

**Written Testimony of**  
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**Before the U.S. Senate Committee on Homeland Security and Governmental Affairs,**  
**Permanent Subcommittee on Investigations**  
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**FINANCIAL HOLDING COMPANIES' ACTIVITIES IN PHYSICAL COMMODITY MARKETS: KEY  
ISSUES FROM THE PERSPECTIVE OF U.S. BANKING LAW AND POLICY**

I am a Professor of Law at Cornell University, where I teach subjects related to U.S. and international banking law and financial sector regulation. Prior to becoming a law professor, I practiced law in the Financial Institutions Group of Davis Polk & Wardwell and served as a Special Advisor on Regulatory Policy to the U.S. Treasury's Under Secretary for Domestic Finance. Since entering the legal academy in 2007, I have written articles examining various aspects of U.S. financial sector regulation, with a special focus on systemic risk containment and structural aspects of U.S. bank regulation. In 2013, I published an article examining the legal and regulatory authority and potential implications of large U.S. financial holding companies' growing involvement in physical commodity and energy markets.<sup>1</sup> On July 23, 2013, I testified before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions and Consumer Protection, in a hearing on "*Examining Financial Holding Companies: Should Banks Control Power Plants, Warehouses, and Oil Refineries?*"<sup>2</sup>

This written submission incorporates some of the key arguments laid out in my article and prior congressional testimony, and examines important additional factors that merit attention in light of various market and regulatory developments since July 2013. In particular, this submission addresses some of the principal arguments repeatedly advanced by financial industry representatives and other interested private parties denying the need for regulatory action in this area.

**I. Why Banking Organizations' Participation in Physical Commodity Markets Raises Legal and Policy Issues: Some (Relevant) History on the Separation of Banking from Commerce**

One of the core principles underlying and shaping the elaborate regime of U.S. bank regulation is the principle of separation of banking and commerce, which generally prohibits banks and their corporate parent- and sibling-companies from engaging in non-financial businesses. The existence of an explicitly legislated "wall" between banking and commerce is the fundamental

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<sup>1</sup> Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265 (2013), [hereinafter, "**Merchants**"], available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2180647](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647).

<sup>2</sup> Written Testimony of Saule T. Omarova, Associate Professor of Law, University of North Carolina at Chapel Hill, before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions and Consumer Protection (July 23, 2013) [hereinafter, the "**2013 Testimony**"], available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=6d49a599-f7dc-4c1f-9455-fa8d891f04c6](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=6d49a599-f7dc-4c1f-9455-fa8d891f04c6).

structural factor distinguishing the U.S. from many European and Asian countries.<sup>3</sup> In contrast to the European “universal bank” model, for example, the default rule for U.S. banking entities is that they are *not* allowed to conduct purely commercial activities. Any *permissible* commercial activity is an *exception* to that basic rule, which must be granted by or recognized under the relevant law governing individual banking entities’ business.

Therefore, for any U.S. banking organization, a decision to participate in the production, processing, transporting, storing, and trading physical commodities – all purely commercial activities – is never just a matter of their own or their clients’ profitability or convenience: it is, first and foremost, a matter of their *legal authority*. In order to enter the physical commodities supply chain, at any point and in any capacity, a bank or any bank-affiliated company has to find a specific legal or regulatory authorization to do so.

What this means is that, under U.S. law, these types of business decisions are deemed too important to be left purely to individual banks’ managers or private owners and, instead, are inextricably and fundamentally linked to broad considerations of *public policy*. That same fundamental premise must inform and guide the much-needed discussion of where to draw the line between permissible and impermissible commodities activities of U.S. banking entities in today’s complex financial system.

However, since the summer of 2013, when the controversy over certain large U.S. banking institutions’ growing commodity merchant businesses moved to the forefront of policy debate, the banking industry and its representatives – including powerful financial industry trade associations and prominent private law firms – have been trying to subvert and confuse the discussion by, among other things, misrepresenting what is at stake.

One of their fundamentally misleading arguments implies that the U.S. legal prohibition on mixing banking and commerce is not a significant barrier to allowing banks to drill for oil.<sup>4</sup> To support this claim, they cite selectively to various bits of ancient and medieval European and Asian history as proof that there is nothing “radically new” – meaning, “nothing worrisome” – about JPMorgan selling electricity to Californians or Goldman Sachs controlling aluminum supplies to U.S. beer-brewers. This is a meaningless claim that serves only to distract from the real policy questions in the debate. Sampling of ancient foreign history is irrelevant as an argument about the proper application of current U.S. statutes and regulations.<sup>5</sup>

Perhaps aware of that obvious weakness, the same banking industry experts advance another logically specious claim that the principle of separation of banking from commerce is somehow

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<sup>3</sup> See Bernard Shull, *The Separation of Banking and Commerce in the United States: An Examination of Principal Issues*, 8 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 1 (1999).

<sup>4</sup> See, e.g., Securities Industry and Financial Markets Association, American Bankers Association, Financial Services Forum, Financial Services Roundtable, Institute of International Bankers, *Comment Letter on the Advance Notice of Proposed Rulemaking on Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities (Docket no. R-1479; RIN 7100 AE-10)*, April 16, 2014

[hereinafter, the “**Trade Associations’ Comment**”]. The following discussion addresses the industry’s history-based arguments contained primarily in Part II of the Trade Associations’ Comment.

<sup>5</sup> It’s also worth noting that, in addition to being irrelevant, these industry proponents’ narrative conspicuously ignores various “inconvenient” episodes in the European history. For example, in 1374, the Venetian Senate specifically prohibited bankers from dealing in copper, tin, iron, lead, saffron, and honey – an early instance of prudential and market conduct regulation aiming to prevent banks from excessive risk-taking and monopolizing trade in these commodities. See Shull, *supra* footnote 3, at 3.

not legally binding (and perhaps even non-existent), simply because there have always been some limited exceptions to its application in practice. In lieu of supporting evidence, they simply describe various ways in which banks and securities firms in the past pushed against various regulatory boundaries, mostly unrelated to commodities, which finally led to the passage of the Gramm-Leach-Bliley Act in 1999 – an event this argument treats as something akin to the end of history, a naturally pre-ordained conclusion of the long journey from ancient Egypt to President Clinton’s desk.

Incredibly, this narrative almost completely – and it seems deliberately – fails to mention the two key federal statutes that established the legally binding line between banking and commerce: the National Bank Act of 1863 and the Bank Holding Company Act of 1956. It is these statutes that embody most clearly the principle of separating banking from commerce – which is very much alive today – and articulate the main public policy objectives of such separation. A narrative that deliberately ignores that crucial part of the history of U.S. banks’ involvement in commodity markets is hard to take seriously as offered in good faith.

Although this written statement does not seek to present a full historical account of U.S. banks’ commodities activities, it is important to set the record straight by discussing briefly the genesis of and policy rationale behind the legal separation of banking and commerce in the United States.

The principle of separation of banking from commerce has always been a fundamental feature of the U.S. banking system. Early American banks were chartered by state legislatures, and these legislative grants typically limited chartered banks’ business activities by prohibiting them from “dealing in merchandise.”<sup>6</sup> In 1825, New York became the first state to adopt a legal definition of banking powers and to expressly prohibit any activity not affirmatively allowed by the statute.<sup>7</sup> Throughout most of the 19<sup>th</sup> century, despite the widespread adoption of general corporation laws giving rise to the modern corporate form, banks remained subject to restrictive special chartering that defined the nature of the enterprise. An important factor underlying the persistence of special bank charters was the recognition that banking was essentially an exercise of “public powers” that had to be granted with an explicit view toward a public purpose.<sup>8</sup>

When Congress created the federal bank charter in 1863-64, it followed New York’s approach: the famous “bank powers clause” of the National Bank Act generally limits national banks only to activities within a relatively narrow band of “the business of banking.”<sup>9</sup> Since then, U.S. banks have been operating within the boundaries of that clause, which imposed an explicit statutory limit on their ability to move into commercial activities. To evade this legal prohibition, U.S. banks began developing various forms of entity arbitrage, including the formation of legally separate holding companies that were not technically subject to the bank powers clause and, therefore, could conduct bank-impermissible financial and non-financial activities.<sup>10</sup> The early 20<sup>th</sup> century saw many of these arbitrage techniques end in financial panics, political scandals, and legislative reforms. The break-up of the “money trusts” and the subsequent birth of U.S.

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<sup>6</sup> Id. at 7.

<sup>7</sup> Id.

<sup>8</sup> Id. at 8.

<sup>9</sup> 12 U.S.C. §24 (Seventh).

<sup>10</sup> For a discussion of the rise of bank holding companies in the early 1900s and the history of the U.S. bank holding company regulation, see Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN'L L. 113 (2011-12).

federal antitrust regulation and the Federal Reserve System were, to a great extent, responses to these developments.

The next step in this process came on the heels of the Great Depression and the New Deal reforms of the 1930s, which further limited bank powers, this time by prohibiting deposit-taking institutions from dealing and underwriting corporate securities and from affiliating with securities firms. At the same time, Congress established the federal deposit insurance system – a critically important element of U.S. bank regulation and a powerful embodiment of the inherently public-private nature of modern banking. The federal government’s extraordinary step of directly guaranteeing banks’ private liabilities to their depositors significantly raised the public-policy salience of keeping banking – now, an explicitly publicly subsidized business – separate from general commerce.

Yet, the New Deal legislation, including the famous Glass-Steagall Act, did not explicitly preclude banks – especially the more aggressively growth-oriented large “money-center” banks – from using the holding company structure to engage, albeit indirectly, in purely *commercial* activities. In the aftermath of the World War II, a number of large banks pursued aggressive growth through holding company acquisitions of additional banks and commercial enterprises – a trend that ultimately led Congress to pass the Bank Holding Company Act of 1956 (the “BHCA”), the single most important modern federal statute explicitly operationalizing the traditional U.S. policy of separating banking from commerce.<sup>11</sup> Under the BHCA, all bank holding companies (“BHCs”) – i.e., companies that own or control U.S. banks – are generally restricted in their ability to engage in any business activities other than banking or managing banks, although they may conduct certain financial activities “closely related” to banking through their non-depository subsidiaries.<sup>12</sup>

The BHCA is designed to address the key policy reasons underlying the long-standing U.S. principle of separation of banking from commerce. Traditionally, these policy reasons have included the needs (1) to preserve the safety and soundness of the U.S. banking system (by shielding depository institutions from risks associated with commercial activities); (2) to ensure a fair and efficient flow of credit to productive economic enterprise (by, among other things, preventing unfair competition, market manipulation, and bank conflicts of interest); and (3) to prevent excessive concentrations of financial and economic power in the financial sector. In my prior writings, I have elaborated more fully on each of these traditional policy objectives.<sup>13</sup> For present purposes, it is important to re-emphasize that the BHCA was born as a fundamentally antitrust, anti-monopoly, anti-horizontal-integration law, concerned at least as much with the integrity of the nation’s credit market as with the stability of the U.S. banking system.

Since the passage of the BHCA in 1956, U.S. banking organizations wishing to conduct any commodities activities have had to find their way around the Act’s prohibitions and fit their commodities operations into specific statutory or regulatory exemptions.<sup>14</sup> These efforts

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<sup>11</sup> Bank Holding Company Act of 1956, Pub. L. No. 84-511, §§ 1-12, 70 Stat. 134, 135 (1956).

<sup>12</sup> 12 U.S.C. §§1841-43.

<sup>13</sup> See Omarova, *Merchants*, *supra* note 1; Omarova, 2013 Testimony, *supra* note 2.

<sup>14</sup> Both the National Bank Act and the BHCA contain certain limited exceptions to their general restrictions on permissible activities of banks and BHCs. The line separating banking from commerce has never been completely impenetrable in practice. Yet, that fact does not lend support to arguments denying the existence or fundamental significance of the separation of banking from commerce as a matter of U.S. law. The very existence of such

intensified greatly beginning in the 1980s-1990s, when significant changes in financial markets – such as the listing of the first standardized oil futures and the creation of over-the-counter commodity derivatives – prompted Wall Street firms to start actively trading and dealing in commodity-linked financial instruments. Elsewhere, I describe in detail how, beginning in the mid-1980s, some of the largest U.S. commercial banks lobbied the Office of the Comptroller of the Currency (“OCC”) to allow them to enter into commodity-linked derivatives contracts.<sup>15</sup> The OCC, eager to help national banks to compete against securities firms, adopted an increasingly broad interpretation of the bank powers clause in the National Bank Act and ultimately allowed banks to trade in commodity derivatives and, subject to certain conditions, to make and take delivery of the underlying physical commodities.<sup>16</sup> For present purposes, however, the key takeaway is not the OCC’s questionable interpretation of the statutory language but rather the underlying premise: in order to be able to trade even commodity derivatives – financial instruments, not physical materials – U.S. banks needed an explicit regulatory permission. This is hardly the kind of legal system in which statements to the effect that “banks have always traded in commodities” or “commodities have always been treated the same as paper money” are even remotely true.<sup>17</sup> This is a legal system in which no bank could safely assume its “natural” historical or legal right to trade paper referencing commodity risk, let alone start drilling for oil or storing aluminum.

Not surprisingly, in the 1980s-1990s, the banking industry also began actively lobbying for relaxation of the BHCA limitations on BHCs’ activities, both financial and non-financial. Prior to 1999, the history of amendments to the BHCA largely reflected the familiar dynamics, where a statutory prohibition prompted the industry to arbitrage around it, which led to a new round of legislation to close specific loopholes, and so on. One classic example of such a loophole-closing amendment to the BHCA was the 1970 repeal of the “one-bank holding company” exemption that allowed companies controlling a single U.S. bank to avoid regulation as BHCs.

Congressional resolve to continuously enhance the statutory regime by preventing entity arbitrage proves that keeping banks out of non-financial businesses remained a strong federal policy priority. The Federal Reserve, an agency in charge of administering the BHCA, was especially cautious about BHCs’ moving into the physical commodities business. For instance, in 1997, despite industry lobbying, the Federal Reserve refused to add the acceptance and delivery of physical commodities under derivatives contracts to the regulatory list of BHC-permissible activities “closely related to banking.”<sup>18</sup>

The most significant set of amendments to the BHCA came in 1999, when Congress passed the Gramm-Leach-Bliley Act (the “GLBA”), a statute that partially repealed the Glass-Steagall Act. The GLBA amended the BHCA to allow certain BHCs qualifying for the status of “financial holding company” (“FHC”) to conduct broader activities that are “financial in nature,” including

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statutory exceptions underscores the supremacy of the main rule that banking and commerce are not to be mixed freely.

<sup>15</sup> Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the “Business of Banking”*, 63 MIAMI L. REV. 1041 (2009).

<sup>16</sup> Id.

<sup>17</sup> For examples of this type of claims, see Trade Associations’ Comment, *supra* note 4, Part II.

<sup>18</sup> The Federal Reserve, however, added these activities to its regulatory “laundry list” in 2003. For a more detailed discussion, see Omarova, *Merchants*, *supra* note 1, at 299-301.

securities dealing and insurance underwriting.<sup>19</sup> In addition, the GLBA created important new authorizations for FHCs to conduct certain *commercial* activities.

## **II. Why the Current Legal and Regulatory Framework for FHCs' Commodity Activities Is Inadequate: the Unforeseen Effects of the Gramm-Leach-Bliley Act**

Under the BHCA, as amended by the GLBA, there are currently three main sources of legal authority for FHCs (i.e., diversified financial groups that can control under one corporate roof commercial banks, securities firms, insurance firms, and other non-bank subsidiaries) to conduct *purely commercial* activities, despite the general separation of banking from commerce: (1) merchant banking authority; (2) “complementary” powers; and (3) “grandfathered” commodities activities. In order to engage, directly or through any subsidiary, in any non-financial, commercial activity – including producing, refining, storing, transporting, or distributing any physical commodity – an FHC has to “fit” that activity within the legal confines of at least one of these three statutory exceptions created by the GLBA. In that sense, the GLBA did not fundamentally alter the basic premise of the BHCA scheme. On the contrary, these new provisions have always been framed as merely opening some new “doors” in the wall separating banking from commerce, not demolishing the wall itself.<sup>20</sup>

The real question, however, is whether these three statutory exceptions to the general rule are being implemented in a cautious and prudent manner, so as to achieve their stated goals without causing unanticipated damage to the broader regulatory scheme of the BHCA. That is precisely the question that the financial industry advocates do *not* want us to ask. According to them, the formally stated statutory conditions on the exercise of each of these three authorities are, by themselves, *a sufficient safeguard and practical proof* that large U.S. FHCs – such as JPMorgan, Goldman Sachs, and Morgan Stanley, for example – are *actually* conducting their physical commodities businesses (whatever those might be) in a safe and sound manner, fully consistent with the interests of the American taxpaying public. In other words, the argument goes, because the statute *says* FHCs are not to take these new powers too far, their new powers are not – and cannot possibly be – taken too far in the *real world*.<sup>21</sup>

Despite its facially flawed nature, this type of claim is widespread and insidious enough to warrant a brief explanation why it is not an effective argument against the need to re-examine, in light of our collective experiences in the past fifteen years, the practical impact of the GLBA on the system of separation of banking from commerce. Three simple points should suffice:

First, *what the law says* and *what the banks do* (to comply with it *and* to evade it) are not the same thing: if they were, we would not need law enforcement or bank supervision.

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<sup>19</sup> 12 U.S.C. §1843(k)(1)(A).

<sup>20</sup> For a detailed description of the GLBA provisions governing FHCs’ physical commodity activities, see Omarova, *Merchants*, *supra* note 1, at 278-292.

<sup>21</sup> This is the distilled logical essence of numerous arguments and claims advanced repeatedly by various pro-industry actors. Again, the Trade Associations’ Comment represents the most convenient compilation of these and other arguments. See *supra* note 4. Of course, the well-paid and credentialled industry advocates are careful not to state their position in a way that would clearly expose its basic flaws. To the contrary, their claims are usually lengthy, repetitive, and exceedingly technical-sounding, with meticulous cites to specific sub-sections of the statute. Yet, they often merely restate various formal requirements of the statute and then make a logical leap to conclude that there are, in fact, strong practical limits to FHCs’ ability to build physical commodity empires.

Second, the wording and the legislative history of the GLBA provisions allowing FHCs to conduct commercial activities often create significant ambiguity with respect to the precise scope of what's allowed. And such ambiguities can be easily exploited to push the statutory exceptions farther than originally intended.

Third, the Federal Reserve exercises significant regulatory discretion in interpreting and implementing the GLBA provisions governing FHCs' physical commodities activities. Understanding how the statute translates into practice, therefore, necessarily involves conducting an inquiry into the Federal Reserve's decision-making process.

As I have noted in my previous writings on the matter, the shortage of detailed public information on large FHCs' physical commodities activities and on the Federal Reserve's internal policy-formulation processes makes it difficult for an outsider to make a full assessment of how effective or ineffective the GLBA framework is in today's world of financial super-intermediaries. Nevertheless, there are plenty of reasons to doubt that the current legal and regulatory regime effectively safeguards the traditional U.S. policy of separating banking from commerce. In other words, there is considerable doubt whether the three GLBA-created "doors" in the venerable wall between banking and commerce can protect that wall from being effectively demolished in practice.<sup>22</sup>

### Merchant Banking

Prior to 1999, a BHC was generally permitted to make passive private equity investments in any commercial company only if such investments did not exceed 5% of such company's voting securities.<sup>23</sup> In the 1990s, banks viewed this as a major competitive disadvantage that kept them from making potentially lucrative private equity investments in start-up Internet and high-tech companies. Section 4(k)(4)(H) of the BHCA, added by the GLBA, sought to remedy that situation by permitting FHCs to acquire or control, directly or indirectly, up to 100% of the ownership interest in any commercial entity under the "merchant banking" authority.

The statute does not define the term "merchant banking." In 2001, the Federal Reserve and the Department of Treasury jointly issued a rule (the "Merchant Banking Rule"), which defines "merchant banking" as a catch-all authorization for FHCs to invest in commercial enterprises, as long as any such investment meets several requirements.<sup>24</sup> Thus, the investment cannot be held through an FHC's bank-subsidiary and must be sold within 10-15 years after the acquisition (barring any special circumstances). The investment must be made "as part of a bona fide underwriting or merchant or investment banking activity" (i.e., it must be a financial investment for the purpose of appreciation and ultimate resale). Furthermore, an FHC cannot "routinely manage or operate" any portfolio company in which it has made the investment, except as may be necessary in order to obtain a reasonable return on investment upon resale.

These requirements were designed to ensure that FHCs use the merchant banking powers to facilitate their financial intermediation activities, as opposed to getting involved in the

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<sup>22</sup> The following discussion of the three specific sources of the FHCs' statutory authority to conduct physical commodity activities is based on Saule T. Omarova, *Beyond Finance: Permissible Commercial Activities of U.S. Financial Holding Companies*, in AN UNFINISHED MISSION: MAKING WALL STREET WORK FOR US, A REPORT BY AMERICANS FOR FINANCIAL REFORM & THE ROOSEVELT INSTITUTE, ED. BY MIKE KONCZAL & MARCUS STANLEY (2013), pp. 110-25.

<sup>23</sup> 12 U.S.C. § 1843(c)(6),(7).

<sup>24</sup> 12 C.F.R. § 225.170(a).

commercial businesses of companies in which they invest. Although an FHC is permitted to acquire full ownership of a commercial firm, the principal purpose of its investment must remain purely financial: making a profit upon subsequent resale or disposition of its ownership stake.

The real question is whether, in practice, FHCs comply with the rule's formal requirements while circumventing its intended purpose – that is, to what extent they are able to use merchant banking authority as a means of engaging in impermissible commercial activities. For instance, in general discussions of FHCs' merchant banking activities, the statutory prohibition on "routinely managing" portfolio companies is often understood as a requirement – and an effective assurance – of a purely passive "arm's length" relationship between an FHC and commercial entities it controls under that authority. Yet, this is not necessarily the case. The regulators interpreted the term "routinely managing" narrowly, leaving ample opportunities for FHCs to exercise decisive managerial control over their portfolio companies – and, in effect, to engage in such portfolio companies' non-financial business. Under the Merchant Banking Rule, the indicia of impermissible "routine management" of a portfolio company include certain kinds of "executive officer" interlocking and explicit contractual restrictions on the portfolio company's ability to make routine business decisions (e.g., hiring non-executive personnel or entering into transactions in the ordinary course of business).<sup>25</sup> Examples of permissible arrangements that do not constitute "routine management" include contractual agreements restricting the portfolio company's ability to take actions not in the ordinary course of business; providing financial, investment, and management consulting advice to, and underwriting securities of, the portfolio company; and meeting with the company's employees to monitor or advise them in connection with the portfolio company's performance or activities.<sup>26</sup> FHCs can also elect any or all of the directors of any portfolio company, as long as the board does not directly run the company's day-to-day operations. The last condition means merely that the portfolio company must employ officers and employees responsible for routinely managing and operating its affairs.<sup>27</sup>

Thus, unwrapping regulatory interpretation of the statutory language reveals that FHCs enjoy considerable flexibility in directing business affairs of portfolio companies in which they invest pursuant to merchant banking authority. In practice, it is not difficult to structure an FHC's relationship with any particular commercial entity in a way that avoids formal indicia of "routine management" but gives it effective control over important substantive aspects of that entity's business – for the sake of *actually engaging in that business* rather than simply *financing* it.

#### "Complementary" to Financial Activities

The GLBA also authorizes FHCs to conduct commercial activities determined by the Federal Reserve to be "complementary" to a financial activity. The Federal Reserve must determine that any such complementary activity does not "pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."<sup>28</sup> Once again, however, the statute does not define what "complementary" means.

Procedurally, the Federal Reserve makes these determinations on a case-by-case basis. Any FHC seeking to engage in any commercial activity it believes to be "complementary" to a financial

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<sup>25</sup> 12 C.F.R. § 225.171(b)(1).

<sup>26</sup> 12 C.F.R. § 225.171(d)(2),(3).

<sup>27</sup> 12 C.F.R. § 225.171(d)(1).

<sup>28</sup> 12 U.S.C. § 1843(k)(1).

activity must apply for the Federal Reserve's prior approval and provide detailed information about the proposed activity. In making its determination, the Federal Reserve is required to make a specific finding that the proposed activity would produce public benefits that outweigh its potential adverse effects. The statutory list of such public benefits includes "greater convenience, increased competition, or gains in efficiency."<sup>29</sup> The Federal Reserve must balance these benefits against such dangers as "undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the United States banking or financial system."<sup>30</sup> This list of potential dangers directly channels the policy concerns underlying the principle of separation of banking from commerce, which indicates Congress's intention to limit FHCs' potential expansion into commercial sphere. Yet, the statutory language leaves too many opportunities for interpreting "public benefits" too broadly and potential risks too narrowly.

The legislative history of this provision shows that the industry deliberately sought the inclusion of the "complementary" clause as an open-ended source of legal authority for banking organizations to engage in any commercial activities that may become feasible or profitable in the future. Again, banks' real goal was to be able to invest in internet and high-tech companies. Yet, the industry framed the congressional debate on "complementary" activities as a debate primarily about low-risk, low-profile activities, such as publishing travel magazines and using back-office over-capacity to offer telephone help lines.<sup>31</sup>

After 1999, the banking industry found other, less innocuous-looking uses for this "complementary" power, such as physical commodity and energy trading.<sup>32</sup> Beginning in 2003, the Federal Reserve issued several orders allowing Citigroup, JPMorgan, Bank of America, and other FHCs to trade in a wide range of physical commodities as an activity "complementary" to their commodity *derivatives* businesses. In making its determinations, the Federal Reserve routinely equated the "public benefits" of proposed activities with the primarily *private* benefits to individual FHCs: their enhanced competitiveness and profitability.<sup>33</sup> With respect to potential adverse effects, the orders typically briefly noted the absence of any "substantial risks" to the safety and soundness of the FHC or the U.S. financial system.

The main safety-and-soundness limitation the Federal Reserve imposed on these activities was the prohibition on FHC ownership or operation of facilities for the extraction, storage, processing, or transportation of physical commodities. In response, FHCs developed ways to obtain effective operational control of power plants and oil refineries through contractual arrangements. And when, in the wake of the recent crisis, three large FHCs – Goldman Sachs, Morgan Stanley, and JPMorgan – emerged as major commodity merchants and owners of oil

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<sup>29</sup> 12 U.S.C. § 1843(j)(2)(A).

<sup>30</sup> *Id.*

<sup>31</sup> For an in-depth discussion of the legislative history of the GLBA provisions granting FHCs authority to conduct physical commodities activities, see Omarova, *Merchants*, *supra* note 1 , at 278-292.

<sup>32</sup> Between 2003 to 2013, the Federal Reserve approved only one other type of activity – certain disease management and mail-order pharmacy services – as complementary to a financial activity of underwriting and selling health insurance. Wellpoint, Inc., 93 Fed. Res. Bull. C133 (2007).

<sup>33</sup> See, e.g., Citigroup, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 89 Fed. Res. Bull. 508 (2003).

pipelines and metals warehouses, the Federal Reserve’s original line-drawing began to seem even less relevant in practice.<sup>34</sup>

More generally, this selective expansion of large FHCs into commodities and energy – vitally important and volatile sectors of the economy, inherently vulnerable to market manipulation and speculative bubbles – raises fundamental questions as to whether the vague regulatory concept of “complementarity” imposes meaningful limits on banking organizations’ commercial activities. Ultimately, any economic activity can be viewed as “complementary” to finance, simply by virtue of the universality of finance itself. How do we know where to stop?

#### “Grandfathered” Commodity Activities

The third source of authority for FHCs to enter commerce is Section 4(o) of the BHCA, which authorizes any company that becomes an FHC after November 12, 1999, to continue “activities related to the trading, sale, or investment in commodities and underlying physical properties,” if that company “lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States.”<sup>35</sup>

On its face, Section 4(o) seems to allow a qualifying FHC to conduct virtually any kind of commodity trading and any related commercial activities (for example, owning and operating oil terminals and metals warehouses), if it happened to conduct any commodities business – even if on a very limited basis and/or involving different kinds of commodities – prior to the 1997 cut-off date. Potentially, so broadly stated an exemption may open the door for large financial institutions to conduct sizeable commercial activities of a kind typically not allowed for banking organizations.

The statute requires that the FHC’s aggregate consolidated assets attributable to commodities or commodity-related activities, *not otherwise permitted to be held by an FHC*, not exceed 5% of the FHC’s total consolidated assets (or such higher percentage threshold as the Federal Reserve may authorize).<sup>36</sup> Although this statutory 5% limit on the FHC’s total consolidated assets attributable to grandfathered commodities activities seems to operate as a built-in brake on a new FHC’s purely commercial activities in various markets for physical commodities, its practical significance is subject to considerable doubt. In absolute terms, even such a small fraction of total consolidated assets of a large FHC (with a trillion-dollar balance sheet) may allow for a considerable expansion of its commercial business of owning, producing, transporting, processing, and trading physical commodities. Perhaps even more importantly, the language of the provision may be read as capping only those physical commodity assets for which a qualifying FHC cannot find an alternative authorization, either under its merchant banking or “complementary” powers. In that sense, such grandfathered commodity operations may be viewed by the interested FHCs as a generous extra “add-on” to various (capped or uncapped) physical commodity operations “otherwise permitted” to them under the GLBA regime.

Generally, this kind of extreme open-endedness of the statutory language creates a fundamental ambiguity and raises a critical question: Does a mechanically permissive reading of the plain words of the statute properly reflect the original legislative intent? Does the word “continue,” for instance, refer only to a temporal factor (“proceed without interruption”) or does it also

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<sup>34</sup> For a detailed discussion, see Omarova, *Merchants*, *supra* note 1, at 299-332.

<sup>35</sup> 12 U.S.C. § 1843(o)(1).

<sup>36</sup> 12 U.S.C. § 1843(o)(2).

implicitly limit the scope of the activities to be grandfathered (“only activities *already under way* before the cut-off date would be allowed to *continue* without interruption”)?

I have discussed at length the curious legislative history of Section 4(o) in my prior writings.<sup>37</sup> For present purposes, suffice it to say that the legislative history provides no support for the financial industry advocates’ claims that Congress in 1999 deliberately sought to allow firms like Goldman Sachs and Morgan Stanley to gain full access to the public subsidy available to banking organizations and, with the federal government’s explicit backing, to start accumulating control over oil, gas, electricity, copper, aluminum, grain, or any other commodity market they might view as offering profitable opportunities at any future time. In fact, former Representative Jim Leach was recently quoted as saying, “I assume no one at the time would have thought it would apply to commodities brokering of a nature that has recently been reported.”<sup>38</sup>

Normally, ambiguous statutory provisions are interpreted by the regulatory agency in charge of administering the relevant statute. Unfortunately, the Federal Reserve has never interpreted the commodity grandfathering clause of the GLBA. The clause remained largely unnoticed until Morgan Stanley and Goldman Sachs, which became FHCs in September 2008, claimed it as the legal basis for keeping and aggressively expanding their vast operations in physical commodities and energy markets. Yet, even in the face of this radical shift in the scale and scope of mixing banking with commodities business, the Federal Reserve refrained from exercising its power to resolve the ambiguities in the “grandfather” clause.<sup>39</sup> Not surprisingly, the controversy over this issue added a particular sense of urgency to the recently reignited public debate on the proper limits of banking institutions’ non-financial activities – and the dangers of failing to police these limits in practice.

### **III. Why FHCs’ Physical Commodity Activities Raise Potentially Serious Public Policy Concerns: The Stakes in the Debate**

Despite the financial industry advocates’ attempts to deny or diminish the game-changing nature of the GLBA with regard to mixing banking with physical commodities trade, the fact remains that U.S. banking conglomerates began aggressively expanding the scope and scale of their direct involvement in commodities markets in the early 2000s. The ready availability of new sources of legal authority to conduct commodities operations was especially convenient at that time, given the beginning of a major global commodities “super-cycle” and the market void left by the failure of Enron, the company that created a lucrative new business model combining large-scale physical energy trading with dealing in related derivatives. The story of large U.S. FHCs’ transformation into global commodity merchants of the Enron variety is, by now, well-

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<sup>37</sup> See Omarova, *Merchants*, *supra* note 1 , at 289-292.

<sup>38</sup> Matt Taibbi, *The Vampire Squid Strikes Again: The Mega Banks’ Most Devious Scam Yet*, ROLLING STONE, Feb. 12, 2014.

<sup>39</sup> Section 5(b) of the BHCA grants the Federal Reserve broad authority to issue orders and regulations necessary to administer the statutory scheme and to prevent evasions thereof. 12 U.S.C. § 1844(b). Interpreting an ambiguous statutory provision, especially where the ambiguity directly implicates the fundamental purposes of the BHCA, falls within this grant of regulatory authority.

known.<sup>40</sup> It is, however, important to reiterate why this trend raises significant potential public policy concerns.

### Safety and Soundness

One of the traditional policy reasons for separating banking from general commerce is the need to protect banks – private institutions performing critical public functions – from exposing their inherently vulnerable balance sheets to novel and potentially excessive risks associated with various commercial businesses. The creation of the federal deposit insurance scheme in the early 1930s further elevated the importance of keeping banking institutions from incurring additional risks, often of the kind not present in or necessary to their traditional activities. Running brick-and-mortar enterprises in the physical commodity supply chain introduces a broad variety of such additional risks exogenous to the business of banking. Catastrophic risks related to environmental accidents or terrorist attacks are the clearest examples of the potentially extreme risks that banking organizations face when they operate oil pipelines or nuclear power plants. Even the day-to-day operational, market, reputational, and legal risks associated with these activities may be both significant and unjustified.

The mere fact that banks routinely take on considerable risk (at least, in theory) when they extend 30-year mortgage loans – their traditional business activity – does not mean they should also be taking on a nearly infinite variety of unrelated or unnecessary risk exposures. Any potentially beneficial diversification effects of FHCs’ physical commodity activities must be carefully and precisely assessed in light of such additional exposures and their impact on the institution’s overall risk profile.

### Systemic Risk

To the extent that large FHCs are already systemically important in their role as complex and inter-connected financial intermediaries, any potential increase in their individual risk exposure and profile raises significant concern about systemic financial (and broader economic) stability. In the aftermath of a major global financial crisis, this truth is self-evident. And the more tightly today’s complex and unstable financial markets are linked with the equally complex and unstable markets for vital physical commodities, the more salient these systemic-risk concerns become.

### Market Integrity and Consumer Protection

Another traditional policy goal behind keeping banks out of commerce is preventing banks from abusing their financial power to distort competition or manipulate prices for real goods. This concern is especially strong where large FHCs act simultaneously as major global dealers in commodity derivatives and as merchants in the underlying physical commodities. An FHC’s ability to affect the price of an underlying commodity – even if only for a short period of time or in a particular market – may generate windfall profits in the same FHC’s commodity derivatives business. This structural conflict of interest is especially worrisome both because such manipulative behavior may be difficult to detect or prosecute and because its ultimate costs are usually borne by ordinary Americans.

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<sup>40</sup> See, generally, Omarova, *Merchants*, *supra* note 1.

### Leakage of Public Subsidy

Another important issue raised whenever publicly-subsidized banking institutions start competing with unsubsidized commodity merchants is whether, and to what extent, access to the public subsidy gives the former an unfair advantage over the latter. Lower costs of funding, which banks and their affiliates enjoy because of the explicit and implicit public backing of their private liabilities, may be the main reason why they can supply their individual clients with cheaper raw materials and related services. To protect American taxpayers' interests, it is critical to ascertain that banking institutions do not, in fact, misuse the public subsidy in this manner. So far, however, the financial industry failed to produce any evidence to that effect.

### Institutional Governability

Large FHCs that are active in physical commodities markets are all extremely complex organizations that conduct a wide range of financial activities through hundreds (and even thousands) of subsidiaries all around the globe. The latest financial crisis and a series of scandalous post-crisis revelations of misconduct and failure of risk-management at all of these institutions demonstrate how difficult – perhaps, even impossible – it is for them to keep track even of their core financial activities. Dealing with numerous additional risk-management and regulatory-compliance issues involved in running physical commodity businesses is likely to make matters far worse. Neither financial firms' public professions of success in managing and controlling all of their own (and all of their clients') risks, nor their voluminous "written policies and procedures," without more, provide sufficient comfort in this respect.

### Regulatory capacity

Allowing banking organizations to conduct extensive and varied physical commodity activities also creates potentially insurmountable challenges from the perspective of FHC regulation and supervision. The current system of financial services oversight is already notoriously fragmented and complex, with many opportunities for socially harmful regulatory arbitrage. Introducing multiple non-financial regulatory agencies into the mix is likely to exacerbate jurisdictional conflicts, confusion, and inconsistencies in the application of different regulatory schemes. Moreover, neither the Federal Reserve nor any other financial regulator are properly equipped to exercise effective oversight of companies that operate oil pipelines and coal mines. Stretching their administrative and intellectual resources beyond reasonable boundaries serves no discernable public purpose.

### Excessive Concentration of Economic and Political Power

Recent expansion of large U.S. financial conglomerates into direct production, processing, transporting, storing, and marketing physical commodities raises significant concerns related to the broader political-economy impact of this trend. It's been a venerable American tradition to view large aggregations of economic and financial power in the hands of a few "money trusts" with great suspicion and fear of this power translating into undue political influence. When the financial industry advocates dismiss these concerns as entirely frivolous, they are, in effect, dismissing one of the core values of American democracy: an active rejection of monopolistic power, in all of its incarnations.

#### **IV. Why the Most Common Arguments Against Limiting FHCs' Physical Commodity Activities Are Ineffective: Dangerous Pitfalls in the Debate**

Since July 2013, large financial institutions seeking to preserve their ability to conduct physical commodity operations appear to have mobilized the industry's significant resources to preempt potential regulatory or legislative action in this area. I cannot speak to the nature of these groups' non-public communications with policymakers and will limit my observations to their public statements.

Individual FHCs, financial industry trade associations, law firms representing large financial institutions, and FHCs' end-user clients submitted scores of comment letters defending the status quo in response to the Federal Reserve's Advanced Notice of Proposed Rulemaking ("ANPR") published on January 21, 2014. These letters, together with the industry-commissioned private reports and media statements, generally advance three types of arguments as to why Congress, the Federal Reserve, and the American public should not pursue stricter regulation or curtailment of FHCs' commodities activities. For the sake of simplicity, I refer to these three common themes as "pro-industry arguments."

*Pro-industry argument no. 1: "There is no empirical evidence that FHCs' physical commodities activities have already caused, or will definitely cause, a serious problem in financial markets, so there is no need to worry"*

One such common thread in the financial industry advocacy is to deny the existence and/or significance of any reasons for being concerned about FHCs' expansion into physical commodities. Some versions of this general argument, for example, hold that physical commodities businesses do not involve any unusually high or principally new risks, as compared to the typical risks associated with the business of banking. Industry advocates often demand an "empirical proof" that FHCs' physical commodities activities have actually caused a systemic failure and stress that, to date, no FHC has incurred an actual loss from a catastrophic accident, such as a major oil spill or a nuclear plant explosion. Other versions of this general argument stress that whatever risks there may be, all of them are successfully managed, controlled, and insured by the FHCs.

All of these variations on the theme suffer from the same fundamental logical flaw: their stated premises do not lead to their desired conclusions. Just because an oil spill has not happened yet does not mean it will never happen. Just because no bank has yet been publicly found as manipulating oil prices does not mean such manipulation is not going on undetected. In this connection, one might recall how, prior to September 2008, many financial industry experts argued that credit derivatives or synthetic CDOs, for example, were perfectly safe and well-managed for any significant risks. After all, until September 2008, there was no hard "empirical evidence" that either of those financial instruments could actually cause systemic instability. The latest crisis provided that evidence.

This argument implicates the fundamental issue of who should bear the burden of proof here. Contrary to the industry's claims, that burden should be placed on the FHCs and their advocates. Without specific and substantive evidence of how individual financial institutions and the industry as a whole assess, monitor, and manage the full gamut of risks posed by their physical commodity operations (and not only, e.g., the risk of having their corporate veils "pierced" in

court proceedings), the industry’s assertions of having everything under control are of little value.

*Pro-industry argument no. 2: “FHCs’ physical commodities trading provides indispensable benefits to commodity end-users, so any attempt to push them out will hurt the economy”*

The second line of the industry’s defense is that FHCs are necessary participants in physical commodity markets because they are uniquely suited to provide liquidity and other benefits to end-users. Therefore, if banking institutions are forced to exit physical commodity markets, numerous commercial end-users will potentially face higher cost of doing business.

This argument fails to address the crucial question at hand: Why exactly are large FHCs able to provide such uniquely “efficient” (essentially, cheaper) intermediation services in physical commodities markets? Undoubtedly, FHCs’ individual clients often benefit from FHCs’ commodity trading. However, what might be “efficient” (i.e., relatively cheap and more convenient) for the individual parties in a transaction might not be *socially efficient*, if a significant reason for such micro-efficiency is the existence of implicit *public subsidies* to large financial institutions. We need to understand and evaluate this critical link before concluding that FHCs are, in fact, the most *efficient* – rather than simply *publicly-subsidized* – providers of liquidity in physical commodity markets. Purely declaratory and generalized assertions of private benefits accruing to individual end-users are neither responsive nor relevant to this inquiry. This argument, in any of its variations, can be relevant only if its advocates provide specific proof that the source of FHCs’ superior ability to provide commodities intermediation services is entirely independent of their access to any form of public subsidy.

Recently, newspapers have reported that “small-town officials from Alabama, Louisiana, North Carolina and other states” have been lobbying policymakers not to restrict FHCs’ activities in physical commodity markets claiming that any such restrictions could inhibit their local utilities’ ability to hedge exposure to fluctuations in fuel prices – which could result in higher local prices for natural gas.<sup>41</sup> This is, of course, the same familiar type of a pro-industry argument discussed immediately above, except with a politically more appealing “small-town,” “Main Street” face. In this particular instance, however, there are at least two additional reasons to think that these claims overstate the industry’s case.

First, even if FHCs are restricted in their ability to make physical fuel deliveries to municipal utilities, those utilities will still be able to continue hedging their commodity price risks by entering into *financial contracts (derivatives)* with banks – an activity traditionally provided by banks and other financial (and, increasingly, commercial) intermediaries. Banking institutions always tout their superior ability to create innovative, individually-tailored derivatives instruments that enable commercial clients, such as municipal utilities, to transfer the financial risks of their commercial operations. It is not a proven fact that banks’ ability to supply physical natural gas to individual utilities is an indispensable condition to such financial risk transfer.

Second, getting all of the municipalities’ natural-gas supplies and related risk-management services from one big-bank player may very well generate cost-savings in the short run – after all,

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<sup>41</sup> See Deborah Solomon and Ryan Tracy, *Small Towns Go to Bat for Wall Street Banks*, THE WALL STREET JOURNAL, Nov. 17, 2014.

that's why super-market shopping is (sometimes) better than buying produce at multiple specialty shops. However, by putting all of the municipality's proverbial eggs – physical and financial – in one basket may not be prudent in the longer run because (1) it concentrates the municipality's risk, and (2) potentially exposes the municipality to the complex array of hidden financial-market risks of the kind and magnitude not typically present in its daily activities. What will happen, for example, if Goldman Sachs or JPMorgan suddenly runs into serious trouble in its purely financial business and, as a result, is not able to supply gas to the utility that depends on it? The possibility of something going wrong in the world of complex global finance is a very realistic one, and no municipal utility can ignore the cost of living with that risk, especially if financial institutions don't get a government bailout next time around. Even in the absence of a financial-crisis scenario, what would prevent Goldman Sachs or JPMorgan, for example, from raising the cost to municipalities of their "integrated services" if they decide to do so in the future? In other words, while municipal utilities may be benefiting from FHCs' physical commodities activities in some important ways, these benefits must be examined in the broader context of all these other potentially important factors.

*Pro-industry argument no. 3: "Unregulated and less transparent entities could take FHCs' place in commodities markets, which would make these markets less safe"*

The third line of the pro-industry argumentation is that banning banking institutions from physical commodities will backfire by leaving global commodity markets to less transparent, unregulated entities. Several commodity end-users' comments on the Federal Reserve's ANPR, for example, expressed their concern about having to deal with less creditworthy, less transparent, and mostly unregulated non-bank commodity trading companies or trading arms of large commodity producers.

This argument confuses two separate issues: (1) the need for greater transparency and regulatory oversight of physical commodity markets, and (2) the desirability of allowing U.S. FHCs to participate in such markets. Proponents of this argument erroneously equate FHCs' unique regulatory status as *financial institutions* with the regulatory status – or overall health - of *physical commodity markets* in general. In reality, however, there is no logical connection between these two phenomena. U.S. banks and bank holding companies are heavily regulated and supervised under a system designed explicitly to address the risks of their financial activities. In fact, one of the principal tools for ensuring these institutions' safety and soundness is an imposition of severe restrictions on their non-financial activities. It is deeply ironic that this heavily restrictive regulation, designed fundamentally to keep banking organizations out of general commerce, is now being cited as a principal reason for allowing FHCs to function as global commodity merchants.

Because U.S. bank regulation is not designed specifically to address the risks associated with large-scale commodity merchanting, FHCs' participation in physical commodities markets cannot cure such markets' internal dysfunctions. In their capacity as physical commodity traders, FHCs are not necessarily more transparent or more effectively supervised than non-bank commodity trading houses. The fact that global commodity markets are opaque and dysfunctional is not an argument for allowing FHCs to participate in those markets but instead is an argument for bringing greater transparency and oversight to commodity markets.

## V. Looking Ahead: Potential Avenues for Reform

Devising a comprehensive legal framework for regulating FHCs' activities in physical commodities markets is an ambitious and complex task. My far more modest goal in this submission is to highlight – on a broadly *conceptual level* rather than in specific detail – some of the potential options for addressing the key public policy concerns identified above.

As a general matter, various prescriptions for strengthening the regulatory regime governing FHCs' involvement in physical commodity markets may be viewed as specific points along a single continuum, from more radical (banning all such activities) to less radical (further restricting and dis-incentivizing such activities). In addition, some proposed measures require legislative amendments to the BHCA, while others can be accomplished through regulatory action alone.

The following brief list of potentially desirable legal and regulatory changes is not exhaustive but merely suggestive.

### Repeal of certain statutory provisions

Two potential legislative measures merit serious consideration by Congress: (1) repealing the commodity grandfathering clause (Section 4(o) of the BHCA), and (2) repealing the statutory grant of merchant banking powers to FHCs.

The commodities grandfathering provision, added by the GLBA, is too open-ended and, in any event, doesn't seem to serve any appreciable policy purpose at this point.

There is also a potentially strong argument for repealing the statutory authorization of FHCs' merchant banking activities. The banking industry originally sought the inclusion of this authority in the GLBA to enable it to invest in Silicon Valley start-ups. Today, long after the dotcom boom ended in bust, FHCs can use this provision to conduct commercial activities that go far beyond the vague statutory concept of "bona fide merchant banking." Given the practical difficulty of ensuring compliance with the spirit and purpose of this provision, it would make sense to reassess whether the real public benefits of allowing banking organizations to act as private equity funds outweigh potential risks such activities pose from the public policy perspective. U.S. capital markets may be perfectly capable of providing commercial companies with private capital from unsubsidized sources (venture capital funds, hedge funds, even crowdfunding), and FHCs will continue to play a critical intermediation role in this process, even if they would not be able to make direct "merchant banking" investments any more.

If these statutory provisions are not repealed, the Federal Reserve should limit the dangerously permissive potential of both of these sources of FHCs' authority to conduct physical commodity activities through regulatory action. The Federal Reserve should issue an official interpretation of Section 4(o) of the BHCA that clarifies and establishes meaningful limits on any newly-registered FHCs' properly grandfathered commodity activities, in line with the original legislative intent. Similarly, the Federal Reserve should amend its Merchant Banking Rule to tighten the restrictions on FHCs' ability to use their portfolio companies as vehicles for conducting physical commodities activities.

### Size limits and capital requirements

More generally, the Federal Reserve has significant powers to strengthen the regulatory regime governing FHCs' physical commodity operations through agency action. The Federal Reserve announced its ongoing review of the regulatory policy in this area back in July 2013 and, in January 2014, published the ANPR (referred to above) soliciting public comments on a variety of issues. As of this writing, there has been no formal action by the Federal Reserve.

Nevertheless, it's generally expected that, if the Federal Reserve does adopt a formal rule, it is likely to address primarily the FHC safety and soundness concerns and to focus on (1) establishing more restrictive quantitative size limits of FHC-permissible physical commodity assets (e.g., by limiting the value of such assets to a lower percentage of some capital measure), and/or (2) imposing higher regulatory capital requirements on FHCs' physical commodity activities.

If adopted, both of these measures would be a welcome potential improvement to the current regime. However, such partial measures should be viewed with caution. The Federal Reserve should not focus its efforts solely, or even mainly, on the FHC safety and soundness: such micro-focus is inappropriate in today's regulatory environment. As elaborated above, the purposes of the BHCA are inherently antitrust and anti-monopoly oriented and explicitly channel the long-standing public policy concerns behind the traditional U.S. principle of separating banking from commerce. Any regulatory action implementing the statute must take into account these purposes as well and seek to address the full range of potential concerns with market integrity, consumer protection, prevention of excessive concentration of economic and financial power, and so forth.

It is also important to keep in mind that excessive reliance by regulators on quantitative measures, including percentage limits and minimum capital thresholds, often enables financial institutions to play sophisticated arbitrage games and to minimize the intended impact of such rules on their business practices. Therefore, how effective any particular size-limit or regulatory-capital measure is likely to be in practice depends greatly on how punitive and firm (or, conversely, how generous and pliable) each regulatory limit is. Given the sheer size of the large FHCs' balance sheets, the regulator should set the quantitative size limits much lower than the current "5%" of assets or capital. Regulatory quantitative limits should not be inconsistent or easy to manipulate; they should be transparent and non-additive (so that different size limits cannot be combined to raise the actual threshold above the official number). It would make sense, in this respect, to impose an overall cumulative size limit on all of the relevant FHC's permissible physical commodities activities.

Putting a tough rule on paper, however, is only the first step in the process. Ultimately, the practical impact of any quantitative or capital-based regulatory limitations on FHCs' commodity activities will depend on the Federal Reserve's ability and willingness to supervise and monitor FHCs' compliance with the rules.

### Redefining supervisory objectives

It is critical that the Federal Reserve (1) collects more granular quantitative and qualitative data on each FHC's commodity activities, and (2) monitors each FHC's compliance with the statutory and regulatory requirements much more closely. The agency's principal supervisory goal should

be to understand and evaluate not only each FHC’s full commodity-activity profile but also the overall pattern and potential effects (internal and external) of combining its physical and financial commodity operations.

In evaluating compliance, Federal Reserve examiners must not rely on review of FHCs’ corporate documents and formal “policies and procedures.” For instance, with respect to commodity assets held under the merchant banking authority, examiners should scrutinize the *actual relationships* between each FHC and its portfolio companies, in order to ensure that the FHC’s merchant banking portfolio contains only genuinely *financial-in-nature* investments. The examiners’ task would be to monitor the relationship between an FHC and each of its merchant banking portfolio companies for the indicia of de facto operational influence that potentially cross the line between *financing* commodity business and *engaging* in commodity business.

#### Portfolio-level reporting

To this end, the Federal Reserve could require that each commercial company controlled by an FHC pursuant to merchant banking authority regularly provide quantitative and qualitative information detailing all of its business dealings with the FHC or its clients (e.g., percentage of the company’s revenues generated from such dealings, lists of business contracts with the FHC or its clients, specific information on FHC’s participation in the management and business decisions of the company, etc.). To ease the administrative burden, this portfolio-level reporting requirement may be applied specifically and solely to portfolio companies engaged in physical commodity businesses.

The same type of reporting may be mandated with respect to FHCs’ subsidiaries engaged in “complementary” activities in physical commodity markets. While the specific purpose of supervisory scrutiny in this context is somewhat different than in the case of FHCs’ merchant banking portfolio, the overall goal is fundamentally similar: to ascertain the extent to which an FHC’s “complementary” physical commodity activities indicate any potentially troubling (micro- or macro-) trends.

#### Additional procedural safeguards

The existing scheme for “complementary” activities can be further strengthened by imposing additional procedural requirements on the Federal Reserve’s decision-making. For example, the BHCA can be amended to require the Federal Reserve to provide a more detailed substantive justification of its determination that the *public* benefits (which are not to be equated with profitability and competitive gains of FHCs) of allowing a particular FHC to engage in a specific complementary commodity-related activity outweigh *all* of the potential adverse effects specified in the statute (and not only those directly related to individual institutions’ safety and soundness). Putting these implicit requirements directly into the words of the statute would make it more likely that the Federal Reserve fulfills its responsibilities as the guardian of the public interest.

It is also desirable to mandate periodic regulatory reviews and re-authorizations of each order granting individual FHCs’ requests to conduct physical commodity activities “complementary” to finance. In effect, this requirement would create an automatic “sunset” period (e.g., every 5 or even 3 years) for “complementary” power grants, which would force the Federal Reserve to reconsider its decisions in light of new information. Again, in issuing re-authorization orders, the

Federal Reserve should be required to lay out in full the substantive reasoning behind its decision.

#### Targeted review of potential misuse of market information

Finally, the Federal Reserve should conduct a targeted review and analysis of FHCs' physical commodity operations, in order to evaluate whether FHCs improperly use their resulting informational advantages and cross-market presence. This is a problem with combining physical and financial commodity-related activities in general. Conceptually, however, this issue is particularly pronounced in the context of "complementary" power grants.

On the one hand, the primary justification for the "complementarity" between commodity merchanting and commodity derivatives businesses is the need for FHCs to access valuable proprietary information with respect to the pricing of physical commodities underlying their derivatives transactions. On the other hand, that same informational synergy creates a unique opportunity for an FHC to use its physical commodity operations to manipulate pricing and artificially boost profitability of its commodity derivatives trades. It gives large FHCs both the capacity and the incentives to engage in sophisticated market manipulation that may be difficult to detect under the existing regulatory schemes.

Financial institutions claim that they maintain impenetrable internal informational walls separating their physical traders from their derivatives traders. Leaving aside the question of such claims' veracity, it is obviously problematic when the same institutions that advocate seamless informational flow between physical and derivatives trading while petitioning for regulatory approval of their "complementary" commodity trading deny the very existence of such informational flows when questioned about the integrity of their market conduct.

It is critical, therefore, that we have a full understanding of how this tension is resolved in practice. 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. If the former is true, the Federal Reserve simply should not permit FHCs to conduct physical commodity activities as "complementary" to their financial activities. If the latter is true, the agency should both (1) seriously reconsider and toughen its existing policy of granting FHCs' requests for "complementary" powers, and (2) institute a much stricter and more intrusive system of regulatory and supervisory controls over FHCs' market conduct on both sides of the informational divide.

## **VI. Conclusion**

Large U.S. banking organizations' direct involvement in physical commodity markets raises a wide range of important and often difficult public policy issues. Some of these issues have traditionally been addressed through the regime of legal separation between banking and commerce, while others reflect relatively new concerns with the transmission and amplification of systemic risk and managing complexity in today's markets. I hope this written submission helps to clarify what is really at stake in this debate and to keep the focus on what really matters – the long-term interests of the American public.