United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510–6250

April 16, 2014

FILED VIA EMAIL (regs.comments@federalreserve.gov)

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

**RE: Advanced Notice of Proposed Rulemaking**
**Related to Physical Commodities**
**Docket No. 1479 and RIN 7100 AE-10**

Dear Mr. deV. Frierson:

The purpose of this letter is to respond to the request for comment by the Board of Governors of the Federal Reserve System ("Board" or "Federal Reserve"),[1] and offer strong support for issuing a proposed rulemaking with new restrictions on physical commodity activities conducted by financial holding companies to ensure those activities are conducted in a safe and sound manner and in accordance with law.

The advanced notice of proposed rulemaking requests comment on numerous issues. This letter addresses the following. It advocates using a proposed rulemaking to:

(1) **Complementary Activities:** tighten approval of complementary activities by requiring financial holding companies to demonstrate how a proposed physical commodity activity would be directly linked to and support the settlement of other financial transactions conducted by the company;

(2) **Denial of Unduly Risky Activities:** clarify that the Federal Reserve will act with caution when reviewing applications and deny approval of unduly risky activities;

(3) **Public Benefit and Adverse Effects Analysis:** reinvigorate the public benefits and adverse effects analysis that the statute requires the Federal Reserve to apply when reviewing applications under the complementary powers provision;

(4) **Prudential Safeguards:** strengthen prudential safeguards for all physical commodity activities, whether under the complementary, merchant banking, or

[1] "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities," Docket No. R-1479, RIN 7100 AE-10 (hereinafter "Federal Reserve Notice").

grandfather authority, to prevent undue risks and unsafe or unsound practices, including by:

(a) **Single Integrated Limit:** developing a single, integrated limit on the dollar value of physical commodity holdings that may be maintained by a financial holding company at one time, no matter what authority was used to acquire the holdings or what type of subsidiary -- bank or nonbank – holds them;

(b) **Allowable Commodities:** 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 Commodity Futures Trading Commission for trading on an exchange;

(c) **Extraction, Transportation, Storage, Distribution and Refining Limits:** strengthening the existing limit against financial holding companies 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 financial holding companies from circumventing that limitation through indirect arrangements; and

(d) **Capital and Insurance Requirements:** imposing additional capital and insurance requirements on financial holding companies engaged in physical commodity activities that may experience a catastrophic event;

(5) **Merchant Banking:** 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; and

(6) **Grandfather Clause:** reduce physical commodity activities conducted under the grandfather clause by clarifying that it authorizes only activities that were lawfully underway prior to a key date in 1997, and were still underway when the affected institution became a financial holding company, and by applying additional reporting requirements to facilitate regulatory oversight.

## A. Need for Proposed Rulemaking

The U.S. Senate Permanent Subcommittee on Investigations, which I chair, and the U.S. Senate Banking Subcommittee on Financial Institutions and Consumer Protection, chaired by Senator Sherrod Brown, have been examining financial holding company involvement with physical commodities. Those activities were also the topic of Banking Subcommittee hearings in 2013 and 2014. The evidence indicates that, since enactment of the Gramm-Leach-Bliley Act of 1999, which explicitly authorized financial holding companies to engage in a range of commercial activities, a dozen or so major financial holding companies have taken ownership interests in, or entered into arrangements allowing them to exert substantial control over, a variety of businesses handling physical commodities. While a few of those financial holding companies are currently reducing their physical commodity activities, others are planning to increase them. Today, a small group of large financial holding companies has become a major factor in U.S. commodities markets, not only by dominating commodities trading on financial markets, but also by owning or exercising control over businesses that produce, store, transport, refine, supply, and utilize physical commodities, including electrical power plants, oil storage facilities, mining operations, natural gas pipelines, commodity warehouses, and commodity shipping operations.

Those physical commodity activities raise a variety of safety and soundness concerns that, in many ways, are novel to the U.S. banking industry since, prior to the Gramm-Leach-Bliley Act, banks were discouraged from mixing banking and commerce. One of the key issues raised by the Federal Reserve Notice involves the risks associated with a commodity business that experiences a low probability, but high cost catastrophic event. Citing past industrial occurrences of massive oil spills, railway crashes, nuclear power plant meltdowns, and natural gas explosions, the Notice describes how a single catastrophic event could shake public confidence in a major financial institution associated with the catastrophe. Depositors might react to such an event by pulling deposits from the affected bank; creditors might decline to renew lines of credit; counterparties might decline to enter into or demand exit from derivative trades or other transactions; financial institutions might decline to offer financing or impose more expensive terms; or stockholders might sell shares and depress the company's share price, all of which could trigger a range of financial difficulties. The contagion could also spread beyond the financial holding company to its banking and non-banking commercial enterprises, its business partners, and other financial institutions. If the financial holding company were large enough and the catastrophe severe enough, it could even affect the U.S. financial system.

The Federal Reserve Notice observes that a financial holding company associated with a business that experiences a catastrophic event may have difficulty escaping liability, even with no direct ownership stake in the business and may incur large, unanticipated expenses. The Notice explains, for example, that financial holding companies risk a finding of liability under the Oil Pollution Act, Clean Water Act, and Comprehensive Environmental Response, Compensation, and Liability Act, if found to own or operate a facility involved with an operational or environmental disaster. The Notice also explains that the levels of capital and insurance currently held by financial holding companies are likely inadequate to pay the costs of a catastrophic event, and that corporate structures designed to deflect legal liability for such costs may be insufficient under the law. The Notice also points out that the more safeguards a financial holding company imposes to mitigate risk, such as monitoring programs, disaster plans, and safety requirements, may have "the unintended effect of increasing the potential that the [financial holding company] may become enmeshed in or liable to some degree from a catastrophic event."[2]

The operational and environmental risks identified in the Federal Notice, as well as the legal, financial, and reputational risks associated with physical commodity activities, have not received close analysis in the past, in part because bank and financial holding company

[2] Id. at 8.

involvement with physical commodities was historically limited. In addition, few of the physical commodity activities were discussed during the debate on the Gramm-Leach-Bliley Act. The recent surge in financial holding company involvement with physical commodities warrants the proposed examination as well as stronger safeguards to prevent undue risks and unsafe and unsound practices. In addition, physical commodity activities undertaken in response to three different authorizing provisions of the Gramm-Leach-Bliley Act, known as the complementary powers, merchant banking, and grandfather authorities, have been compartmentalized and subjected to isolated and uncoordinated rules, when they should be subject to integrated prudential limits and oversight. A proposed rulemaking would provide a valuable opportunity to address each of those concerns.

### B. Complementary Authority

The Federal Reserve Notice identifies Section 103 of the Gramm-Leach-Bliley Act as the first of the three statutory provisions that authorize financial holding companies to engage in physical commodity activities.[3] This first statutory provision is known as the complementary powers provision, and provides the statutory basis for many physical commodity activities undertaken by financial holding companies in the United States. The statute gives the Federal Reserve sole authority to approve a financial holding company's engaging in any activity, or retaining the shares of any company engaged in any activity, that the Federal Reserve determines "is complementary to a financial activity,"[4] does "not pose a substantial risk to the safety and soundness of depository institutions or the U.S. financial system generally,"[5] and "can reasonably be expected to produce benefits to the public … that outweigh possible adverse effects."[6] The statute identifies three possible public benefits: "greater convenience, increased competition, or gains in efficiency," and five possible adverse effects: "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."[7]

To implement the law, the Federal Reserve has issued regulations establishing a system for approving complementary activities. The regulations require financial holding companies seeking authorization for an activity under the complementary powers provision to submit a formal application and obtain express, prior Federal Reserve approval.[8] In the application, the financial holding company is required to describe the proposed activity, its proposed size and scope, the financial activity to which it would be complementary, how the proposed activity would complement the financial activity, the attendant risks, and the public benefits that would be produced.[9] Since the law's enactment in 1999, the complementary powers provision has been used almost exclusively to permit financial holding companies to engage in activities involving physical commodities.[10]

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[3] See Federal Reserve Notice, at 2.
[4] 12 U.S.C. § 1843(k)(1)(B).
[5] 12 U.S.C. § 1843(k)(1)(B).
[6] 12 U.S.C. § 1843(j). See also 12 CFR § 225.89(b)(3).
[7] 12 U.S.C. § 1843(j)(2)(A).
[8] 12 C.F.R. § 225.89(a).
[9] Id.
[10] Information provided by the Federal Reserve to the Permanent Subcommittee on Investigations.

From 2003 to 2009, in response to applications filed by large financial holding companies, the Federal Reserve has issued a series of orders allowing them to engage in certain physical commodity activities found to be "complementary" to their trading in commodity derivatives.[11] The Federal Reserve Notice states that it has currently authorized 12 financial holding companies to engage in physical commodity activities under the complementary powers provision.[12] The Federal Reserve Notice summarizes the authorized activities as allowing financial holding companies to take and make delivery of physical commodities to settle derivative transactions, and buy and sell physical commodities in the spot markets. In addition, they allow financial holding companies to enter into energy tolling agreements and energy management services agreements with the owners of electrical power plants.[13]

To minimize the accompanying risks created by those physical commodity activities, each order issued by the Federal Reserve has required the financial holding company to make a number of commitments to limit the size and scope of the permitted complementary activities. For example, each order has required the financial holding company to commit that the market value of its commodities holdings resulting from the authorized complementary activities would not exceed 5% of its consolidated Tier I capital, and that the company would alert the Federal Reserve if the market value exceeded 4%.[14] In addition, each order typically requires the financial holding company to commit to trade only in commodities which have been approved by the Commodity Futures Trading Commission (CFTC) for trading on U.S. futures exchanges, unless it otherwise obtains permission from the Federal Reserve.[15] Each order also requires the financial holding company to make a commitment that it will not: (a) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities; or (b) process, refine, or otherwise alter commodities.[16]

The Federal Reserve Notice raises issues and requests comment on a variety of matters related to the complementary powers provision. The key issues include whether the currently authorized activities are truly complementary to a financial holding company's financial activities; how to evaluate the risks, potential public benefits, and potential adverse effects associated with specific activities; and whether the prudential safeguards should be strengthened.

### (1) Tightening Approval of Complementary Activities

The complementary powers provision has been in place for nearly 15 years, and in that time, has been used primarily to grant financial holding companies the authority to engage in a wide range of physical commodity activities. The Federal Reserve Notice solicits comment on

[11] See, e.g., 2003 Federal Reserve "Order Approving Notice to Engage in Activities Complementary to a Financial Activity," in response to a request by Citigroup, Inc., 89 Fed. Res. Bull. 508, 509 (12/2003) (hereinafter "Citigroup Order"), http://fraser.stlouisfed.org/docs/publications/FRB/2000s/frb_122003.pdf. In the order, the Federal Reserve wrote that the complementary authority "is intended to allow the Board to permit FHCs to engage on a limited basis in an activity that appears to be commercial rather than financial in nature, but that is meaningfully connected to a financial activity such that it complements the financial activity." Id. at 509.
[12] Federal Reserve Notice, at 3.
[13] Id.
[14] See, e.g., Citigroup Order.
[15] Id.
[16] Id.

whether the physical commodity activities being undertaken by financial holding companies are truly complementary to their financial activities.[17]

Virtually all of the complementary orders granting financial holding companies authority to conduct physical commodity activities describe the authorized activities as complementary to the companies' commodities derivatives trading. That reasoning makes sense when the order allows financial holding companies to take or make delivery of physical commodities to settle futures, swaps, or other derivative transactions. Those physical commodity transactions are directly linked to and support the resolution of the related financial transactions. In addition, some commodity futures contracts explicitly permit the transactions to be settled financially or through the physical delivery of the specified commodity; to trade in those contracts, financial holding companies should be able to make and take delivery of the physical commodities and physically settle the transactions. Those physical commodity transactions have a clear and direct connection to the financial holding company's financial activities.

That same rationale makes less sense, however, when used to justify financial holding companies being able to buy and sell commodities in the physical spot markets, when those trades have no direct connection to the settlement of any derivative transaction. Buying and selling physical commodities in the spot market are activities that can take place independently of any other transactions; they do not necessarily involve any derivative financial transaction outside of those already discussed in the prior paragraph. For example, some financial holding companies have purchased jet fuel for the sole purpose of selling that fuel to one or more airlines; some have purchased coal to supply one or more power plants; others have purchased and stockpiled large amount of metal on the expectation that the value of the metal would increase over time. Those physical commodity transactions are not necessarily linked to or have a meaningful connection with the companies' other financial activities, and it is difficult to see how they are complementary in a way similar to the first set of physical commodity activities.

Questions also arise regarding the complementary function of energy tolling agreements and energy management services agreements. In an energy tolling agreement, a financial holding company typically promises to pay a power plant operator its costs for running the power plant plus a fixed additional amount, while selling all or part of the power output and keeping the resulting profits (or losses). As part of the tolling agreement, the financial holding company may also supply or pay for the fuel used to run the plant. It is difficult to see how that tolling agreement complements other financial activities undertaken by the financial holding company, especially since it typically functions as an independent investment.[18] Tolling

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[17] See Federal Reserve Notice, at 14, Questions 13-14.

[18] Beginning in 2002, the OCC issued a series of interpretive letters expanding bank authority to participate in electricity derivatives and related businesses, and treating those activities as financial in nature. For example, the OCC allowed banks to hedge their transactions by taking title to electricity commodities. See, e.g., OCC Interpretive Letter No. 937 (6/27/2002)(allowing banks to engage in customer-driven, cash-settled derivatives based on electricity prices and in related hedging activities); OCC Interpretive Letter No. 962 (4/21/2003) (allowing banks to engage in "customer-driven, electricity derivative transactions that involve transfer of title to electricity"); OCC Interpretive Letter No. 1025 (4/6/2005) (allowing banks to engage in "customer-driven electricity derivative transactions and hedges, settled in cash and by transitory title transfer"). The OCC also allowed banks to acquire royalty interests in energy reserves and use reserve royalty payments to repay loans extended to the reserve owner. See OCC Interpretive Letter No. 1117 (5/19/2009) (allowing banks to issue credit to an electricity producer in return for receiving a limited royalty interest in the producer's hydrocarbon reserves and receiving payments from the

agreements also involve financial holding companies in the day-to-day profitability of an ongoing commercial business, even though financial institutions do not normally operate power plants. Financial holding companies sometimes allege that tolling agreements give them greater access to power plant and electricity pricing information, but providing added information about a commodity is a limited function that should be seen as falling short of a reasonable complementary standard. It is a far cry from helping a financial holding company settle a derivatives transaction.

The same analysis applies to energy management services agreements, in which a financial holding company typically assumes the role of an "energy manager" and acts as a financial intermediary for a power plant, substituting its own credit and liquidity for the power plant to facilitate the power plant's business activities. The energy manager also typically supplies market information and advice to support the power plant's efforts and increase its profitability. As with tolling agreements, this arrangement typically functions as an independent investment with no clear or compelling connection to the financial holding company's other financial activities. Even more than the tolling agreements, it involves the financial holding company in the direct operation of an ongoing commercial business, even though financial institutions do not normally have expertise in power generation. While financial institutions have traditionally used their greater credit and liquidity to support their business clients, they have traditionally done so by supplying financing or helping to raise capital, rather than taking on operational aspects of the business itself. Again, some financial holding companies have alleged that energy management services agreements provide them with access to useful, inside information about electricity pricing, but that informational function alone should be seen as insufficient to meet a reasonable complementary standard.

The proposed rulemaking should consider tightening the criteria used to approve applications under the complementary powers provision to focus on physical commodity activities which involve the financial holding company's making or taking delivery of the commodity to settle a futures, swap, or other derivative transaction. That authority should also include buying and selling commodities in the spot market when executed to settle derivatives transactions. In addition, the proposed rulemaking could provide guidance on what additional activities would not qualify as complementary. It could state, for example, that activities that provide commodity information alone or simply substitute physical commodities for cash are insufficient to meet the complementary standard, and must instead provide a direct link – a clear and compelling connection -- between the proposed physical commodity activity and the execution of other, specific financial transactions by the financial holding company. This approach would require other types of physical commodity investments, now treated as complementary activities, to be reconstituted as merchant banking investments with no day-to-day management of the underlying business allowed and with clear limits on the duration of the investment.

energy produced from those reserves over a stated term, so-called "Volumetric Production Payment" loans). None of those financial activities requires, however, a tolling agreement to function.

### (2) Weighing Risks, Public Benefits, and Adverse Effects

The Federal Reserve Notice also requests comment on how the Board can better evaluate the risks, potential public benefits, and potential adverse effects associated with specific physical commodity activities, as required by the Gramm-Leach-Bliley Act.[19] Evaluating those risks, benefits and effects is essential to effective implementation of the law as well as to ensuring physical commodity activities are undertaken in a way that promotes the safety and soundness of the U.S. financial system. A proposed rulemaking could reinvigorate that evaluative process.

**Evaluating Risks.** The Financial Reserve Notice for the first time provides explicit recognition of the risks associated with many physical commodity activities, including financial, operational, environmental, and reputational risks. A proposed rulemaking should identify and describe those risks, and require each to be taken into account when the Board is reviewing an application by a financial holding company under the complementary powers provision. The proposed rulemaking may also want to require the application to contain more detail than is currently required about the nature of anticipated risks and how each would be mitigated. It could also require additional information about existing or proposed insurance coverage and how Risk Weighted Assets would be used to calculate any additional capital requirements related to the new physical commodity activity. The proposed rulemaking should also include a statement that the Federal Reserve will exercise caution when reviewing applications in order to prevent undue risks or unsafe or unsound practices at financial holding companies; and that it will deny approval of unduly risky activities and activities where an applicant has failed to show how potential adverse effects would be outweighed by public benefits.

**Evaluating Public Benefits.** The Gramm-Leach-Bliley Act requires the Federal Reserve to examine possible "public benefits" when considering applications requesting authorization of activities under the complementary powers provision, naming three in particular: "greater convenience, increased competition, or gains in efficiency." Currently, there is little guidance on how those factors should be demonstrated by the applicant or analyzed, weighed, and applied by the Federal Reserve. For example, the term "greater convenience" does not indicate whether it is the public's convenience or private industry's convenience that should be evaluated. "Increased competition" is frequently cited by financial holding companies as a reason to allow them to conduct a physical commodity activity, but if the proposed commodity is already the subject of significant competition, such as coal mining or power plant generation, it is unclear how much importance should be attached to adding one more player to that market. Similar issues apply to "gains in efficiency." Financial holding companies sometimes claim that their participation in physical commodity activities would create certain efficiencies that would reduce commodity costs for the public. Currently, however, that position is typically supported by a general assertion rather than any data or detailed analysis, and it is often unclear how the efficiencies that benefit a private corporation would translate into lower prices for the public. It is also unclear how much weight should be given to each of those public benefits in comparison to possible adverse effects from a proposed activity.

Supporters contend that financial holding company involvement with physical commodities produces significant public benefits by enabling financial holding companies to act

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[19] Id. at 11, 14, Questions 1, 5, 6, 16, 17.

as financial intermediaries for commodity clients and use the holding company's own credit and liquidity to lower their clients' financing costs. An example brought up by some supporters is how one financial holding company helped a bankrupt airline by purchasing jet fuel on its behalf at a lower cost than the bankrupt airline could have obtained, reselling that fuel to the airline, and saving the airline significant fuel expenses. Another example involves a financial holding company that purchased power plants experiencing hardships and improved their profitability, while increasing competition in the electricity markets.

One problem with those examples is that it is unclear whether the actions taken by the financial holding company actually translated into lower costs for the public. Another problem is that, in each case, the financial holding company helped its client by taking on greater risk – paying the upfront costs of purchasing, storing and transporting jet fuel while awaiting repayment from the bankrupt airline, and entering into a tolling agreement that transferred the power plant's economic risk of losses to the holding company. It is that increased risk that the Federal Reserve has to evaluate, in part by comparing the possible public benefits that could be achieved against the possible adverse effects that could follow. Another factor is whether the airline or power plant could have turned to other market participants or means to address their issues. It is far from clear that those commercial businesses should be encouraged to use financial holding companies as their financial intermediaries, in light of longstanding U.S. policy against mixing banking and commerce.

A proposed rulemaking could play an important role in clarifying how the public benefits mandated by the statute should be demonstrated by a complementary powers applicant; how they should be analyzed by the Federal Reserve, and how they should be weighed by the Federal Reserve in comparison to possible adverse effects.

**Evaluating Adverse Effects.** The list of adverse effects that the statute requires the Federal Reserve to consider when reviewing applications has, to date, drawn little analysis in the published complementary orders and should be given a more prominent role in the evaluation of allowable physical commodity activities by financial holding companies. The statute requires the Federal Reserve, when reviewing an application by a financial holding company to engage in a complementary activity, to consider at least five possible adverse effects: whether the proposed activity would lead to an "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." Despite the passage of nearly 15 years, virtually no rules or guidance indicate how those factors should be analyzed, weighed, or applied to specific applications, or whether the existence of the five adverse factors versus the three public benefits signifies that the Federal Reserve should give greater weight to possible negative developments and exercise caution when asked to approve new activities. It is also unclear whether the applicant bears the burden of proof in establishing that the possible adverse effects would be outweighed by the potential public benefits. A proposed rulemaking could fill those gaps.

**Undue Concentration of Resources.** The first adverse effect that the statute indicates should be considered by the Board is whether a proposed physical commodity activity would lead to an "undue concentration of resources." The phrase "undue concentration of resources" is unclear. One way to interpret it would be to link it to longstanding concerns about undue concentrations of economic power within major financial institutions, a common reason for opposing the mixing of banking and commerce.[20] Using that approach, applications could be evaluated in terms of whether the proposed activity would permit major financial institutions, which already dominate U.S. deposit, lending, and credit markets, to influence key raw material, agriculture, or energy pricing, unduly expanding their economic reach beyond the banking sector and creating additional risks by concentrating so many resources within a single institution.

An alternative way to view this factor would be to focus on the related problem of too-big-to-fail financial institutions. Using that approach, applications could be evaluated in terms of whether a proposed activity would add undue size or complexity to a financial holding company, creating a financial conglomerate that would be too big to manage or regulate. Businesses involved with power generation, oil transport, mining, warehousing,shipping, or refining, are, in themselves, complex enterprises with multiple regulatory and practical difficulties. Adding those complexities to the complexities already inherent in a global systemically important financial institution deepens the risk that the resulting entity, with an undue concentration of resources, would become too big to manage or regulate.

A proposed rulemaking could clarify whether and to what extent such considerations should be encompassed within this first statutory factor requiring Board evaluation of an application's possible adverse effects. It could also clarify how those possible adverse effects should be weighed against the possible public benefits, and in cases of unclear or uneven evidence, whether either the negative or positive considerations should be given more weight. It could also clarify that the burden of proof in showing that the possible adverse effects are outweighed by the possible public benefits rests with the applicant.

**Unfair Competition.** The second adverse effect that the statute indicates should be considered by the Federal Reserve is whether the proposed activity might lead to "decreased or unfair competition." Again, little information is currently available on how this factor should be interpreted or applied. One approach would be to focus on the fact that financial holding companies, through their banks, typically have greater access to low cost financing, through intracompany or interbank loans bearing low interest rates, compared to nonbank businesses. Large financial holding companies also typically have ongoing relationships with other large financial institutions, which may make it easier to obtain financing and new capital than nonbank businesses would experience. The Board could consider whether this financing advantage would distort the commodity markets being targeted, by giving financial holding companies an unfair competitive edge over nonbank competitors.

A second approach would be to focus on whether the financial holding company's proposed activity would provide it with an unfair informational advantage over its competitors. Financial holding companies that, through subsidiaries, own oil storage facilities, pipelines, warehouses, shipping operations, or similar commodity enterprises are likely to acquire useful information about commodity flows from both their own operations and their clients' activities. They may also gather useful information as a result of carrying out financial transactions on behalf of their clients. In addition, given the absence of insider trading prohibitions in commodity markets, financial holding companies can legally ask their subsidiaries for nonpublic information and use that information to trade in the commodity futures, swaps, and options

[20] See, e.g., "The Merchants of Wall Street: Banking, Commerce, and Commodities," Professor Saule Omarova, 98 Minnesota Law Review 265, 276 (2013).

markets. For example, a financial holding company whose subsidiary has a controlling interest in a warehouse could quickly learn of warrant cancellations or incoming shipments and use that inside information to profit from positions taken in commodity markets for themselves or their clients. A financial holding company with a subsidiary that controls a shipping operation could find out when bad weather has delayed deliveries and, again, use that inside information legally to profit in the commodities markets from shorting the affected commodities. The Board could consider whether this informational advantage, like the financing advantage, would distort the commodity markets being targeted and contribute to unfair competitive conditions favoring the financial holding company.

A proposed rulemaking could clarify how these concerns should be analyzed, weighed, and applied to evaluate applications seeking complementary authority to expand a financial holding company's physical commodity activities.

**Conflicts of Interest.** The third adverse effect that the statute indicates the Board should consider when reviewing applications is the issue of "conflicts of interest." Historically, bank holding companies did not own or engage in commercial enterprises, and so had few conflicts of interest affecting their lending or other banking decisions. Once financial holding companies were allowed to participate in commercial operations, however, they necessarily opened up a raft of conflict of interest problems that pit the company's commercial interests against those of its clients or counterparties.

For example, if a financial holding company's subsidiary owns or controls a business that handles physical commodities, it may be tempted to direct its bank, not only to extend credit to that business on favorable terms, but also to deny credit to its competitors, even if those competitors are good credit risks. Temptations may also arise to use its physical commodity activities to benefit the financial holding company's trading operations at the expense of its counterparties. For example, if a financial holding company subsidiary supplies crude oil to a refinery while another subsidiary trades oil futures, the financial holding company could use knowledge of delayed oil deliveries to boost the value of its subsidiary's long position, while decreasing the value of the short positions held by its counterparties. Similarly, if a subsidiary operates a commodity-based exchange traded fund backed by gold, the financial holding company could direct its subsidiary to release some of that gold into the marketplace and lower gold prices, so that another subsidiary could profit from a short position in gold futures or swaps, even if some clients held long positions. If one subsidiary owned a metals warehouse and another traded metals in the futures market, the financial holding company could help its trading subsidiary to time its metals trades to take advantage of metal movements at the warehouse, even if those trades were contrary to the interests of its clients.

A related set of conflict of interest concerns involves issues of market manipulation. In July 2013, the Federal Energy Regulatory Commission (FERC) charged Barclays Bank with manipulating electricity prices in California from 2006 to 2008, in order to benefit its swap positions in other markets, assessing a penalty totaling $435 million.[21] Barclays is contesting both the finding and penalty. That same month, JPMorgan paid $410 million to settle a FERC complaint that it used multiple pricing schemes to manipulate the price of electricity produced by

[21] FERC v. Barclays Bank PLC, Docket No. IN08-8-000, Order Assessing Civil Penalties, 144 FERC ¶ 61,041 (7/16/2013).

power plants it controlled in California and Michigan.[22] Charging artificially higher electricity prices likely contravened the interests of multiple JPMorgan clients. Prior investigations by the Permanent Subcommittee on Investigations have also presented evidence of bank participation in commodity trading strategies that have, collectively, constituted excessive speculation in such commodities as crude oil, natural gas, and agricultural products.[23] A proposed rulemaking could clarify how these market manipulation concerns, as well as other conflict of interest issues, should be taken into account when determining whether to approve a physical commodity application.

**Unsound Banking Practices.** The fourth adverse effect that the statute directs the Board to consider is whether an application could lead to "unsound banking practices." Again, little guidance exists as to how this factor should be analyzed, weighed, or applied. One set of issues involves lending decisions. As explained earlier, the concern is that, if a financial holding company's subsidiary owns or controls a business handling physical commodities, the financial holding company could direct its bank to extend credit to that business on overly favorable terms, while denying credit to its competitors, even if those competitors are better credit risks. Because of its commercial involvement, the financial holding company might direct its bank to make credit decisions that are no longer based on objective lending criteria, but reflect the company's desire to see its subsidiary's business succeed. A related concern involves a financial holding company's directing its bank to extend financing to a business that supplies the financial holding company with physical commodities, such as coal or jet fuel that the financial holding company then sells to a third party. In that case, credit would be extended, not to the financial holding company's own subsidiary, but to a business partner. Similarly, a financial holding company might direct its bank to extend financing to businesses which the financial holding company wants to partner with in a physical commodity venture. Because commodity activities often require substantial sums to purchase, store, or transport physical inventory, a bank's lending facilities may be used by a financial holding company to entice other parties to participate in a transaction. Distorted lending decisions are a prime example of unsound banking practices.[24] A proposed rulemaking should clarify how those and other banking concerns should be addressed when reviewing an application, including what safeguards would be warranted to prevent lending abuses.

**Systemic Risks.** The fifth and final adverse effect that the statute directs the Board to consider is whether a proposed physical commodity activity poses a "risk to the stability of the

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[22] See "FERC, JP Morgan Unit Agree to $410 Million in Penalties, Disgorgement to Ratepayers," FERC News Release (7/30/2013).

[23] See, e.g., "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," report released by Permanent Subcommittee on Investigations, S.Prt. 109-65 (6/27/2006); "Excessive Speculation in the Wheat Market," hearing before Permanent Subcommittee on Investigations, S.Hrg. 111-155 (7/21/2009).

[24] See, e.g., Investment Company Institute v. Camp, 401 U.S. 617, 631-632 (1971), in which the Supreme Court warned about the consequences of a bank's helping to "shore up" an affiliate experiencing financial difficulties: "[S]ince public confidence is essential to the solvency of a bank, there might exist a natural temptation [by the bank] to shore up the affiliate through unsound loans or other aid. Moreover, the pressure to sell a particular investment and to make the affiliate successful might create a risk that the bank would make its credit facilities more freely available to those companies in whose stock or securities the affiliate has invested or become otherwise involved. … The bank might exploit its confidential relationship with its commercial and industrial creditors for the benefit of the [mutual] fund. ... The bank might make loans to facilitate the purchase of interests in the fund."

United States banking or financial system." As with the prior factors, it is unclear how this factor should be analyzed, weighed, and applied. One approach would be to use this factor to examine whether a proposed activity would produce systemic risks. For example, this factor could lead the Board to consider whether a proposed activity would expose large financial holding companies to excessive risks from a low probability, but high-cost pollution event or industrial accident. Another example might be, if a financial holding company applied for permission to extend financing in exchange for interests in physical commodities, the Board could consider whether the holding companies would then become overly dependent upon volatile commodity prices. In both situations, this factor could lead the Board to consider, not only the risks to the individual financial holding company, but also – if financial difficulties arise – possible broader adverse impacts on the financial holding company's counterparties, clients, business partners, other financial institutions, and the U.S. financial system as a whole.

This factor could also be used to consider whether the approval of an application would encourage additional financial holding companies to enter a commercial field best left to nonbanking enterprises. This analysis might take into consideration, as indicated earlier, the need to prevent undue concentrations of economic power in which financial holding companies might dominate, not only the U.S. financial sector, but also key energy, raw materials, or agriculture sectors or the pricing of related commodities. As with the earlier adverse factors, a proposed rulemaking could clarify how this last factor should be interpreted, analyzed, weighed, and applied when evaluating applications by financial holding companies to enlarge their physical commodity activities.

### (3) Strengthening Prudential Safeguards

The Federal Reserve Notice also requests comment on a variety of issues related to prudential safeguards.[25] Given the Board's duty to ensure that financial holding companies operate in a safe and sound manner, the Board should clearly continue requiring them to make commitments, in connection with obtaining orders to conduct complementary activities, to adopt policies and practices ensuring those activities are operated in a safe and sound manner. In addition, the existing safeguards should be strengthened and broadened to encompass all physical commodity activities undertaken by the financial holding company, and some new safeguards should be added to ensure all of its physical commodity activities are undertaken in a prudent way.

**5% Limit.** Currently, a key prudential safeguard devised by the Federal Reserve is obtaining a commitment from each financial holding company that it will not allow the market value of its commodities holdings resulting from its complementary activities to exceed 5% of its consolidated Tier I capital. Comments were solicited as to whether this safeguard adequately protects against unsafe or unsound concentrations of physical commodities or should be strengthened.[26] While the existing limit plays an important prudential role now, it would benefit from being strengthened in two ways.

First, when applying the limit, the Federal Reserve should require financial holding companies to consider, not just the commodity holdings of their nonbank subsidiaries, but also

[25] See Federal Reserve Notice, at 11-12, Questions 1-8.
[26] See Federal Reserve Notice, at 12, Question 5.

the holdings of their federally insured depository institutions. Currently, financial holding companies, when calculating their physical commodity holdings for purposes of the 5% limit, are permitted to exclude their banks' physical commodity holdings, which is not only counterintuitive, but also significantly weakens the ability of the 5% limit to prevent an undue concentration of complementary activities at the financial holding company. In addition, excluding bank holdings renders the limit less able to prevent unsafe or unsound concentrations of physical commodities.

Second, the 5% limit should be broadened to encompass, not only physical commodity activities undertaken pursuant to the complementary powers provision, but also those authorized under the Gramm-Leach-Bliley merchant banking and grandfather provisions. Currently, each of the three statutory provisions allowing physical commodity activities has been implemented in isolation, with different limits that operate independently of each other. A better approach would be to coordinate and integrate the limits so that a financial holding company operates with a single, integrated limit on the size of its physical commodity activities. That integrated limit could then be made a condition of the financial holding company's engaging in any complementary activities.

The Federal Reserve Notice also requests comment on whether the Board should reduce the 5% limit and possibly employ absolute dollar limits or caps.[27] It should. The financial holding companies engaged in physical commodity activities today have such massive holdings that a 5% limit translates into billions of dollars of physical commodities. At the same time, some financial holding companies have bumped up against that limit and sought ways around it. A better approach would be to lower the limit to 3% of Tier I capital, to prevent physical commodity holdings from becoming a substantial portion of the financial holding company's assets. Commodity values are notoriously volatile over time, and are also subject to market manipulation and excessive speculation. In addition, if a financial holding company amasses a large commodities position, which many do, even small price changes can lead to massive gains or losses. To reduce the financial risk and prevent an excessively concentrated position in physical commodities, the Federal Reserve should lower and broaden the overall 5% limit.

**CFTC Approved Commodities.** A second existing safeguard is the required commitment that financial holding companies trade only in commodities approved by the CFTC for trading on an exchange. Comments were requested on whether this safeguard, as currently configured, provides adequate protection or whether it, too, should be strengthened.[28] The current approach would benefit from strengthening.

Right now, if the CFTC has approved exchange trading of a commodity, a financial holding company can initiate physical trading of that commodity under a complementary order, without any prior notice to or permission from the Federal Reserve. One example that illustrates the problems with this approach involves the trading of physical uranium. In its natural form, uranium is not a harmfully radioactive substance, but once enriched, it gains significant levels of chemical toxicity. The CFTC has approved exchange trading of several uranium futures, representing different stages of enrichment. At least two financial holding companies have considered or have actually engaged in trading physical quantities of enriched uranium or

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[27] Id., at 11, Question 2.
[28] Id., at Question 4. See also Question 1.

financial instruments related to enriched uranium. At the same time, uranium trading carries multiple risks due to a generally illiquid market and volatile prices, as well as a slew of operational, environmental, insurance-related, and reputational issues.

Instead of continuing the existing approach, the Federal Reserve should consider restricting trading to a smaller group of allowable commodities. In addition to restricting financial holding company involvement to physical commodities approved by the CFTC for exchange trading, the Federal Reserve should consider such additional factors as the volume and liquidity of the commodity's trading on the futures markets, the volume and liquidity of its trading in the physical spot markets, whether the financial holding company has effective trading controls to prevent undue concentrations of risk in that commodity, the ability of the financial holding company to sell its physical and financial holdings in the event of a market disruption, and the variety of risks associated with trading in that particular commodity, including financial, operational, and reputational risks. CFTC trading approvals currently focus on whether exchanges can develop viable markets for individual commodities; they do not consider issues of risk to individual traders which, in the case of financial holding companies, is the sole responsibility of the Federal Reserve. A better approach would be for complementary orders to permit trading in commodities that the Federal Reserve has found to meet a number of prudential concerns in addition to CFTC approval for exchange trading, while also requiring Board approval for trading any others.

**Extraction, Transportation, Storage, Distribution, and Refining Limits.** A third existing safeguard is the required commitment that financial holding companies not own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities; or process, refine, or otherwise alter commodities. This limitation also would benefit from strengthening.

First, a proposed rulemaking should broaden this safeguard to apply, not only to physical commodity activities authorized under the complementary powers provision, but also to those authorized under the Gramm-Leach-Bliley merchant banking and grandfather provisions. Some financial holding companies are already using those other authorities to operate or invest directly in oil and natural gas pipelines, shipping operations, warehouses, truck or railway transport businesses, or refining operations. As with the 5% limit, this broader restriction could be made a condition of the financial holding company's engaging in any complementary activities.

Second, the proposed rulemaking should make it clear that this prohibition cannot be circumvented through indirect arrangements such as investments made through a private fund or through use of a tolling agreement that avoids direct ownership yet places the financial holding company in charge of a physical commodity business in all but name. If the objective is to ensure financial holding companies are not engaging in physical commodity activities with undue risks, then action must be taken to ensure those financial holding companies cannot do indirectly, what they are prohibited from doing directly.

**Additional Capital and Insurance Requirements.** The Federal Reserve Notice also requests comment on whether it should impose additional capital and insurance requirements on financial holding companies engaging in physical commodity activities.[29] It should.

Adequate insurance is critical to ensuring financial institutions can readily handle unanticipated and often large expenses associated with high-cost pollution events or industrial accidents, particularly since those types of expenses do not normally arise in banking operations and may not be part of a financial institution's normal financial planning. Insurance policies need to be designed to cover the specific types of mishaps or disasters that can affect the particular physical commodity activities being undertaken by the financial holding company, and which can vary from power plant outages to natural gas pipeline explosions to shipping oil spills to mining disasters. To ensure adequate insurance, the Board should issue general guidance stating, for example, that financial holding companies are expected to undertake best practices in procuring adequate insurance, as well as specify key features of a best practices approach. In addition, the Board may want to require financial holding companies to acquire "adequate insurance" to protect against a major pollution event or industrial accident, define what that standard entails, and perhaps even establish minimum dollar amounts or types of insurance that must be obtained for different lines of physical commodity businesses.

At the same time, as the Federal Reserve Notice observes, the costs associated with a catastrophic event are unlikely to be fully covered by even well designed insurance policies. As the Notice recounts, existing pollution insurance policies "typically have maximum payouts that are well below the amount of damage that an environmental disaster may cause."[30] In addition, "certain types of significant costs, such as those associated with clean-up, may be expressly excluded from the insurance policies."[31] Because even conscientious financial holding companies may lack adequate insurance to cover a catastrophic event, it is critical that the Federal Reserve require those companies to carry sufficient capital to protect against related costs.

For several years, the Federal Reserve and other U.S. banking regulators have worked on a new system of Risk Weighted Assets to help identify a financial institution's capital requirements. The new capital framework includes revised capital requirements related to commodities, including physical commodities, held under the complementary and grandfather authorities;[32] as well as investments made under the merchant banking authority.[33] A proposed rulemaking would provide a valuable opportunity to invoke those new capital requirements in the context of orders issued under the complementary powers provision, and determine whether additional risk weights should be assigned to physical commodity activities bearing out-of-the-norm financial, operational, environmental, or reputational risks, including the possibility that the activity could experience a serious pollution event, industrial accident, or other catastrophic event.

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[29] Id,, at 11, Questions 2, 3.
[30] Id., at 10, footnote 39.
[31] Id., at 10.
[32] See 12 C.F.R. part 225, Appendix F; 12 C.F.R. part 217, subpart F.
[33] See 12 C.F.R. part 225, Appendix A, section II.B.5; 12 C.F.R. § 217.152.

Unless it has sufficient capital to withstand the costs associated with such an event, any financial holding company whose physical commodity activities experience a catastrophic event may lose market confidence, begin to experience financial difficulties, and require a taxpayer bailout to prevent its collapse and negative impact on the U.S. financial system. If a financial holding company chooses to participate in physical commodity activities, it must be prepared to handle the attendant risks.

### C. Merchant Banking Authority

The Federal Reserve Notice identifies Section 4(k)(4)(H) of the Gramm-Leach-Bliley Act as the second source of statutory authority for financial holding companies to engage in physical commodity activities. Section 4(k)(4)(H) creates what is called merchant banking authority, allowing for the first time in U.S. banking statutes broad authority for financial holding companies to purchase up to a 100% ownership interest in one or more non-financial commercial enterprises.[34] At the same time, the law restricts those ownership interests in several ways; they must be for only a limited period of time, the financial holding company may not directly manage the underlying enterprise, and each investment must be undertaken as a "bona fide" merchant banking investment.[35] The law also authorizes financial holding companies to make merchant banking investments as either a principal or on behalf of a client.

The Gramm-Leach-Bliley Act did not define the term "merchant banking," and a 2001 joint "Merchant Banking Rule" issued by the Federal Reserve Board and Treasury[36] does not offer much additional guidance, simply stating that merchant banking activities are "those not otherwise authorized" under Section 4 of the Bank Holding Company Act.[37] Clarifying how the Gramm-Leach-Bliley merchant banking authority applies to physical commodity activities would be an important issue to address in a proposed rulemaking.

**Growing Use of Merchant Banking Authority.** According to the Congressional Research Service (CRS), relying on data provided by the Federal Reserve, from 2000 to 2013, financial holding companies have increased their merchant banking holdings from $9.5 billion to $46.2 billion, a fivefold increase.[38] CRS has also determined that, as of 2013, twice as many foreign banks as domestic banks, 23 to 10, were conducting merchant banking activities in the

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[34] Gramm-Leach-Bliley Act, Section 4(k)(4)(H); 12 U.S.C. § 1843(k)(4)(H). See also "Merchant Banking: Mixing Banking and Commerce Under the Gramm-Leach-Bliley Act," Congressional Research Service, No. RS21134 (10/22/2004), at 1 ("Before [the Gramm-Leach-Bliley Act], banking companies could use equity-investing authority only through Small Business Investment Companies (SBICs) and other limited powers. Bank holding companies could own [only] noncontrolling interests in nonfinancial companies: not more than 5% to 10% of voting securities. [The Gramm-Leach-Bliley Act] allows [financial holding companies] into the high-risk, high-reward private equity market.").
[35] See 12 U.S.C. § 1843(k)(4)(H).
[36] 66 Fed. Reg. 8466 (1/31/2001), codified at 12 C.F.R. Part 225, Subpart J.
[37] 12 C.F.R. § 225.170(a). See also "Merchant Banking: Mixing Banking and Commerce Under the Gramm-Leach-Bliley Act," Congressional Research Service, No. RS21134 (10/22/2004), at 1 ("Merchant banking mixes banking with commerce. The term comes from European practices, in which *bankers* financed foreign trade and other high risk ventures undertaken by *merchants* such as ship owners and importers for a share of the profits, rather than receiving interest returns from lending. Taking a stake in a venture made it merchant banking.")(emphasis in original).
[38] "Merchant Banking Assets of Financial Holding Companies," memorandum by CRS (12/20/2013) at 5 (using data provided by the Federal Reserve).

United States.[39] According to CRS, due to data limitations, the Federal Reserve is unable to indicate what portion of those merchant banking investments involve commodities as opposed to other types of business investments. It is clear, however, that some financial holding companies are invoking the merchant banking authority to justify conducting physical commodity activities not otherwise permitted under Gramm-Leach-Bliley's complementary authority.

One banking expert has described the merchant banking provision as creating essentially "a catch-all authority" for financial holding companies to invest in nonfinancial, commercial enterprises.[40] The same expert has characterized the primary purpose of the provision as enabling banks to compete with securities firms and venture capital funds in investing in start-up companies.[41] The preamble to the Merchant Banking Rule took the position, however, that the merchant banking authority created by the Gramm-Leach-Bliley Act was not intended to mix banking and commerce, but to allow financial holding companies to make purely financial investments. The Rule explained that, to "preserv[e] the financial nature" of the merchant banking investment and "maintai[n] the separation of banking and commerce," the principal purpose of the investment must be to make a profit for the financial holding company from the resale or disposition of its ownership stake and not from running the nonfinancial business.[42]

**Qualifying Investments.** To qualify as a merchant banking investment under the Merchant Banking Rule, an investment must meet a number of statutory and regulatory requirements, including the following:

(1) the investment must not be made or held, directly or indirectly, by a U.S. depository institution;[43]
(2) the investment must be "part of a bona fide … merchant or investment banking activity," including investments made for the purpose of appreciation and ultimate resale;[44]
(3) the financial holding company must use a securities affiliate or an insurance affiliate with a registered investment adviser affiliate to make the investment;[45]
(4) the investment must be held on a temporary basis, "only for a period of time to enable the sale or disposition thereof on a reasonable basis"[46] and generally for no longer than ten years;[47] and
(5) the financial holding company generally must not "routinely manage or operate" the company in which it has made the investment.[48]

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[39] Id.
[40] Testimony of Professor Saule T. Omarova, "Large U.S. Banking Organizations' Activities in Physical Commodity and Energy Markets: Legal and Policy Considerations," hearing before the U.S. Senate Banking Subcommittee on Financial Institutions and Consumer Protection (7/23/2013), at 3.
[41] Id.
[42] 66 Fed. Reg. at 8469.
[43] 12 U.S.C. § 1843(k)(4)(H)(i); 12 C.F.R. § 225.170(d).
[44] 12 U.S.C. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(b).
[45] 12 U.S.C. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(f). A bank can also use a private equity fund that meets certain requirements to make the merchant banking investment. 12 C.F.R. § 225.173.
[46] 12 U.S.C. § 1843(k)(4)(H)(iii); 12 C.F.R. § 225.172(a).
[47] 12 C.F.R. § 225.172(b)(1).
[48] 12 U.S.C. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171(a) and (b)(e).

In contrast to the complementary powers provision, financial holding companies generally do not have to obtain prior approval by the Federal Reserve before making a merchant banking investment.[49]

**Routine Operation and Management.** One key area that a proposed rulemaking could clarify involves how the statutory prohibition on financial holding companies providing "routine operation and management" applies to physical commodity activities. Some financial holding companies, for example, have entered into tolling or energy management services agreements with power plant owners, and used those agreements to become very involved with the plant operations. In some cases, a financial holding company, acting through a nonbank subsidiary, has conducted reviews of the plant operations to save money, increase efficiencies, or improve profitability, and made detailed recommendations for operational changes, corporate restructurings, or pricing strategies.[50] Similar issues apply to such activities as running a commodity warehouse, owning a natural gas pipeline network, or acting as a jet fuel distributor for an airline. A proposed rulemaking would provide an opportunity to clarify what actions by financial holding companies would qualify as "routine operation and management" of a business purchased as a merchant banking investment.

In addition, in at least one case, a financial holding company claiming to have made a merchant banking investment took steps to advertise its acquisition of the underlying business, encourage clients to use the business' services, and integrated some of the business operations with the financial holding company's other activities. A proposed rulemaking could clarify that those steps go beyond what is appropriate for a merchant banking investment.

**Ten and Fifteen Year Investment Periods.** Another set of issues involves the investment periods that result when a financial holding company makes a direct merchant banking investment versus an indirect merchant banking investment through a fund. Under existing regulation, a direct merchant banking investment has a maximum 10-year investment period before the investment must be sold, while an indirect merchant banking investment through a fund has a 50% longer investment period of up to 15 years. The reason for the much longer investment period awarded to an indirect merchant banking investment made through a fund is unclear. In addition, it is currently unclear what types of funds would qualify for the 15-year investment time period, in particular since the Volcker Rule, discussed below, has generally prohibited banking entities from making investments through private funds. One question, for example, is whether, in light of the Volcker Rule restrictions, a financial holding company can use a wholly or partially owned "infrastructure fund" to make merchant banking investments and, if so, whether that fund would be eligible for the 15-year investment period. It is also unclear, in light of the Volcker Rule, the extent to which investments made by a financial holding company's asset management division must rely on the merchant banking authority.

In addition, the Federal Reserve Notice has raised questions about the length of the 10 and 15-year time periods.[51] Those time periods appear to be significantly longer than the

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[49] See 12 C.F.R. § 225.174(a).
[50] See, e.g., JPMorgan Chase's involvement with power plants in California. In Re Make-Whole Payments and Related Bidding Strategies, FERC Docket Nos. IN11-8-000 and IN13-5-000, "Order Approving Stipulation and Consent Agreement," 144 FERC ¶ 61,068 (7/30/2013).
[51] See Federal Reserve Notice, at 17 and Question 19.

investment periods typically used by venture capital or private-equity funds. In addition, both investment periods are so long that they may encourage a financial holding company to try to profit from running the underlying business rather than from selling its ownership stake. A third concern, raised by the Notice, is whether the time periods should be shortened to limit the risks associated with financial holding companies maintaining extended ownership interests in businesses that may experience a major pollution event or industrial accident. A related concern is whether, if such a catastrophic event should occur, part of the liability might attach to the financial holding company as a partial owner.

A proposed rulemaking would provide an opportunity to reconsider the 10-year and 15-year investment time periods. The rulemaking should consider shortening both periods to reflect current investment practices and limit risk exposure for financial holding companies. In addition, the proposed rulemaking should consider eliminating the current practice of permitting fund investments to be longer than direct balance sheet investments. If that practice is not eliminated, the rulemaking should clarify what types of funds may be used to make investments eligible for the longer investment period.

**Prudential Safeguards.** Still another key issue is imposing prudential safeguards to ensure that merchant banking investments involving physical commodities do not create undue risks or unsafe or unsound practices for the financial holding companies making those investments. The Federal Reserve has an overriding obligation to ensure the safety and soundness of financial holding companies, their banks, and the U.S. financial system as a whole. That obligation existed at the time the Gramm-Leach-Bliley Act was enacted into law, and the authority established by the merchant banking provision should be interpreted as subject to the Federal Reserve's broader authority to establish prudential safeguards to protect the U.S. banking and financial systems. Those safeguards can and should limit the allowable merchant banking investments by financial holding companies to prevent undue risks and unsafe or unsound practices.

A proposed rulemaking offers the opportunity to establish prudential safeguards for merchant banking investments that involve physical commodities. Those safeguards should include, first, a revised overall limit on the amount of merchant banking investments involving physical commodities that can be maintained by a financial holding company at any one time. A 2001 Federal Reserve regulation setting overall limits on merchant banking investments[52] was recently overridden by a new set of merchant banking capital requirements.[53] Those limits do not distinguish, however, between merchant banking investments that do or do not involve physical commodities. As mentioned earlier, the proposed rulemaking should consider how to coordinate the overall limit on merchant banking investments with the overall limits that now apply to physical commodities held under the Gramm-Leach-Bliley complementary and grandfather authorities, with a view to producing a single, integrated limit that would apply to all physical commodity holdings at a financial holding company. That integrated limit could then be made a condition of the financial holding company's engaging in any merchant banking activities.

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[52] See 12 C.F.R. § 225.174.
[53] See 12 C.F.R. part 224, Appendix A, section II.B.5.

A second set of safeguards should impose additional capital and insurance requirements for physical commodity activities undertaken in connection with the merchant banking provision, as discussed earlier. In addition, the rulemaking should propose more detailed merchant banking reporting obligations to ensure that the Federal Reserve is fully aware of all merchant banking investments by financial holding companies, including those involving physical commodities, and can exercise adequate oversight of those investments to prevent undue risks and unsafe or unsound practices.

**Volcker Rule.** One final merchant banking issue involves the Volcker Rule. The Volcker Rule, created by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, prohibits banking entities, including financial holding companies, from engaging in high risk, conflicts-ridden proprietary trading, including via investments made through private funds.[54] While the Volcker Rule was intended to cover merchant banking investments, whether made directly or through a fund,[55] the final regulation implementing the law is silent on whether those types of investments are covered.[56] At the same time, the Volcker Rule is very clear that banking entities, including financial holding companies, are prohibited from acquiring ownership interests in either hedge funds or private equity funds.[57] It also prohibits any "permitted activity" from creating "a material conflict of interest" with the holding company's clients, customers or counterparties; creating "a material exposure by the banking entity to high-risk assets or high-risk trading strategies"; or posing a "threat to the safety and soundness" of a banking entity or "to the financial stability of the United States."[58]

To ensure that financial holding companies comply with the Volcker Rule, the proposed rulemaking should reference the Volcker Rule's prohibitions to ensure financial holding companies are aware of them and do not make merchant banking investments through prohibited funds. In addition, the proposed rulemaking should clarify what types of funds could be used to make non-financial, merchant banking investments, taking into account both the Gramm-Leach-Bliley and Volcker Rule restrictions. Finally, the proposed rulemaking should ensure that financial holding companies are aware of and comply with the Volcker Rule's restrictions on high risk activities and conflicts of interest, when making merchant banking investments.

### D. Section 4(o) Grandfather Authority

The Federal Reserve Notice identifies Section 4(o) of the Gramm-Leach-Bliley Act as the third and final source of statutory authority for financial holding companies engaging in physical commodity activities. Section 4(o), also called the grandfather clause, was enacted nearly 15 years ago in 1999, yet its contours have yet to be delineated by the Federal Reserve in regulation, guidance, or order. Resolving questions about its scope gained urgency six years ago, in 2008, when Goldman Sachs and Morgan Stanley converted to bank holding companies and invoked the clause as the legal basis for engaging in a wide range of physical commodity activities, including

[54] See Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. l 11-203 (adding Section 13 to the Bank Holding Company Act of 1956, codified at 12 U.S.C. § 1841 *et seq.*).
[55] See, e.g., 156 Cong. Rec. S5894, S5895 (daily ed. July 15, 2010).
[56] See 17 C.F.R. Part 75.
[57] 12 U.S.C. § 1841(a).
[58] See 12 U.S.C. § 1841(d)(2).

activities not otherwise permitted under the complementary or merchant banking authorities. It is long past time for the Federal Reserve to provide needed guidance on the scope and meaning of the grandfather clause and to prevent its being used to justify unsafe or unsound practices. The proposed rulemaking provides an opportunity to accomplish those objectives.

The grandfather clause provides that any company that becomes a financial holding company after November 12, 1999, "may continue" to conduct "activities related to the trading, sale, or investment in commodities and underlying physical properties," provided that several conditions are met.[59] Those conditions include that the company "lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States"; that its non-authorized commodity assets do not exceed 5% of the company's total consolidated assets or any higher threshold set by the Federal Reserve; and that the company does not permit a subsidiary engaged in grandfathered commodities activities to cross-market its products and services to an affiliated bank.[60]

**Clarifying the Scope of the Grandfather Clause.** Given its ambiguous wording, the grandfather clause has given rise to multiple interpretations about what it authorizes. Some contend that the grandfather clause should be read so expansively that if a financial holding company's subsidiaries, affiliates, or predecessor companies conducted any type of physical commodity activities in the United States to any degree prior to or on the key date in 1997, then the financial holding company is entitled to engage in all types of physical commodity activities at any time into the future, subject to the 5% cap. Others read the grandfather clause more narrowly, reasoning that its sole purpose was to protect firms from having to discontinue or disinvest their commodity activities upon becoming a financial holding company. They contend that the grandfather clause should be read as preserving only those specific commodity activities that originated prior to the key date in 1997, and that were ongoing in the United States on the date that the firm converted to a financial holding company.

The more narrow interpretation comports with the legislative history of the statutory provision, with grandfather clauses generally, and with the Federal Reserve's obligation to ensure the safety and soundness of financial holding companies operating in the United States. That narrow interpretation could and should be given effect in a proposed rulemaking.

Grandfather clauses, by their nature, typically safeguard existing activities, rather than authorize new or expanded activities. The legislative history indicates that, in keeping with that approach, the Gramm-Leach-Bliley grandfather clause was presented as a way to avoid forcing a securities firm to discontinue or divest itself of existing commodity activities in order to become a financial holding company. The Senate Banking Committee Chairman at the time, Senator Phil Gramm, who offered the amendment that formed the basis for Section 4(o), entitled it: "Gramm Amendment on Grandfathering Existing Commodities Activities." The amendment also contained this short explanation of its purpose:

> "The above amendment assures that a securities firm currently engaged in a broad range of commodities activities as part of its traditional investment banking activities, is not

[59] 12 U.S.C. § 1843(o).
[60] Id.

> required to divest certain aspects of its business in order to participate in the new authorities granted under the Financial Services Modernization Act. This provision 'grandfathers' existing commodities activities."[61]

That language indicates that the only stated purpose of the amendment was to prevent disinvestments of "existing commodities activities," not authorize new activities not then in existence.

The Committee report on the bill should be read in a manner consistent with the Gramm Amendment explanation. It states:

> "[A]ctivities relating to the trading, sale or investment in commodities and underlying physical properties shall be construed broadly and shall include owning and operating properties and facilities required to extract, process, store and transport commodities."[62]

That Report language should be read as intending to protect from disinvestment a broad range of commodity activities that were then in existence; it should not be interpreted as converting the grandfather clause into an unbounded license for financial holding companies to engage in activities not then underway. Instead, the Committee Report language should be read in tandem with the Gramm explanation which focused on protecting only existing commodity activities from disinvestment.

Clarifying the meaning and scope of the grandfather clause is one of the most important potential contributions of a rulemaking on financial holding company involvement with physical commodities. It is particularly important because Goldman Sachs continues to invoke the clause as the statutory basis for its engaging in physical commodity activities not otherwise permitted. The clause states that a firm can "continue" its commodities "activities" provided that, in part, it was lawfully engaged in those activities in the United States "as of" September 30, 1997. The rulemaking should make it clear that the grandfather clause authorizes only those "activities" which were lawfully underway in the United States on that key date and which continued to be underway in the United States on the date on which the firm was designated a financial holding company. The rulemaking should also make it clear that when the clause grandfathered "any" commodity activity, it entitled a firm to continue, without disinvestment, any of the statute's listed activities that the firm was conducting on the date of its designation as a financial holding company, but did not entitle the company to revive activities from the past or expand into wholly new commodity activities in the future.

**Prudential Safeguards.** In addition to clarifying the meaning and scope of the grandfather clause, the proposed rulemaking should impose prudential safeguards on all physical commodity activities undertaken pursuant to the grandfather clause to prevent undue risks and unsafe or unsound practices. As explained earlier, at the time the Gramm-Leach-Bliley Act was enacted into law, the Federal Reserve operated under an ongoing obligation to ensure the safety and soundness of financial holding companies, their banks, and the U.S. financial system as a

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[61] Committee Amendment No. 9, "Gramm Amendment on Grandfathering Existing Commodities Activities," offered by Senator Phil Gramm during committee markup of the Financial Modernization Act, (3/4/1999), http://banking.senate.gov/docs/reports/fsmod99/gramm9.htm.

[62] Gramm-Leach-Bliley Act, H.R. Committee Report No. 104-127, pt. 1, at 97 (5/18/1995).

whole. For that reason, the authority established by the grandfather clause should be interpreted as subject to the Federal Reserve's broader authority to establish prudential safeguards limiting the activities otherwise permitted under the grandfather clause.

A proposed rulemaking offers the opportunity to establish prudential safeguards for physical commodity activities undertaken on the basis of the grandfather clause. Those safeguards should include, first, as explained earlier, a revised overall limit on the physical commodity holdings that can be maintained by a financial holding company at any one time under the grandfather clause. The current statutory limit, which is set at 5% of the financial holding company's consolidated assets, is an extremely high limit, differs from the complementary authority limit of 5% of the financial holding company's Tier I capital, and significantly exceeds the 3% Tier I capital limit in the Volcker Rule for asset management investments. That high statutory limit does not preclude the Federal Reserve from setting a lower regulatory limit to ensure the safe and sound operation of financial holding companies. In addition, as recommended earlier, the proposed rulemaking should consider how to coordinate the limit placed on physical commodity holdings from grandfathered activities with the limits that now apply to physical commodity holdings under the Gramm-Leach-Bliley complementary and merchant banking authorities, so that financial holding companies can operate under a single, integrated limit that applies to all of their physical commodity activities. That integrated limit could then be made a condition of the financial holding company's engaging in any grandfathered activities.

A second set of prudential safeguards should impose additional capital and insurance requirements, as discussed earlier, for physical commodity activities undertaken in connection with the grandfather clause. In addition, the rulemaking should propose more detailed reporting obligations to ensure that the Federal Reserve is fully aware of all physical commodity activities undertaken by a financial holding company on the basis of the grandfather clause and so that the Federal Reserve can exercise adequate oversight of those activities to prevent undue risks and unsafe or unsound practices.

Thank you for the opportunity to submit these comments.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations