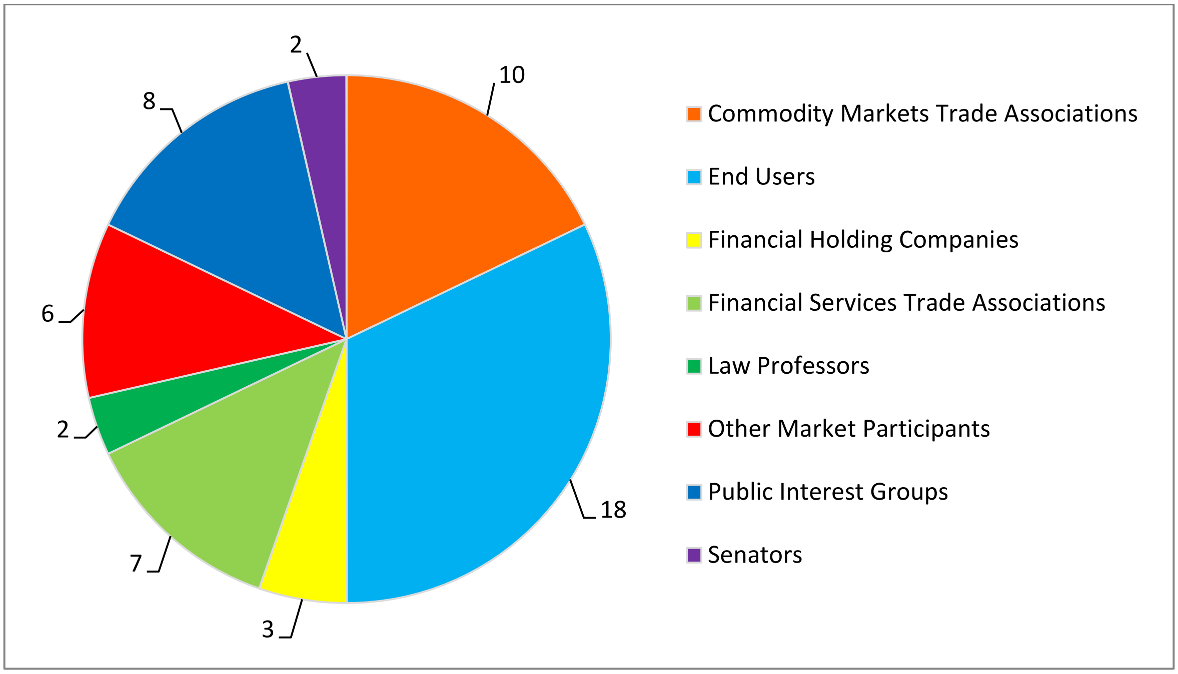
Comment Letters

As of 5:00 p.m. on Friday, April 25, 2014, 181 comment letters on the ANPR had been posted by the Federal Reserve on its website.[1] 56 letters were submitted by organizations, senators or law professors, and 125 by individuals, some anonymously. The letters submitted by the first group, along with a letter submitted by an individual from the second group that provided particularly detailed comments, are summarized and hyperlinked in the newsletter attached to this memorandum. The letters submitted by individuals can be found **here**.

[1] The Federal Reserve has noted that it has received more than 16,900 form comment letters on the ANPR that have not been posted on the Federal Reserve's website. The Federal Reserve has posted examples of the content of 13 different form letters, which generally urge the Federal Reserve to prohibit bank ownership of commodities in order to protect the economy and prevent the 2008 financial crisis from repeating itself.

Of the 56 letters submitted by organizations, senators and law professors, 10 were submitted by commodity markets trade associations, 18 by end users, 3 by financial holding companies, 7 by financial services trade associations, 2 by law professors, 8 by public interest groups, 2 by senators and 6 by other market participants.

The distribution of these letters by commenter type is illustrated in the pie chart below:



The overwhelming majority of these letters (38–15) strongly support the view that the Federal Reserve should ***not*** curtail or eliminate the existing authority of FHCs to engage in physical commodities activities. Many of these letters are joint letters co-authored by multiple trade associations, end users or other market participants. Thus, the number of commenters in this supporting group is substantially in excess of the number of letters submitted. Virtually all of the letters submitted by commodity markets trade associations, financial services trade associations, end users, financial holding companies or other market participants fall within this group.

These letters all argue to one degree or another that allowing FHCs to engage in physical commodities activities has produced, and will continue to produce, substantial public benefits in the form of increased convenience for customers, increased competition, market efficiency gains, greater liquidity, tighter and more efficient spreads between bid and ask prices for commodities, more efficient convergence of prices between the physical commodities and commodity derivatives markets, lower commodity prices, better and more efficient tools for customers to manage inventories, more customized and effective risk-management tools for end users, better financing terms, and other benefits to end users, the physical commodities markets, the commodity derivatives markets, and the wider economy, including the stability of the financial system.

A subset of these letters address the potential risks of physical commodities activities. These letters argue to one degree or another that the potential risks are not as great as the ANPR implied. Among others, these letters include the argument that the risks associated with commodities intermediation activities with respect to *any* commodities, or transporting, storing or otherwise handling commodities that are not environmentally sensitive, such as agricultural commodities and industrial metals, are not fundamentally different from or greater than those associated with traditional banking or other permissible financial activities, such as maturity transformation or market making in financial instruments. They also argue that the tail risks associated with transporting, storing or otherwise handling environmentally sensitive commodities can be substantially mitigated by following certain well-established risk mitigation safeguards, including corporate separateness safeguards.

Two of the letters submitted by insurance industry participants are neutral and primarily urge the Federal Reserve to exclude insurers from the application of any action the Federal Reserve might take as the result of the ANPR.

15 of the remaining 16 letters question whether the public benefits of physical commodities activities outweigh their potential risks. Some of these letters also include multiple authors, such as the joint letter submitted by Senators Sherrod Brown and Elizabeth Warren. All of the letters submitted by senators, law professors and public interest groups fall within this category. Some of these letters argue that Congress may not have been fully informed, but in any case made a mistake, when it authorized FHCs to engage in or grandfathered any physical commodities activities in 1999, and the Federal Reserve made a similar mistake when it authorized certain FHCs to engage in physical commodities activities as a complement to their permissible financial activities. Some of them also argue that this legislative or regulatory action is inconsistent with what these commenters characterize as the right place to draw the line between banking and commerce. Some of them urge the Federal Reserve to conduct a more comprehensive and demanding risk-benefit analysis of these activities, and others argue that the potential risks of physical commodities activities clearly outweigh their potential public benefits. A few argue that the Federal Reserve should require FHCs to provide much more extensive disclosure about their commodities activities to the public.

The remaining letter is mixed. It supports allowing FHCs to continue engaging in physical commodities activities, but suggests that they should not be allowed to own metals warehouses.

It is not clear how long it will take for the Federal Reserve to complete its review or what, if any, action it may take upon completing its review.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Davis Polk

April 28, 2014

Review of Comment Letters on the Federal Reserve Board's Physical Commodities Activities ANPR

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- Coalition of Physical Energy Companies
- Electric Power Supply Association
- Futures Industry Association
- International Wrought Copper Council
- Interstate Natural Gas Association of America
- National Association of Corporate Treasurers
- U.S. Chamber of Commerce

End Users

- Alon USA Energy, Inc.
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- Clarke-Mobile Counties Gas District and The Black Belt Energy Gas District
- Converse and Company, Inc.
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Financial Holding Companies

- Goldman Sachs
- Morgan Stanley
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Financial Services Trade Associations

- American Council of Life Insurers
- Financial Services Roundtable
- Institute of International Bankers
- International Swaps and Derivatives Association
- Private Equity Growth Capital Council
- SIFMA, ABA, FSF, FSR and IIB
- TCH, ABA, FSF, FSR and IIB

Individuals

- Cathy Santoro

Law Professors

- Professor Robert Hockett, Cornell University Law School
- Professor Saule T. Omarova, UNC School of Law

Other Market Participants

- Aon Risk Solutions
- CME Group
- Denham Capital Management LP
- Energy Capital Partners and EquiPower Resources Corp.
- Sunesis Capital, LLC
- Teachers Insurance and Annuity Association of America

Public Interest Groups

- Americans for Financial Reform
- Better Markets, Inc.
- Commodity Markets Oversight Coalition
- Institute for Agriculture and Trade Policy
- New America Foundation
- Occupy the SEC
- Public Citizen
- The Other 98%

Senators

- U.S. Senator Carl Levin
- U.S. Senators Sherrod Brown and Elizabeth Warren

Commodity Markets Trade Associations

American Gas Association, America's Natural Gas Alliance and American Exploration & Production Council

- Commodities markets benefit from a maximum number of stable and creditworthy competitors. Eliminating, or substantially reducing, FHC participation would harm competition. Additional conditions, such as increased capital requirements could well deter FHCs from pursuing physical commodities activities and thereby reduce market participation as well. Especially in the markets for customized commodity derivatives, a retreat by FHC affiliates will lead to greater market illiquidity and inefficient pricing. Market liquidity will suffer because FHC affiliates are frequently the most knowledgeable and active market participants and the most willing to enter into customized trades, and there are few potential new market entrants that can replace them. The current overall regulatory scheme of heightened prudential regulation combined with the size limits is a better protection against the risks of "interconnectedness" and contagion than anything that exists in the unregulated space.
  - Full text of comment letter

American Gas Association, American Public Gas Association, Electric Power Supply Association, National Rural Electric Cooperative Association, U.S. Chamber of Commerce for Capital Markets Competitiveness and U.S. Chamber of Commerce Institute for 21st Century Energy

- Restrictions on FHCs' ability to transact in physical commodities markets may negatively impact non-financial companies' ability to access efficient, transparent, liquid markets for managing their day-to-day physical commodity and related hedging needs. Such a result would lead to greater systemic and commercial risk concentration and less liquidity in physical commodities and commodity derivatives markets. These results could lead to serious, unintended consequences for commercial market participants, giving them fewer and more expensive options for hedging and mitigating commercial risk.
  - Full text of comment letter

Center for Capital Markets Competitiveness

Signed by 33 companies and trade associations

- End users depend on having reliable, credit-worthy, well-regulated counterparties, such as banks, in the commodities markets. Banks' willingness to assume appropriate market and credit risk as market makers, including being able to trade physical commodities, allows end users to manage their risks. If counterparties, such as banks, for financial hedging instruments for end users' physical commodities begin to disappear, end users likely would be forced to tie-up their own capital in holding physical inventories and the related infrastructure to manage those inventories, and may find their options for hedging shrink, become less useful, or more expensive. For end users' business and the economy, that capital is much better directed at long-term investment projects that lead to job creation and growth.
  - Full text of comment letter

Coalition of Physical Energy Companies

- FHCs are valuable as counterparties because they: (1) have strong balance sheets and are creditworthy counterparties that can soundly sustain significant and long-term transactions; (2) have strong compliance cultures and well-resourced support functions; (3) are supervised by regulators such as the Federal Reserve; (4) possess sophisticated risk management abilities; (5) longstanding relationship with physical energy markets, including as lenders; and (6) there are benefits to physical commodity companies in undertaking transactions with FHCs that can span financial and physical activities. If the FHC could not perform the commodity-purchase aspect of the lending transaction, risk would be increased by the physical company being subject to volatile market prices or having to post cash collateral to a third party, with the potential of counterparty default. Given the volatility of energy markets, there is not a robust set of counterparties that have the financial wherewithal to enter into long-term fixed price transactions. The advent of swaps and swap dealer regulation established in the Dodd-Frank Act has only made the FHC function of a market

Commodity Markets Trade Associations *(cont.)*

making intermediary in physical commodity markets more important since many non-FHC commodities trading firms that previously traded and made markets in both the physical and derivatives markets have exited the derivatives markets out of concern of becoming a swap dealer.

- Full text of comment letter

Electric Power Supply Association

- Liquidity is particularly important as the energy industry faces external factors that are impacting the reliability and efficiency of the wholesale electricity markets. All tools that allow electricity to be generated, delivered and sold as reliably and efficiently as possible should be supported by policymakers. The energy industry uses financial and non-financial products and services to make decisions on existing and new resources, and to ensure consistent prices and revenues for physical power producers. Bank holding companies and FHCs reliably make markets, provide risk-management services, extend credit, and engage in other activities that support commodity trading. Bank holding companies and FHCs provide the energy industry with the ability to hedge with a well-qualified counterparty, thus increasing competition in the physical power and wholesale electricity markets since more participants in the market provide greater liquidity. If bank holding companies and FHCs are not potential counterparties, end users would have limited options of hedge funds and other counterparties that operate under less regulation and oversight and likely do so at higher costs to end users and the ultimate consumer. As a result of FHCs exiting the physical commodities markets, many of the counterparties left in the physical energy markets are only willing to enter into short-term contracts, which ultimately distorts the forward prices of power.
  - Full text of comment letter

Futures Industry Association

- Limits on commodities activities would adversely affect the critical intermediary role that FHCs play, could reduce competition and liquidity, and lead to inefficient pricing, which, in turn, may increase costs for end users and consumers. Prohibiting or limiting FHCs from participating in these markets would not reduce potential risk to the financial system, but would rather remove market makers and increase the likelihood for illiquidity and inefficient pricing. End users and consumers would suffer the adverse effects of such developments. As financial intermediaries, FHCs perform unique functions in the physical commodities markets that are unlikely to be replicated by replacement market participants. End users also rely on FHCs for a broad spectrum of significant commodity-related financial services, many of which are dependent upon FHC market expertise and participation. FHCs are highly-regulated and publicly-traded entities making them especially reliable and credit-worthy counterparties.
  - Full text of comment letter

International Wrought Copper Council

- Semis-manufacturers have been adversely affected by extraordinary commodity price volatility and physical metal availability. Since 2008, aluminum stocks on the London Metal Exchange (LME) have increased more than five-fold to an unprecedented 5.5 million tons, equivalent to almost 10% of annual global demand. Commensurate with the increase in these stocks of aluminum has been the purchase of LME Warehouse companies by financial institutions and trading companies. LME warehouses were originally founded to accommodate the needs of metal producers and metal processors. Their primary purpose now seems to be to serve the non-physical industry. The relevant authorities should fully investigate the possible links between warehouse ownership and excessive metal stocks and, if necessary, take appropriate and swift action to restore the metal markets to their primary purpose of serving all participants without favor.
  - Full text of comment letter

Commodity Markets Trade Associations *(cont.)*

Interstate Natural Gas Association of America

- The proposed new restrictions on FHCs' ability to transact in the physical commodities markets could negatively impact non-financial companies' ability to access efficient, transparent, liquid markets for managing their day-to-day physical commodity and related operational needs, which would lead to greater systemic and commercial risk concentration and less liquidity in physical commodities and commodity derivatives markets. Limiting the ability of FHCs to participate in physical commodities markets will artificially restrict competition in those markets, which could result in lessened market liquidity and inefficient pricing for commodities.
  - Full text of comment letter

National Association of Corporate Treasurers

Signed by 15 major corporations that are end users of physical commodities and commodity-related derivatives

- FHCs already have begun to exit physical commodities markets. Further regulation could hasten their departure, which will create more concentrated, illiquid markets, which will make it very difficult for end users of physical commodities to efficiently transact in these markets. FHCs are uniquely situated to serve the distinct needs of end users of physical commodities and likely cannot be replaced by other market participants.
  - Full text of comment letter

U.S. Chamber of Commerce

- FHCs are important to the participation of commercial end users in physical commodities markets. Transacting with FHCs for hedging and risk management solutions is essential for end users because FHCs are well-regulated, well-capitalized, highly liquid counterparties that have the capacity to enter into highly customized transactions, designed specifically to match the size and duration of a company's exposure to a particular commodity. For some global end users, their ability to hedge their fuel costs with precision using an FHC gives them a critical pricing advantage over foreign competition. Given the crucial role of FHCs in the physical commodity markets, a determination by the Federal Reserve that restricts, deters or eliminates FHCs' participation in the physical commodities markets could cause these markets to unravel, leading to decreased competition, greater market illiquidity and inefficient pricing as the financial instruments end users rely upon to hedge become less tethered to the underlying commodities markets.
  - Full text of comment letter

End Users

Alon USA Energy, Inc.

- FHCs are well-regulated counterparties / market-makers with which end users can efficiently transact at the appropriate points in time when such actions are needed to best manage risk. The ANPR's assertions regarding tail risk are not substantiated by empirical data. If FHCs exit the physical commodities markets, end users likely would be required to transact with an increased number of unregulated — or less regulated — entities. Engaging in transactions with unregulated entities would create a greater risk to the physical commodities markets than the potential tail risks identified by the Federal Reserve in the ANPR.
  - Full text of comment letter

Apache Corporation

- Further regulation of FHCs could lead to FHCs exiting the physical commodities markets, which will create more concentrated, illiquid markets and make it difficult for end users to efficiently transact in these markets. FHCs are uniquely situated to serve the distinct needs of end users of physical commodities and likely cannot be replaced by other market participants. FHCs are in the business of making markets and their physical commodities activities allow end users to transact in these markets at the specific points in time which they need to do so. FHCs, given their size, sophistication, and business model, allow end users to efficiently transact in the markets, how and when they need to do so. Given their sophistication, FHCs are able to customize trades to each end user's specific needs, allowing end users to most effectively hedge their underlying risks. Because FHCs are large, liquid entities authorized to hold title to physical commodities, end users of physical commodities are able to use FHCs' services through the course of their day-to-day business activities. End users feel comfortable transacting with FHCs because they are already well regulated by agencies such as the Federal Reserve, the FERC, the CFTC and the SEC.
  - Full text of comment letter

Calpine Corporation

- Energy end users transact with bank holding companies and FHCs because of the liquidity and transparency they provide. Without the ability of these counterparties to offer flexible and financially secure risk management products, the market would be dominated by hedge funds and other smaller market participants who are not subject to comparable regulations, oversight, or standards and who are unable to offer a comparable range of risk management products. Bank holding companies and FHCs are important counterparties because they are transparent, well-capitalized, stable and versatile enough to provide a wide range of products and services to energy end user counterparties. Any attempt to limit or deter these entities from participating in the physical commodities markets could diminish the liquidity of the market, thereby limiting end users' ability to manage risk effectively, which ultimately could reduce the ability to finance and develop capital-intensive projects.
  - Full text of comment letter

Central Plains Energy Project

- Natural gas prepayment transactions with FHCs have saved customers millions of dollars in reduced natural gas prices. All of those savings are for the benefit of the gas consuming public and flow through to them in the form of lower gas rates. FHCs provide an essential service to the municipal gas industry that could not be replaced by other industry participants. FHCs are the most creditworthy counterparties with which to transact. FHCs are efficient and operate in a regulated environment, causing them to take a cautious, businesslike approach to their commercial obligations and strict adherence to the requirements of their contracts. FHCs' activities in the gas commodity markets do not involve the ownership of oil and gas producing infrastructure or gas or oil transmission pipelines, or anything that poses the risk of catastrophic loss. Tellingly, none of the disasters pointed to in the ANPR have caused a catastrophic loss to an FHC.
  - Full text of comment letter

End Users *(cont.)*

Chelan County Public Utility District, Clark Public Utilities, Cowlitz County Public Utility District, Public Utility District #2 of Grant County, Eugene Water and Electric Board, Klickitat County Public Utility District, Lewis County Public Utility District, Pend Oreille County Public Utility District #1, Snohomish County Public Utility District and Tacoma Power

- The implications of the Federal Reserve's ANPR for commercial counterparties to FHCs, such as electric utilities who rely on transparent, liquid electricity markets to manage their day-to-day physical commodity and related hedging needs, is concerning to electric utility end users. In order to provide customers with reasonably low and stable rates, end users must manage risks associated with the prices they pay and receive for physical commodities. Most utilities have limited options to manage price risk, and even fewer options to manage volumetric risk. Unlike typical financial transactions, physical energy transactions are often structured to mitigate both price and volume risk. Accessing these markets could be more difficult, more expensive and less efficient without the presence of FHCs. If the result of the ANPR is to prompt the exit of well-regulated, well-capitalized FHCs from the physical commodity markets, there will be fewer and thus more expensive options for end users to manage their operational risks, which ultimately leads to higher retail rates for consumers. FHCs provide liquidity in the forward markets that facilitate effective management of price volatility. FHCs also help to reduce concentration risk by diversifying the participant base by sector. Some FHCs have begun to withdraw from their physical commodities activities in an environment where liquidity for financial commodity swaps already has declined for public power utilities due to recent Dodd-Frank regulations. It is reasonable to conclude that more FHCs, and their affiliates, will exit the marketplace if significant additional restrictions on their physical commodities activities are adopted. Existing regulations and electricity market oversight are proving to be successful through recent enforcement actions, which in turn prompts internal reviews of oversight controls and discourages future prohibited activities. If additional limitations on the participation of FHCs in physical energy markets prompt their exit from the marketplace, utilities and their customers will suffer through higher hedging costs and may ultimately be unable to adequately hedge price and volumetric exposures without undue credit concentration risk.
  - Full text of comment letter

Cheniere Energy, Inc.

- Further regulation of FHCs could hasten the process of additional FHCs exiting the business. The exit of FHCs would raise various concerns, including: the absence of sophisticated financial entities customizing physical products; the reduction of A-rated investment counterparties in the physical trading arena; the reduction of counterparties able to provide a bid or an offer on multiple commodities and products; and the reduction of counterparties with the financial capability to enter into long-term transactions.
  - Full text of comment letter

Clarke-Mobile Counties Gas District and The Black Belt Energy Gas District

- FHCs are among the primary participants in the gas prepayment transaction marketplace as gas suppliers. They provide an essential service to the municipal gas industry, one that could not and would not be replicated or replaced by other industry participants. Not only would the departure of FHCs from the physical commodity marketplace be highly adverse to the interests of municipal natural gas systems and gas consumers, it would serve no countervailing public purpose. FHCs are the most creditworthy counterparties, they are more efficient and operate in a regulated environment that results in them taking a cautious, businesslike approach to their commercial obligations and strict adherence to the requirements of their contracts.
  - Full text of comment letter

Converse and Company, Inc.

- FHCs are well-regulated and credit-worthy counterparties with market experience and ability to handle market volatility. Accessing commodities markets could be more difficult, more expensive and less efficient without the presence of FHCs. The physical commodities marketplace is dominated by a small number of

End Users *(cont.)*

participants in each commodity sector, so competition and pricing could be affected if FHCs exit these markets. Additional regulation of these activities, including, among other things, the imposition of increased capital requirements, will deter FHCs from participating in the physical commodities space.

- Full text of comment letter

Delek US Holdings, Inc.

- End users rely on FHCs to provide customized financing solutions, manage risk and provide the expertise and flexibility afforded by their unique combination of deep financial resources, pivotal market position and strong credibility as commodities counterparties due to their status as heavily regulated entities. To efficiently access the physical and commodity derivatives markets, small end users rely upon FHCs because they are large, sophisticated entities that offer both physically-settled and cash-settled alternatives. If FHCs exit these markets, end users would have difficulty meeting the needs of customers in a cost-effective manner. The remaining intermediaries that exist or could be expected to enter the market would not be able to serve end users' physical commodity and commodity derivatives needs as well as FHCs currently do because of FHCs' unique combination of favorable characteristics. It would be unlikely that any single intermediary could or would be willing to offer end users the combination of strong knowledge of the commodities markets themselves with the financial resources and credibility that FHCs alone offer together.
  - Full text of comment letter

EP Energy LLC

- Any additional restrictions on FHCs' ability to trade in physical commodities will negatively impact energy markets by reducing liquidity, reducing the number of strong creditworthy counterparties and significantly increasing volatility for all market participants. FHCs have been creditworthy and critical market participants. FHCs are well-regulated counterparties/market-makers with whom end users can efficiently and effectively transact in order to best manage risk. If FHCs and their affiliates exit the market place because of additional restrictions on their physical commodities activities, it will negatively impact liquidity and increase costs making it more difficult and expensive for end users to transact in physical commodities activities necessary to run their businesses and serve their customers. Engaging in transactions with unregulated entities will create a greater risk to the physical commodities markets than the potential tail risks identified in the ANPR.
  - Full text of comment letter

Murray Energy Corporation

- Additional regulation of FHCs' physical commodities activities is unnecessary. There is absolutely no evidence that their activities pose substantial risks to the safety and soundness of depository institutions or the financial system generally. Additional regulation would hasten the exit of FHCs from physical markets, further injuring an already depressed coal marketplace. Absent FHCs, end users would be forced to transact with unregulated or less regulated entities. Less regulated entities would likely have less appealing, and less transparent, credit profiles than FHCs, and transacting with them would increase risks to end users' business and the financial system.
  - Full text of comment letter

Noranda Aluminum, Inc.

- Accessing commodities markets could be more difficult, more expensive and less efficient without the presence of FHCs. The physical commodities marketplace is dominated by a small number of participants in each commodity sector, so competition and pricing could be affected if FHCs exit these markets. FHCs provide businesses with a well-regulated counterparty / market-maker with which end users can efficiently transact at the appropriate points in time when such actions are needed to best manage risk. FHCs are credit-worthy counterparties with market experience and the ability to handle market volatility. Additional

End Users *(cont.)*

regulation of these activities, including, among other things, the imposition of increased capital requirements, will deter FHCs from participating in the physical commodities space.

- Full text of comment letter

Novelis Inc.

- FHCs have helped end users keep hedging transactions costs relatively low and stable and improved liquidity. FHCs provide Novelis with well-regulated counterparties/market-makers with which Novells can efficiently transact at the appropriate points in time when needed to best manage risk. FHCs are some of the most creditworthy counterparties available, with the market experience and the means to handle market volatility. FHCs play an important and irreplaceable role in aiding Novelis' working capital goals by holding metal until it is delivered or needed, and offering Novelis extended payment terms on certain transactions. Despite the benefits of allowing FHCs to trade in physical commodities, some additional restrictions are necessary. Allowing FHCs to combine ownership of physical metals and commodities trading with warehousing of physical commodities has a detrimental effect on the aluminum market and opens up the risk of market manipulation of the LME, local market premiums and forward curve dynamics.
  - Full text of comment letter

NRG Energy, Inc.

- At least two products important to the electric power industry — first-lien hedging arrangements and project financing — do not pose material safety and soundness risk to FHCs or systemic risk. FHCs are able to offer these products with competitive pricing because of their in-depth knowledge of the physical power, oil refining and other commodities industries and their real-time knowledge of both physical commodities and financial derivatives markets. FHCs have successfully managed the risks posed by these transactions just as they have successfully managed risk in cases where they have provided secured financing in the physical commodities space. End users view FHCs as desirable counterparties because they are generally well-regulated, well-capitalized and customer driven.
  - Full text of comment letter

PBF Energy Inc.

- FHCs are uniquely positioned to serve the physical commodity markets. The Federal Reserve should develop regulations that allow FHCs to continue in this role. Their physical commodities activities allow end users to transact in these markets at specific points in time, depending on each end user's specific day-to-day business needs and risk profiles. FHCs can customize trades to the specific needs of each end user, allowing end users to most effectively hedge underlying risks. Because FHCs are large, liquid entities authorized to hold title to physical commodities, end users of physical commodities are able to use FHCs' services through the course of their day-to-day business activities, from sourcing raw materials, to delivering refined materials to the point of sale without arranging for independent financing or engaging in additional risk mitigation.
  - Full text of comment letter

Talos Energy LLC

- FHCs already have begun to exit physical commodities markets. Further regulation could hasten this process. FHC departures will create more concentrated, illiquid markets, which will make it very difficult for end users of physical commodities to efficiently transact in these markets. FHCs are in the business of making markets, and their physical commodities activities allow end users to transact in these markets at the specific points in time in which they need to do so. Given their sophistication, FHCs are able to customize trades to each end user's specific needs, allowing end users to most effectively hedge their underlying risks. Because FHCs are large, liquid entities authorized to hold title to physical commodities, end users of

End Users *(cont.)*

physical commodities are able to use FHCs' services through the course of their day-to-day business activities without arranging for independent financing or engaging in additional risk mitigation. End users also feel comfortable transacting with FHCs because they are already well-regulated by agencies such as the Federal Reserve, FERC, the CFTC and the SEC.

  - Full text of comment letter

Tennessee Energy Acquisition Corporation

- Tennessee Energy is an active participant in the municipal gas marketplace, including the marketplace for long-term gas supplies as well as the spot market. FHCs are among the primary participants in this marketplace as gas suppliers. Tennessee Energy is also an active participant in the commodity swap marketplace by providing hedging services requested by its members. FHCs are an essential part of the successful operation of that market. FHCs provide an essential service to the municipal gas industry, one that could not and would not be replicated or replaced by other industry participants, at least not under market conditions that have prevailed over at least the past eight years. FHCs are the most creditworthy counterparties with which end users transact business. FHCs are more efficient and operate in a regulated environment that results in them taking a cautious, businesslike approach to their commercial obligations. They are experienced participants in the natural gas commodities markets and have developed an increasingly sophisticated understanding of the specific markets in which they operate. The commercial activities that FHCs undertake in the gas commodity markets do not involve the ownership of oil and gas producing infrastructure or gas or oil transmission pipelines, or anything comparable to them that poses the risk of catastrophic loss.
  - Full text of comment letter

United Parcel Service Inc.

- FHCs are not only market-makers, but are also particularly sophisticated in constructing hedging transactions and in identifying options to help manage risks in ways that end users otherwise would not have considered. FHCs are regulated by the Federal Reserve and the CFTC, which provides a level of comfort when entering into hedging transactions with FHCs. FHCs have managed risks in these markets, and there is no evidence that market contagion from the Deepwater Horizon or other incidents has posed any underappreciated tail risks to FHCs. The risk profiles of FHC counterparties are transparent and well-known to the end user community, which, as a rule, is not comprised of risk-seekers. The imposition of additional regulations on FHCs could lead to less regulated or even unregulated entities taking FHCs' role in these markets.
  - Full text of comment letter

Financial Holding Companies

Goldman Sachs

- Commodity intermediation activities present similar market and credit risks to those presented by other financial activities. Intermediation services offered by FHCs provide significant public benefits, including serving as efficient means of providing financing and hedging products to producers and end users and promoting greater market liquidity and access to markets, which enhances transparency and pricing. With respect to environmentally sensitive commodities, an FHC engaged in intermediation will not be subject to liability under environmental laws if it adheres to straight-forward policies and procedures designed to prevent an owner of commodities from assuming the status of "operator" of facilities in which commodities are stored, transported or processed. Reputational risk, the risk of market contagion and tail risk are not unique to an FHC's physical commodity activities and should be addressed in the same ways that an FHC addresses these risks in its core financial activities. Comprehensive insurance programs serve as an important component of protection against the risks associated with physical commodity activities. FHCs' involvement in merchant banking has facilitated the transformation of many businesses and promoted broader economic growth. Any different risks are addressed by the existing merchant banking rule and FHCs' integrated risk management programs, including the policies and procedures developed and standards to protect corporate separateness. The connection between physical and financial products is meaningful, and access to physical markets is important in facilitating a broad range of services to clients. FHCs' capabilities in and approach toward commodities markets provide substantial benefits to these markets and the broader economy. The impact of the exclusion of FHCs from these markets would be felt acutely because of the absence of effective alternative providers of these intermediary services.
  - Full text of comment letter

Morgan Stanley

- The common element that should apply to all physical commodities activities and investments is the obligation that such activities and investments be conducted in a safe and sound manner through the means of a robust risk management framework that focuses on all significant categories of risks potentially posed by such activities. The risk management framework should include the measuring, monitoring and mitigation of environmental, legal and other forms of operational risk. It would be an error to conclude, based on the announcement of the proposed sale of Morgan Stanley's oil merchanting business, either that complementary commodities activities are not necessary to ensure competitive equity between FHCs and competitors conducting commodities derivatives or other financial activities, or that the relationship between commodities derivatives and physical commodities markets (or the relationship between participants in such markets) may not be as close as previously claimed or expected. Public benefits of continuing to permit FHC to engage in physical commodities activities are real and significant. Specialized financing and risk management solutions are essential for the operations of U.S. commodity producers, end users, and other commodity businesses. Commodities businesses require tailored solutions involving complex combinations of commodity physically-settled forwards, options and over-the-counter and cleared derivatives to meet their needs. FHCs are uniquely positioned to provide necessary specialized financing and risk management services.
  - Full text of comment letter

Wells Fargo

- Our diverse portfolio of merchant banking investments has increased the safety and soundness of our institution by producing attractive risk-adjusted returns and enabling us to expand customer and client relationships in a range of industries, resulting in new financial opportunities. The benefits of our merchant banking investments can be clearly seen, by way of example, in our investments in small- to medium-sized companies as well as in Wells Fargo's investments in the renewable energy sector. A significant portion of environmental financing that Wells Fargo has provided to date has been made through merchant banking investments in portfolio companies that generate tax credits for investors. Customers request physical commodities services from Wells Fargo because of our creditworthiness and strong relationship that typically spans numerous product offerings, allowing us an in-depth knowledge of customers' business needs and financial standing. The transparency that this relationship affords greatly enhances our ability to monitor credit and operational risk for this customer base. Accordingly, Wells Fargo's physical commodity platform is clearly supplemental and complementary to the other financial products that we offer.
  - Full text of comment letter

Financial Services Trade Associations

American Council of Life Insurers

- Life insurers' ownership of physical commodities is an extremely small component of total assets on an industry wide-bases. Life insurance companies may make these investments directly or indirectly. In the case of such indirect investments, the activity is comparable to investment activity conducted by life insurance companies in their private equity portfolios. Life insurers have been engaged in the physical commodities markets for a long time and have been a source of stability to the market in view of the long term investment horizon. Thus, it would be harmful to the market's stability to unreasonably restrict or burden life insurers' participation in the physical commodities markets. Life insurers have business models, risk profiles, capital structures, and regulations different from banks. Life insurers have predictable long-term patterns of claims, and the products have mechanisms, such as surrender charges, to control and prevent bank-like runs. State insurance laws already provide limits on the extent to which life insurers can acquire physical commodities. While it may make sense to craft a very broad regulatory solution for banks based on their broader range of activities, such an approach would not make sense for the life insurance industry with an existing, robust regulatory framework that constrains investment and commodity related activities. The scope of the ANPR is too broad to be suitable for application to life insurance companies, as it could impact not only direct investments in physical commodities, but also indirect or passive investments. To the extent that it elects to craft any proposals for rulemaking in this area, the Federal Reserve should carefully tailor such proposals to avoid any unwarranted negative impact on the life insurance industry. The ripple implications on the life insurance industry must be carefully considered, especially in light of the different ways the ANPR could impact life insurers, such as life insurers classified as nonbank SIFIs or life insurers having affiliations with savings and loan holding companies.
  - Full text of comment letter

Financial Services Roundtable

- As the Federal Reserve considers the range of risks that may arise from physical commodity activities, it must take into account different risk profiles and recognize the wide range of risk management and risk mitigation steps that companies have already taken to address the risks potentially associated with physical commodity activities. The indistinct but potentially open-ended reference to merchant banking investments in the ANPR makes it difficult for the public to comment intelligently upon the ANPR. If the Federal Reserve were to propose limitations or conditions for certain FHCs on engaging in physical commodity activities, there would be no legal or policy basis for extending them to insurance companies that are affiliated with savings and loan holding companies or that are supervised as nonbank SIFIs by the Federal Reserve. Any such proposed extension would be inappropriate and in conflict with the extensive regulatory system to which insurance companies are subject under state law. The imposition by the Federal Reserve of any regulatory limitations or conditions on the investment authority provided to an insurance company by state insurance law would raise serious concerns under the McCarran-Ferguson Act. The state insurance regulatory system reflects an understanding of the clear differences between the insurance company business model and the business model of other financial institutions. In addition, insurance company investment activities are subject to comprehensive regulation and oversight.
  - Full text of comment letter

Institute of International Bankers

- International banks are uniquely positioned to facilitate the markets for physical commodities. Unlike commodity-intensive business corporations that may be focused primarily on their own inputs and outputs of physical commodities, international banks operate for customer facilitation purposes across a range of products and commodities. Foreign banks, as additional participants in the U.S. physical commodities market, add to the market's capacity to serve customers and bring liquidity to the U.S. market from their trading operations outside of the United States. Participation by foreign banks, to the extent they facilitate access to, and expertise in, other geographic markets, broadens this effect over a wider geographic range. Banks promote enhanced competition both as direct market participants and by supporting other market participants via financing and risk management activities.

- Full text of comment letter

International Swaps and Derivatives Association

- Limits on FHCs' physical commodities activities may impair liquidity and efficiency in both physical and financial markets, causing higher costs and credit risk for end users, impaired hedging activities, reduced consumer choice and greater volatility. FHCs enhance liquidity by being willing to make prices in commodities and take on the role of market maker in otherwise illiquid markets. Moreover, FHCs enhance price integrity by helping to bring about price convergence. FHCs are uniquely desirable counterparties in physical markets due to their strong credit ratings and sophisticated risk management. FHCs' physical commodities activities remain complementary because they provide critical information on the pricing relationships between physical and financial markets, enhanced risk management tools and broader and better alternatives for customers.
  - Full text of comment letter

Private Equity Growth Capital Council

- FHCs provide important intermediation services for members' portfolio companies. Absent their market making activities, other market participants, in order to trade in these markets, generally would have to rely on other firms' desire to enter into transactions for their own commercial or financial reasons. FHCs also engage in transactions with customers designed to help customers manage their risks, for instance, by entering into a hedge with a manufacturer client of the price of a key commodity input of the manufacturing business or by locking in the spread between the price of an input commodity and the price of the output commodity. Participation in the physical markets provides FHCs with more diverse opportunities for hedging their own risks and with greater market information and expertise, allowing FHCs to provide risk management services more efficiently. FHCs' participation in the commodities markets also benefits the markets more broadly.
  - Full text of comment letter

Securities Industry and Financial Markets Association, American Bankers Association, Financial Services Forum, Financial Services Roundtable and Institute of International Bankers

- The public benefits of permitting financial holding companies to continue engaging in physical commodities activities greatly outweigh their potential risks. There has always been a close relationship between banking, physical commodities and physical commodities activities. Insured banks or their non-bank affiliates have long been permitted to engage in certain physical commodities activities, subject to certain limits. Investment banks not affiliated with bank holding companies were always allowed to engage in a wide range of physical commodities activities. The GLB Act authorized FHCs to make merchant banking investments in portfolio companies engaged in nonbanking activities, including physical commodities activities. It also authorized the Federal Reserve to permit FHCs to engage in physical commodities activities as a complement to financial activities. Finally, it permanently grandfathered the physical commodities activities of investment banks that subsequently became FHCs. The risks of commodities activities need to be assessed by type of commodity and activity. The risks of commodity intermediation activities, even with respect to environmentally sensitive commodities, are not fundamentally different from or greater than those associated with traditional banking and other permitted financial activities, including maturity transformation and market making in financial instruments. Nor are the risks associated with the transportation, storage or other handling of agricultural commodities, industrial metals or other commodities that are not environmentally sensitive. The tail risks associated with the transportation, storage or other handling of environmentally sensitive commodities, such as oil, natural gas or nuclear power, can be greater than the market value of the commodities or facilities involved because of potential legal liability for damages to the environment if such commodities are accidentally released into the environment. But these tail risks can be

Financial Services Trade Associations *(cont.)*

avoided or substantially mitigated to an acceptable level consistent with safety and soundness principles if FHCs comply with certain procedures described in Appendix C to the comment letter, when appropriate, including appropriate standards of corporate separateness.

- Full text of comment letter

The Clearing House Association, American Bankers Association, Financial Services Forum, Financial Services Roundtable and Institute of International Bankers

- If the Federal Reserve and Treasury were to determine that the regulatory restrictions or supervisory framework regarding merchant banking should be reconsidered beyond the context set out in the ANPR, they should allow further opportunity for comment before issuing a proposed rule. FHCs' successful experience in managing the risk associated with all types of merchant banking activities over a period of almost fifteen years demonstrates that the existing prudential framework for these activities overall is robust and effective. Though these activities do pose risks, FHCs can manage these risks within the existing supervisory structure by adhering to appropriately designed policies and procedures that are informed by established legal frameworks, such as the principles of corporate separateness and the body of environmental law establishing allocation of liability. There are certain practices that FHCs may incorporate into their policies and procedures that should be effective to avoid or substantially mitigate the risk of potential liability arising from physical commodity activities to a level consistent with an FHC's risk tolerance. The risks cited in the ANPR are the same risks that FHCs have appropriately managed since the merchant banking statutory authority was granted and the rules were adopted by the Federal Reserve and the Treasury. Significant and robust statutory and regulatory requirements already exist that minimize the risk that an FHC would have material exposure to the activities of a merchant banking portfolio company beyond the amount of its investment, and that limit the amount of the investment itself that is at risk. The doctrine of corporate separateness is well established in the law and provides insulation from liability for companies that abide by the contours laid out in the relevant judicial decisions. The doctrine was specifically contemplated in the adopting release of the final merchant banking rule, and the requirements in the rule are designed to help ensure that limited liability will be recognized. Imposing additional restrictions or requirements, such as capital requirements or further limits on holding periods and routine management, on FHCs' merchant banking activities is not only unnecessary but could hamper the ability of FHCs to make such investments, reducing the potential benefits of such investments.
  - Full text of comment letter

Individuals

Cathy Santoro

- Physical commodities (specifically energy resources) are one of the most critical elements in global growth and economic development, maintaining stable and secure access to those resources a priority of all nations. Financial institutions and markets are essential in furthering a country's full economic development potential. Interest rate and FX trading issues, ongoing regulatory reform specific to Basel III and Dodd-Frank, the current low interest rate environment and the timing of future Federal Reserve policy changes increase the risk of uncertainty. The possible adverse effects to the public specific to complementary activities as proscribed in the GLB act have risen substantively. The original intent specific to the GLB amendment with respect to bank holding companies should be reviewed in the context of capital demands, risks, and uncertainties prior to addressing the more granular aspects specific to ownership and investments as outlined in the ANPR. The outcome of such review would likely impact shadow banking commodity investment flows, and future actions and/or reform in regards to physical commodity activities. Clearly, physical commodity investments whether made by an FHC directly for its own balance sheet or via merchant banking investments is an investment and use of capital by the FHC. This capital is critical for continued global economic growth. Aside from FHCs as a primary source of capital, investment by FHCs in nonfinancial companies creates additional risks given the correlation between FHCs and nonfinancial companies specific to non-physical commodity transactions, such as treasury services and debt capital market issuances. Investments in nonfinancial companies by FHCs can serve to introduce additional risks to the market and mitigating such risks across the market should take precedence. Risk mitigation can alleviate demands specific to bank capital requirements in relation to stress tests, which can have broad benefit to the global economy and increase the potential of capital access expansion. That said, in reviewing risks specific to investments by FHCs in relation to nonfinancial companies it is important to be mindful of the importance FHCs serve in regards to advisory services specific to mergers, acquisitions and divestitures, which can be critical in advancing the global economy and those businesses, industries and sectors involved in the physical commodity business directly. FHCs can also serve a critical role in furthering the development specific to global financial markets given the lack of developed and/or stalled financial markets in many of those countries which contain the world's largest oil and gas reserves in relation to nationalized energy sectors and corresponding infrastructure and investment demands. The impact of active advisory engagement in the energy sector and financial market development in developing countries by FHCs can have exponential benefit to the global economy, in turn, serving to mitigate event risk, which is an important element of the U.S. sovereign rating.
  - Full text of comment letter

Law Professors

Professor Robert Hockett, Cornell University Law School

- It is problematic that the disclosure regime to which FHCs are subject does not require that they separately track their direct involvement in the physical commodities markets on the one hand, and their derivative exposures to those markets on the other hand. To allow firms to aggregate information concerning their direct and derivative involvements in the commodities markets is to allow them to prevent regulators and investors from tracking precisely that which must be tracked in order to determine whether physical markets are being cornered or otherwise manipulated in order to affect yields on derivatives markets. The CFTC and FERC are not optimally situated to monitor for market manipulation because would-be manipulators can evade detection by virtue of a gappy regime that effectively 'divides and conquers' those regulators that would otherwise act. FHCs' involvement in these markets should be rendered contingent upon the Federal Reserve's expressly promulgating a system of cross-market monitoring of derivative and physical commodity trading activities with a view to detecting and preventing market manipulative activity. Any determination that the separation of banking and commerce was ill-conceived from the get-go would be so momentous as to call for an extensive process of empirical investment and policy debate — for legislation enacted by Congress, then signed by the President. No regulatory agency should purport to be situated to make such fundamental and far-reaching determinations.
  - Full text of comment letter

Professor Saule T. Omarova, UNC School of Law

- Neither the industry nor the regulators have taken steps to enable the American public to acquire knowledge of the inner workings of the complex commodities markets. Without access to such information, the American public cannot be expected to make a meaningful impact on the Federal Reserve's deliberations. FHCs and their advocates advance three flawed arguments in favor of allowing FHCs to continue these activities, which divert attention from the substantive issues and should not influence the Federal Reserve's decision-making process. The first argument is that FHCs are necessary participants in physical commodity markets because they are uniquely situated to provide liquidity and other benefits to end users. Second, unregulated and less transparent entities could take FHCs' place in commodities markets, which would make these markets less safe. Third, there is no empirical evidence that FHCs' physical commodities activities have caused, or are likely to cause, any systemic financial crisis. Undoubtedly, commercial companies often benefit from FHCs' commodity trading, but what might be "efficient" for the individual parties in a transaction might not be socially efficient, if a significant reason for micro-efficiency is the implicit public subsidies to large financial institutions. Policy concerns include concerns about the safety and soundness of financial institutions and systemic risk associated with their commercial activities, potential leakage of the public subsidy beyond the banking sector, market integrity and consumer protection, and excessive concentration of economic and political power in the hands of financial conglomerates. Authorizations of physical commodities activities as "complementary" to FHCs' commodities derivatives businesses creates a fundamental tension that is consistently overlooked in policy discussions. Either there is no real need for FHCs to trade physical commodities to support their derivatives operations, or the efficacy of internal "information firewalls" is inherently questionable. The Federal Reserve should collect more granular quantitative and qualitative data on FHCs' merchant banking investments anywhere in the physical commodities supply chain, and monitor compliance with the statutory and regulatory requirements more closely. The Federal Reserve should use all of its formal and informal powers to prevent potential over-extensions of grandfathered commodity activities and to minimize the unintended consequences of allowing FHCs to run physical commodity businesses on a scale not anticipated by Congress in 1999.
  - Full text of comment letter

Other Market Participants

Aon Risk Solutions

- Aon Risk Solutions is actively involved in designing and placing programs to insure against the risks that are associated with commodities trading activities. There is little or no risk that a physical loss of owned commodities could be so significantly uninsured as to compromise an FHC. Cargo insurance market capacity is many times greater than the largest anticipated value of commodities in any one loss. The premiums and rates charged by insurers for the liability exposures of commodity traders and charterers are far less than the premiums and rates determined by these insurers for the operators and owners of the vessels, pipelines and storage locations. This reflects the underwriters' view of the limited nature of the risk they are assuming for commodity traders and charterers. The probability that a trader is held liable for a transportation or storage loss is viewed as low by insurers. The ANPR's main liability risk concern is environmental (*i.e.*, an oil spill). However, in practical terms, commodity trader risk mostly involves the transport or storage of commodities. Empirical evidence does not support the assertion that FHCs face substantial liability arising from chartering vessels and owning oil on the vessels, or in storage tanks or pipelines. Due to the remote risk that a cargo owner is brought into a spill claim, commodity traders usually purchase cargo owners legal liability insurance. Commodity traders are quite able to protect their exposures arising from chartering, storing and transporting commodities, as well as, cargo ownership through a liability policy by specialist marine insurance and related markets.
  - Full text of comment letter

CME Group

- An FHC's ability to make or take delivery under a futures contract, and the attendant ability to directly or indirectly own, store and transport related physical commodities, are integrally connected to the commercial hedging and price-basing utility of the physical delivery futures markets. The physical-delivery mechanism, when well-constructed and safeguarded, ensures price convergence between derivatives and their underlying commodities. Curtailing the ability of FHCs to meaningfully participate in the marketing channels for physical commodities would significantly diminish net liquidity in convergence trades, which will weaken the physical delivery contracts' price convergence mechanism. FHCs are a critical source of liquidity for bona fide hedgers that benefit from delivery optionality, which increases the hedging value of physical-delivery futures to end users and improves futures-cash market convergence. FHCs and other bank holding companies registered as swap dealers are reliable, well-capitalized and regulated institutions that are credible counterparties to customized long-term transactions of importance to end users. Transferring bona fide hedging status to swap dealers allows dealers to accommodate the customized needs of end users, to establish large offsetting positions in standardized futures and to channel the pricing signals embedded in customized trades to related exchange-listed and cleared derivatives. Preventing FHCs from acting in this capacity may ultimately affect the cost of commodities, as FHCs will no longer be able to provide an integrated set of services to commercial end users. The ability of FHCs to meaningfully participate in the physical commodity markets directly supports valuable liquidity for convergence trades and delivery optionality in physical delivery futures and thereby the price basing and hedging utility of the benchmark markets. The intermediary services provided by FHCs also broadly benefit end users and transfer liquidity and price signals embedded in customized derivatives to the listed and cleared derivatives markets.
  - Full text of comment letter

Denham Capital Management LP

- Placing additional restrictions on FHCs could impact businesses like energy private equity firms that must purchase and use physical commodities and hedge their risks effectively in order to survive and grow. FHCs provide a steady stream of liquidity in the physical commodities and commodity-related derivatives markets. Outside of FHCs, those markets are often relatively illiquid. Through their expertise, FHCs are able to offer and, in some instances, propose, customized trades that allow companies to improve their risk mitigation techniques. If further regulation is imposed, FHCs may depart physical commodity and related derivatives

Other Market Participants *(cont.)*

markets, which could be catastrophic for companies, reducing liquidity and leaving them searching for alternative methods to manage risks. The departure of FHCs from these markets would likely increase costs to end users and their customers, with no increase in systemic safety. FHC replacements would be less regulated and less creditworthy, and it is unlikely that end users would have the confidence in those counterparties equal to that which they currently invest in FHC counterparties. There is no looming risk that justifies further regulation. Any such risk that might have been posed is now further mitigated by the capital and other requirements imposed by the Dodd-Frank Act on FHCs.
  - Full text of comment letter

Energy Capital Partners and EquiPower Resources Corp.

- As regulations increase and banks exit commodities businesses they will lose critical touch with the transactional side of many sectors of the economy and the businesses to which they lend. EquiPower depends on FHCs as a primary counterparty type, in large part because of the access they provide to a broad network of suppliers and marketers to source fuel for plants. EquiPower also frequently engages FHCs in hedging activity related to the sale of facilities' power output (including physical and financial sales), basis or location differentials impacting delivery of fuel and power to customers, and hedging fuel inputs to manage risk associated with commodity price changes.
  - Full text of comment letter

Sunesis Capital, LLC

- A number of adverse effects have arisen in the aluminum market due to FHCs simultaneously owning physical metal, trading in metal derivatives, and owning official LME storage warehouses of the metal. Specifically: FHCs own an outsize share of official LME metals warehousing. With such warehouse market power, they can exercise manipulative control over aluminum prices and stifle competition; FHCs gain insider information about the future moves of metal in and out of the market, and then trade on such information; the American taxpayer subsidizes FHC activity that causes higher prices on the everyday goods purchased by those same taxpayers because FHCs benefit from an implied TBTF subsidy and access to the discount window.
  - Full text of comment letter

Teachers Insurance and Annuity Association of America

- Application to insurance companies of any proposals that the Federal Reserve may ultimately seek to apply to FHCs would be unnecessary and inappropriate. FHCs and insurance companies diverge significantly in the manner in which they engage in physical commodity activities. Physical commodity activities of insurance companies have typically been limited to passive investment and have not involved active trading or market-making. There is no compelling legal or policy basis for extending additional limitations, restrictions or qualifications on such activities to insurance companies that are affiliated with savings and loan holding companies, which would conflict with the extensive regulatory system to which insurance companies are subject under state law and would raise serious questions under the McCarran-Ferguson Act.
  - Full text of comment letter

Public Interest Groups

Americans for Financial Reform

- The traditional principle of the separation of banking and commerce, as well as the need to ensure bank safety and soundness, require the elimination or significant reduction of commodity ownership from bank portfolios. The increase in commodity ownership by banks has been associated with several episodes of market abuse, calling into question claims of public benefit. Firms enjoying federal financial guarantees and the imprimatur of prudential banking oversight will have greater liquidity resources to fuel such schemes. The Federal Reserve is ill-positioned to measure the public benefits of commodity ownership as they intersect with the possibility of market manipulation, as it has no role in commodity market regulation. The Federal Reserve has not conducted a public benefits test for complementarity, which requires a detailed assessment of whether commodity activities within a bank produce genuine economic complementarities that are not associated with the increased leverage made possible by the public liquidity backstop to banks, and are not associated with anticompetitive tying arrangements in which a bank leverages market power in its financial activities to gain an advantage in commodity markets. Merchant banking investments must be subject to very stringent safety and soundness tests, and must also fulfill the statutory requirement of true independence. Since the limit in grandfathered activities is measured as a percentage of total assets rather than bank capital, it represents a level of bank asset holdings that could wipe out the total capital of even a bank that is properly meeting minimum regulatory leverage requirements. The Federal Reserve should aggressively apply its safety and soundness authorities in the case of grandfathered activities, and the statutory injunction limiting commodity activities engaged in as of 1997 must be read narrowly and literally.
  - Full text of comment letter

Better Markets, Inc.

- The commercial physical commodity activities of FHCs have fostered three dangerous and unacceptable consequences: increased risks to the stability of FHCs, an unfair and anticompetitive environment, and the potential for massive market manipulation. The statutes governing the commodities activities of FHCs are limited and were never intended to permit the wide-ranging commodities activities present today. The Federal Reserve's approach toward complementary activities has been subject to inadequate constraints and introduces significant conflicts of interest. It is unfair that those FHCs including large foreign banking entities that engage in "complementary" commodity activities can take advantage of unfettered access to cut-rate money from the Federal Reserve's Discount Window while U.S. commodity end users and other business competitors enjoy no such access. The Federal Reserve's lenient policy in effectuating the orders approving FHC complementary activities, have created an unacceptable level of risk associated with owning a commodity business. To protect the safety and soundness of the economy, the Federal Reserve must take a more prescriptive and restrictive approach toward "complementary activities" by FHCs.
  - Full text of comment letter

Commodity Markets Oversight Coalition

- FHCs support commercial businesses and industries that produce, refine, store, transport, market or consume commodities such as crude oil, wheat, cattle and steel. Financial institutions also facilitate the financing necessary to construct, install and repair related infrastructure and assist businesses and individuals with managing risks associated with volatile commodity prices. Market manipulation and conflicts of interest are valid concerns. No federal department, agency or commission is currently responsible for monitoring the totality of, or relationship between, these activities and there seems to be little or no public accountability. FHCs enjoy certain financing advantages over competitors in commercial activities. The Federal Reserve should thoughtfully examine this issue and take action as necessary to safeguard commercial businesses and industries, protect the integrity of the financial system and the broader economy, and close the door to potential market manipulation.
  - Full text of comment letter

Public Interest Groups *(cont.)*

Institute for Agriculture and Trade Policy

- The recent pullback of FHCs from physical ownership and trading of commodities is no reason for the Federal Reserve to not regulate further or terminate permission to engage in complementary activities. If a commodity trading house fails, the exposure of the financial system to shadow banking-like failures is relatively small compared to the contagion that would damage smaller financial institutions if FHCs' complementary activities liabilities exceed the leveraged asset ratio. If Federal Reserve guarantees to FHCs are made explicit as part of living wills, the Federal Reserve should exclude from the explicit guarantee those complementary activities with the highest degree of liability exposure. Since FHCs are not required to report granular data of complementary activities, it is difficult to evaluate whether such activities pose a substantial risk to the safety and soundness of FHCs and the financial system. The Federal Reserve should require FHCs to submit quarterly two independent estimates of the cost of environmental, transportation, personal injury and death, public health, reputational and legal liabilities associated with the trading, storage and delivery of the complementary activities. The Federal Reserve should require FHCs to submit annually copies of the insurance policies they and/or third parties contracted by them carry on the storage and delivery of physical commodities. FHCs engaging in complementary activities should be required to have higher capital reserves than FHCs that do not. If an FHC fails to pass a Federal Reserve stress test, it should be required to stop engaging in all complementary activities. The Federal Reserve should evaluate complaints about "burdensome and costly" reporting requirements not in the context of individual or even collective FHC representations, but in terms of systemic costs and benefits. FHCs' physical commodities activities raise conflicts of interest not addressed by existing law. There is no existing law to discipline anticompetitive business practices that arise from synergies in excessive speculation in commodity derivative contracts and physical trading of those commodities.
  - Full text of comment letter

New America Foundation

- The ownership and control of physical commodity assets by banks endangers the public welfare in a host of ways. One aspect of this threat is the manipulation of market prices by large integrated companies free to make financial trades based on their "inside" knowledge about the flow of physical commodities through the pipelines, steamship lines, storage facilities, and other infrastructure that they directly or indirectly control. One key factor enabling this is that the companies that manage most commodities businesses in America have generally grown significantly in size over the last 20 years and have vertically integrated into many new lines of business. There have also been dramatic changes in the structure of delivery contracts and the commodities markets themselves, the emergence of extremely sophisticated surveillance technologies and data analytics tools, and a surge in the amount of money in these markets thanks to the creation of new investment vehicles. This cluster of changes affords the individuals who work at these massive handler-traders both far greater ability and far greater incentive than even a decade ago to manipulate markets using "inside" information. The laws and mechanisms available to regulators to detect and prosecute manipulation in commodity markets appear to be grossly inadequate to the task. The asymmetry in information and power grows by the day.
  - Full text of comment letter

Occupy the SEC

- BHCs have long been prohibited from physical delivery or possession of physical commodities as part of a long-standing statutory firewall between banking and commerce, the purpose of which remains current today. The far-reaching activities of BHCs pose problems, including thwarting competition and posing systematic risk concerns, which were either not evident or not fully analyzed in the Federal Reserve's post-2003 complementary powers Orders. The Federal Reserve has interpreted the grandfathering provisions of the BHC Act in a manner that has allowed newly-converted BHCs to engage in the riskiest and most speculative physical commodities trading. The Federal Reserve's regulations regarding merchant banking avoid a realistic analysis of managerial control and need to be revisited in light of new legal principles and potential environmental and financial catastrophes. The Federal Reserve cannot rely on other statutory schemes to resolve the core concerns of risk, anti-competitive practices, credit allocation, and resource concentration. The subsidiary structure is vulnerable to exactly the financial contagion implicit in the financial crisis as well as the consequences of environmental catastrophe under the harsh liability regime of environmental statutes such as CERCLA, which include reputational and systemic risks, and the real likelihood that the corporate veil will be pierced in such actions. CFTC position limits and exchange trading requirements appear inadequate. The large size of allowed positions, exemptions for end users, and the possibility of continued fraud and market manipulation with regard to smaller positions caution against overconfidence in the effect of the rules on physical commodities trading by FHCs. Although CERCLA places cost of accidents on the responsible parties, the public is commonly responsible for initial remediation costs (even if the polluter and others pay the ultimate costs). The initial costs can result in severe economic and social disruption during an extended process of assessing liability. FHCs have the ability to escape from liability for environmental accidents by insulating themselves with the use of subsidiaries. It would be unjust to allow FHCs to continue participating in these activities in light of the potential uncertainty regarding liability for damages. Serious risks stem from concentrating large swaths of physical commodity-related activities that are deemed “complementary to the business of banking” inside the largest financial institutions. This exacerbates the TBTF problem and has anti-competitive effects. Deregulation of physical commodities and physical commodities derivative markets also has created extraordinary price risks and undermined the ability of end users to hedge risks. The Federal Reserve lacks the expertise to regulate the esoteric instruments and risks involved in physical commodities trading.

  - Full text of comment letter

Public Citizen

- Since 1787, commercial and agrarian interests have endorsed the need to separate banking from commerce, which became expressed in law. This policy has served the nation well, evinced by harsh history lessons when banks breached the banking/commerce wall. It is difficult to understand how a profit-maximizing bank will generate public benefits through commodity ownership. Nor does bank participation in commodities businesses yield greater economic gain.
  - Full text of comment letter

The Other 98%

- The Federal Reserve must act promptly to end the dangerous, risk-intensive physical commodities activities of FHCs, or at the very least significantly expand the oversight into and restrictions on such activities. Multiple factors affect both the safety and soundness of individual institutions and overall U.S. financial stability and warrant significant new limitations on physical commodities activities by FHCs. The concerns outlined in the Federal Reserve’s ANPR are extremely narrow and are based on the precedent of how the Federal Reserve has approached FHC physical commodity activities in the past. The Federal Reserve should broaden the scope of the potential remedies to include, when possible, a revocation of past orders granting authority to FHCs to conduct commodity activities. Because the disclosure of physical commodities is so meager, the public lacks access to information that would further inform the ANPR process. No use of the emergency lending authority should be granted to any financial institution conducting physical commodity activities, on the basis of the financial stress caused by these activities. There are many examples of conflicts of interest that have emerged due to FHC involvement in physical commodities that suggest enforcement is lacking. There must be an additional inquiry into how an FHC structures the relationship between the physical commodity trading and their derivatives trading in order to prevent conflicts of interest. An FHC should only be permitted to make passive private equity investments in commercial companies if that investment does not exceed 5% of the voting shares of the company the FHC is investing in.
  - Full text of comment letter

Senators

U.S. Senator Carl Levin

- The Federal Reserve should tighten approval of complementary physical commodities activities by requiring FHCs to demonstrate how a proposed activity would be directly linked to and support the settlement of other financial transactions conducted by the FHCs. The Federal Reserve should act with caution when reviewing applications and deny approval of unduly risky activities and should reinvigorate the public benefits and adverse effects analysis that the statute requires it to apply when reviewing applications under the complementary authority. The Federal Reserve should strengthen prudential safeguards for all physical commodity activities to prevent undue risks and unsafe and unsound practices, including by: (a) developing a single, integrated limit on the dollar value of physical commodity holdings that may be maintained by an FHC at one time, no matter what authority was used to acquire the holdings or what type of subsidiary holds them; (b) restricting the trading of commodities to those found by the Federal Reserve to meet certain prudential standards in addition to having been approved by the CFTC for trading on an exchange; (c) strengthening existing limit against FHCs owning, operating, or investing in facilities for the extraction, transportation, storage, or distribution of commodities and against processing, refining, or altering commodities, by extending that limitation to activities under the merchant banking and grandfather authorities, and preventing FHCs from circumventing that limitation through indirect arrangements; and (d) imposing additional capital and insurance requirements on FHCs engaged in physical commodity activities that may experience a catastrophic event. With respect to the merchant banking authority, the Federal Reserve should tighten controls over merchant banking investments involving physical commodities by shortening and equalizing the 10-year and 15-year investment time periods, clarifying the actions that qualify as "routine operation and management" of a business, clarifying what funds can make merchant banking investments, clarifying application of the Volcker Rule, and imposing additional reporting requirements to facilitate regulatory oversight. With respect to the Section 4(o) grandfathering authority, the Federal Reserve should reduce physical commodity activities conducted under this authority by clarifying that it authorizes only activities that were lawfully underway as of September 30, 1997, and were still underway when the affected institution became an FHC, and by applying additional reporting requirements to facilitate regulatory oversight.
    - Full text of comment letter

U.S. Senators Sherrod Brown and Elizabeth Warren

- Since the Gramm-Leach-Bliley Act's passage, FHCs have expanded into activities that were not debated at the time, and may not have been intended by the law's authors. The risks associated with, and the liability arising from, FHCs engaging in commercial activities are wide-ranging in nature and unpredictable in their potential severity. Commercial activities create the potential for manipulation, conflicts of interest, market distortions, and other anticompetitive behavior. Non-financial risks of FHCs' commodities activities include: (1) geopolitical risks; (2) compliance with various laws and regulations, including bribery and anti-corruption, environmental protection, management and use of hazardous substances and explosives, management of natural resources, licenses over resources owned by various governments, and labor and occupational health and safety standards; (3) environmental hazards; (4) resource unavailability; (5) catastrophic risks from explosions, fire, vandalism, and crime; (6) availability of commodity supplies; and (7) supply chain issues and availability of infrastructure. The risks are particularly acute when concentrated in large, complex financial institutions — the six largest U.S. banks have a combined 14,420 subsidiaries. Ambiguities in the complementary, merchant banking, and grandfather exemptions have resulted in unnecessarily broad and permissive interpretations of these provisions. Eliciting public comment on the risks and benefits of allowing FHCs to conduct physical commodity activities is of limited value without meaningful disclosure of these activities. The concerns regarding competition and manipulation, whether real or perceived, highlight the need for regulatory action to limit the scope of permissible commercial activities. The Federal Reserve should not be concerned that activities may migrate to non-banks. The CFTC maintains authority to police fraud and manipulation in commodities markets, and the FSOC has the authority to designate firms or activities as systemic.
    - Full text of comment letter

Comment Letters — Links

Commodity Trade Associations

- American Gas Association, America's Natural Gas Alliance and American Exploration & Production Council
- American Gas Association, American Public Gas Association, Electric Power Supply Association, National Rural Electric Cooperative Association, U.S. Chamber of Commerce for Capital Markets Competitiveness and U.S. Chamber of Commerce Institute for 21st Century Energy
- Center for Capital Markets Competitiveness
- Coalition of Physical Energy Companies
- Electric Power Supply Association
- Futures Industry Association
- International Wrought Copper Council
- Interstate Natural Gas Association of America
- National Association of Corporate Treasurers
- U.S. Chamber of Commerce

End Users

- Alon USA Energy, Inc.
- Apache Corporation
- Calpine Corporation
- Central Plains Energy Project
- Chelan County Public Utility District, Clark Public Utilities, Cowlitz County Public Utility District, Public Utility District #2 of Grant County, Eugene Water and Electric Board, Klickitat County Public Utility District, Lewis County Public Utility District, Pend Oreille County Public Utility District #1, Snohomish County Public Utility District and Tacoma Power
- Cheniere Energy, Inc.
- Clarke-Mobile Counties Gas District and The Black Belt Energy Gas District
- Converse and Company, Inc.
- Delek US Holdings, Inc.
- EP Energy LLC
- Murray Energy Corporation
- Noranda Aluminum, Inc.
- Novelis Inc.
- NRG Energy, Inc.
- PBF Energy Inc.
- Talos Energy LLC
- Tennessee Energy Acquisition Corporation
- United Parcel Service Inc.

Financial Holding Companies

- Goldman Sachs
- Morgan Stanley
- Wells Fargo

Financial Services Trade Associations

- American Council of Life Insurers
- Financial Services Roundtable
- Institute of International Bankers
- International Swaps and Derivatives Association
- Private Equity Growth Capital Council
- Securities Industry and Financial Markets Association, American Bankers Association, Financial Services Forum, Financial Services Roundtable and Institute of International Bankers
- The Clearing House Association, American Bankers Association, Financial Services Forum, Financial Services Roundtable and Institute of International Bankers

Individuals

- 125 individuals

Law Professors

- Professor Robert Hockett, Cornell University Law School
- Professor Saule T. Omarova, UNC School of Law

Other Market Participants

- Aon Risk Solutions
- CME Group
- Denham Capital Management LP
- Energy Capital Partners and EquiPower Resources Corp.
- Sunesis Capital, LLC
- Teachers Insurance and Annuity Association of America

Public Interest Groups

- Americans for Financial Reform
- Better Markets, Inc.
- Commodity Markets Oversight Coalition
- Institute for Agriculture and Trade Policy
- New America Foundation
- Occupy the SEC
- Public Citizen
- The Other 98%

Senators

- U.S. Senator Carl Levin
- U.S. Senators Sherrod Brown and Elizabeth Warren