Appendix C – Thematic Discussion of ANPR Comment Letters

What Physical Commodities Activities are "Complementary" to Financial Activities?

As might be expected, on the key question of whether physical commodities activities continued to be "complementary" to financial activities, there were a range of views. The letter of Senators Sherrod Brown and Elizabeth Warren argued that the current range of FHC physical commodities activities exceeded the intent of Congress in enacting the GLB Act; similarly, Public Citizen's letter argued that all commodities are subject to catastrophic risk, and therefore no FHC physical commodities activities should be viewed as "complementary." Occupy the SEC took the position that many members of Congress that voted for the GLB Act were under the impression that "complementary" activities were "limited to innocuous activities such as publishing travel brochures" and that the Federal Reserve had significantly and inappropriately expanded the "complementary" concept. Comment letters of The Other 98%, Better Markets, and Americans for Financial Reform took similar positions.

Letters of the banking industry and customers of FHCs, by contrast, took the position that all of the physical commodities activities currently engaged in by FHCs were complementary. The letter of the Securities Industry and Financial Markets Association (SIFMA) contended that "[t]here has been no change to the business of [C]omplementary Commodities Activities, or the financial activities they support and complement" that would change the rationale of the Federal Reserve's Section 4(k) orders. Notably, many end-users' comment letters argued that FHCs' current activities were all a form of permissible financial intermediation.

In his letter, Senator Carl Levin took an intermediate position: he recommended that the Federal Reserve adhere to its prior view that making or taking delivery to a commodity in connection with settling a derivatives transaction was "complementary" to the financial activity of engaging in the derivatives contract, but that engaging in spot transactions that had no direct link to settling a derivative transaction, and energy tolling and energy management activities, should each be deemed a commercial activity and therefore impermissible for FHCs.

Some commenters also criticized the Federal Reserve's application of the "public benefits" test in its Section 4(k) physical commodities orders.[1] Americans for Financial Reform stated that the test should focus on "public benefit and safety" and not on "profitability," and that it required "a detailed assessment of whether locating commodity activities within a bank produces genuine economic complementarities that are not associated with the increased leverage made possible by the public liquidity backstop to banks, and are not associated with anti-competitive tying arrangements." Senator Levin similarly argued that the Federal Reserve should take a much harder look than in its prior orders when determining whether the public benefits of permitting particular FHCs to engage in physical commodities activities outweighed adverse effects.

Should the Federal Reserve Impose Heightened Prudential Standards on Complementary Activities?

A range of comments were received on the question of whether the Federal Reserve should impose heightened prudential standards on complementary commodities activities, with critics of the banking industry taking one side of the question, and FHCs and end-users taking the other.

Senator Levin recommended numerous additional limitations and regulations: that there be one overall limit for ***all*** commodities activities, including merchant banking and Section 4(o) activities, and that it be lower than the 5% of Tier 1 capital limit in the Federal Reserve's Section 4(k) orders; that the Federal Reserve exclude certain CFTC-approved commodities from its list of approved commodities; that the Section 4(k) prohibition on owning and operating facilities for extraction, transportation, storage, refining, and distribution of commodities should be extended to activities engaged in under the merchant banking authority and Section 4(o); and that additional capital and insurance requirements should be imposed.

1 12 U.S.C. § 1843(j)(2)(A) (requiring that, in connection with approving a notice to engage in nonbanking and complementary activities, "the [Federal Reserve] shall consider whether performance of the activity by a bank holding company or a subsidiary of such company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such 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.").

More intrusive restrictions were suggested by, for example, The Other 98%, which advocated for – if physical commodities activities were not altogether banned – prohibiting the use of the Federal Reserve Act's emergency lending authority for any FHC conducting commodities activities; having the Environmental Protection Agency and Federal Energy Regulatory Commission (FERC) review the resolution plans of such FHCs; revoking the physical commodities authority of any FHC that failed a Dodd-Frank stress test; imposing super-capital requirements (15% regulatory capital to assets); prohibiting FHCs from acquiring more than 10% of the voting securities of any company engaged in complementary activities; limiting complementary activities to 5% of an FHC's total revenue; mandating that orders authorizing complementary activities be limited to 3 years in duration and an FHC demonstrate that no risks had materialized from the activity in order to renew the order; and for the creation by the Federal Reserve and FERC of a list of commodities warranting heightened regulatory scrutiny.

Critics of the banking industry also generally argued that the Federal Reserve should require more disclosure of FHCs commodities activities. For example, the Institute for Agriculture and Trade Policy stated that FHCs should submit quarterly independent estimates to the Federal Reserve of all liabilities – environmental, personal injury and death, public health, reputational and legal – associated with the trading, storage and delivery of physical commodities and make annual submissions of their insurance policies. Other commenters noted that the Federal Reserve currently required reporting of the total value of all commodities held on an FHC's balance sheet and recommended a more granular presentation.

By contrast, the industry and several end-users took the position that heightened prudential standards would result in constricted markets with less liquidity. Energy Capital Partners contended that FHCs are already restricted enough with respect to their complementary activities and the risks associated with the commodity sector are different than the risks identified in the ANPR: "[U]nlike the risks associated with banks' financial sector activities, which are systemic in nature, typically highly leveraged and characterized by widespread cross holdings by FHCs, the commodity sector activities are defined more idiosyncratic risk, less leveraged investments where equity investors, not lenders, bear most risk, and primarily single company exposure." SIFMA's comment letter noted that FHCs' activities were already subject to extensive regulation by the FERC and the CFTC with respect to market manipulation and liability under antifraud and antitrust statutes, as well as the recently promulgated Basel III capital requirements, under which, for example, merchant banking investments in non-financial companies were subject to 300% to 400% risk weights.

Finally, although Senator Levin's letter stated that "the costs associated with a catastrophic event are unlikely to be fully covered by even well designed insurance policies," this assertion was disputed in a letter from Aon Risk Solutions, which took the position that catastrophic events resulting from the physical commodities activities in which FHCs were primarily engaged could be appropriately insured against.

<u>Do FHC Commodity Activities Raise Inherent Conflicts of Interest?</u>

On the question of conflicts of interest, critics of the banking industry were fairly uniform in their view that physical commodities activities presented inherent conflicts of interest. Public Citizen, for example, focused on what it saw as an information advantage that FHCs obtain from participation in the spot commodities markets, which it claimed leads to FHCs being able to profit improperly in transactions with their clients, a view shared by Senators Warren and Brown. The comments letters of The Other 98% and Better Markets made similar claims, focusing on information advantages in the derivatives markets and deriving from the ownership of warehouses.

In contrast, may end-user letters took the position that they ***preferred*** to transact with FHCs because their information advantages allowed them to design more tailored products that better suited their needs. Banks and their trade groups argued that existing commodities regulations and internal policies and procedures are sufficient to address conflicts of interest, and further asserted that the type of intermediation and merchant banking activities at issue do not present unique conflict risks. Senator Levin's letter urged the Federal Reserve to be aware of the potential for market manipulation and focus on conflict of interest issues when acting on complementary activities applications under Section 4(k).

Can the Dangers to Particular FHCs Arising From Environmental Liability Be Controlled?

The potential for risk to FHCs from environmental liability seems to have been a principal animating factor of the ANPR, which mentioned commodity-related disasters going back to 1910. On this subject, critics of the banking industry maintained a focus on the potential for catastrophic harm, mentioning certain commodities activities in particular, such as the transport and storage of oil. Occupy the SEC argued that it was not appropriate for FHCs to engage in "activities that could cause pollution impacts that the federal government might be responsible for remediating under CERCLA," viewing this government cleanup responsibility as an undue governmental subsidy. Like the ANPR itself, however, the banking industry's critics do not cite to any particular environmental event that has caused a loss to an FHC. Nor do they provide concrete evidence that corporate separateness would not be respected if an FHC commodities subsidiary suffered losses.

It was on the topic of corporate veil-piercing that the banking industry focused its attention¸ presenting a study by four law firms. The study made the following points: although an extensive body of environmental statutes and regulations allocates liability for environmental incidents, the parties generally responsible for damages include the owner and operator of the facility from which the release occurred, and the parties that directly handle the commodity. Liability does not generally attach to an entity that only owns a commodity that is released or that enters into ordinary course contracts for transportation and storage, or to an entity that invests in a business that is engaged in the activity that causes the release. Investors in operating companies generally are not liable for environmental damages unless they become involved in the environmental affairs of the operating company, or so dominate and control the operating company that the two are "alter egos" under common law principles. The corporate separateness doctrine, therefore, shields investors that own or operate facilities that handle environmentally sensitive commodities from liability as long as those investors adhere to appropriate managerial guidelines.

Certain end-users also took issue with the assertion of potential harm, noting, for example, that none of the disasters mentioned in the ANPR had noticeably affected the financial industry.

On the subject of the appropriate level of insurance, the comment letter of Aon Risk Solutions took issue with the premise that environmental harm could not be insured against. It contended that "in practical terms, commodity trader risk [generally] involves the transport or storage of commodities. The size of one exposure loss does not come close to the size of exposures in an offshore oil well," such as Deepwater Horizon. Aon also took the position that commodity traders were fully able to protect their exposures arising from chartering, storing and transporting commodities under existing insurance arrangements.

Do Physical Commodities Activities Threaten Systemic Risk?

The debate on environmental risk carried over into the discussion of whether FHC commodities activities threaten systemic risk. Critics of the banking industry relied on the arguments that environmental risks were wide-ranging in nature and unpredictable in potential severity, and therefore by significantly destabilizing one FHC, they could destabilize the financial system through contagion. Occupy the SEC, for example, stated that the environmental, reputational, price and financial system risks of physical commodities activities "are not ones that a system of additional or revised prudential requirements such as insurance, capital requirements, or trading volume limitation requirements can entirely prevent." Professor Saule Omarova of the University of North Carolina Law School argued that it is inappropriate "to den[y] legitimacy to prospective, preventative regulation" on the ground that no connection between commodities activities and systemic risk had yet been shown.

These assertions were disputed by a number of end-users and the banking industry itself, each of which argued that the risks posed by FHC commodity activities were no different than those posed by other financial activities, and could be mitigated by existing rules and policies and procedures. SIFMA's comment letter presented the ORX Report on Operational Risk Loss Data, which stated that, between 2006 and 2011, for operational risk loss events relating to "Disasters and Public Safety," 66 U.S. and non-U.S. banking organization members incurred aggregate operational losses of EUR 337 million. The letter argued that this amount – which was certainly far from suggesting a potential for systemic risk – may actually have overstated environmental losses.

Should the Federal Reserve Place Prudential Limits on the Section 4(o) Authority?

As they had with Section 4(k)'s complementary authority, critics of the banking industry advocated for significant prudential restrictions on the legal authority contained in Section 4(o) of the BHC Act. Senator Levin, for example, stated that the Federal Reserve should interpret Section 4(o) in a manner that clarified that it authorized only those activities for Goldman Sachs and Morgan Stanley that were being conducted both in September 1997 and when they became FHCs in 2008. He also suggested imposing an overall limit on an FHC's physical commodities activities, which would be narrower than the 5% of total assets limitation contained in Section 4(o) itself. Senators Brown and Warren, and Public Citizen, called for both a narrow statutory interpretation and the imposition of heightened standards like capital requirements.

In response, the SIFMA comment letter noted that Section 4(o) itself included its own prudential requirements that had been imposed by Congress, and that the considerations justifying maintaining current regulatory practice with respect to Section 4(k)'s complementary authority applied with equal force to Section 4(o). Morgan Stanley noted that the common element that should apply to all physical commodities activities and investments is that such activities and investments be conducted in a safe and sound manner through a robust risk management framework that focuses on all significant categories of risks that the activities pose.

Should the Federal Reserve Limit Merchant Banking Holding Periods and Further Restrict FHC Management of Merchant Baking Portfolio Companies?

The banking industry and its critics similarly diverged on the question of imposing additional restrictions on merchant banking investments in portfolio companies engaged in physical commodities activities. Senators Brown and Warren expressed concern that FHCs would use the merchant banking authority to evade restrictions on commodities activities, and Senator Levin argued that the holding period for merchant banking investments (10 years, or up to 15 years, if made by a qualifying private equity fund) should be shortened and that the Federal Reserve should revisit its interpretations on what constituted routine management and operation of portfolio companies. Public Citizen's letter called for increased capital requirements. Professor Omarova advocated enhancing the reporting and monitoring of merchant banking investments, particularly in the energy and commodities sectors. The Other 98% stated that FHCs should be permitted to make only passive no-more-than 5% voting share investments in commercial companies.

SIFMA's comment letter responded that there was no evidence that merchant banking investments in commodities companies posed materially different risks that investments in other non-financial companies, and emphasized that current risk management practices were well designed to avoid liability under veil piercing doctrines. Although it did not believe that enhanced reporting requirements for merchant banking investments were warranted at this time, the SIFMA letter did state that if the Federal Reserve found additional reporting useful, expanding the use of certain reports would not be objectionable. Wells Fargo added that, in its view, shortening the 10-year merchant banking holding period would increase, rather than mitigate, risk.

Merchant banking was one area in which an FHC did recommend a change from existing practice. Goldman Sachs suggested that during the "exigent circumstances" in which the Federal Reserve permits an FHC to exercise routine management and operation over a portfolio company engaged in physical commodities activities, the FHC be required to engage a third-party to assume operational responsibility for environmental matters and day-to-day control over facilities that could have environmental effects. In this way, the FHC would be better insulated from corporate veil-piercing claims.

What Would Be the Effects on the Commodities Markets Themselves From New Restrictions?

The end-user community spent the most time commenting on the effects on the commodities markets themselves from new restrictions on FHC commodity powers. Comment letters came from a large and diverse cohort, which included county public utility districts, an independent wholesale power company, an electric company, United Parcel Service, the National Association of Corporate Treasurers (signed by 15 end-user companies), a terminal developer and operator, oil and gas companies, and trade associations for energy suppliers and other members of the energy industry.

On this subject, end-users generally believed that due to the substantial market-making role played by FHCs to the exclusion of other counterparties, additional restrictions would have substantial negative effects both on their businesses and consumers, including the following:

- an absence of sophisticated financial entities with the ability to customize end-user products;
- fewer well-capitalized and well-rated counterparties;
- fewer publicly traded counterparties with readily available and transparent financial information;
- fewer counterparties available to provide bid and offer prices on multiple commodities;
- fewer counterparties with the ability to enter into long-term transactions and to offer a range of financial solutions – such as loans and hedging transactions; and
- diminished liquidity and greater risk concentration in relevant markets

The end-user community also noted that regulatory considerations independent of the ANPR, such as Basel III capital requirements, had already resulted in a number of FHCs leaving the market, and strongly cautioned the Federal Reserve from taking actions that would result in additional market concentration. They added that certain products that were essential to their businesses, including first-lien hedging arrangements, project financing, volumetric production payment structures, and working capital facilities, were generally not available from non-FHC counterparties. Calpine's comment letter noted that as a result of recent FHC departures, the California physical energy markets had experienced noticeably reduced liquidity at several key delivery points. Most end-users also asserted that additional restrictions on FHCs participation in the commodities markets would result in greater costs to consumers.

Certain letters from industry critics, however, also took the position that even if restricting FHCs from the commodities markets would result in less competition and decreased liquidity, these negative consequences were outweighed by public benefits such as decreased risk to FHCs and the financial system generally. In addition, some end-users called attention to negative effects in the market for aluminum that they believed derived from FHC ownership of warehouses, particularly London Metals Exchange warehouses.

<u>What is the Danger of FHC Commodity Roles Being Taken Over By Shadow Market Players?</u>

A second, consistent end-user theme was a distinct lack of comfort with the possibility of being forced to engage in commodities transactions with less-regulated, and in some cases, non-U.S., alternatives to FHCs. End-users stated that they generally preferred to transact with entities that were subject to comprehensive, consolidated supervision by the Federal Reserve, in addition to CFTC and FERC regulation, because they saw Federal Reserve supervision generally resulting in better capitalized and financially stable counterparties. End-users indicated further that they are comfortable transacting with FHC counterparties in part because of the existing relationships they have. These relationships allow end-users to better assess the credit quality of their counterparties, which they would not have the capacity to do with, for example, multiple, unfamiliar counterparties transacting in physical commodities.

Senators Brown and Warren offered a contrary view, that an increased role for "shadow" players should not be a significant concern. They argued that the CFTC retained its authority to police fraud and manipulation in the commodities markets, and if the activities of shadow players create systemic risk, the Financial Stability Oversight Council has the authority to designate such players as systemically significant – at least with respect to such players' U.S. operations. Professor Omarova stated that the advantages FHCs possess as a result of Federal Reserve regulation are also due to subsidies deriving from their Too-Big-To-Fail status.