United States Senate
WASHINGTON, DC 20510

April 16, 2014

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

Re: Docket No. R-1479, RIN 7100 AE-10; Complementary Activities, Merchant Banking, and Other Activities of Financial Holding Companies Related to Physical Commodities

Dear Mr. deV. Frierson:

We appreciate the opportunity to comment on the Board of Governors of the Federal Reserve System's (the Board) Advance Notice of Proposed Rulemaking (ANPR) on the Bank Holding Company Act (BHCA) provisions enabling Financial Holding Companies (FHCs) to engage in various commercial activities. Our letter outlines the significant concerns associated with FHCs' expansion into activities that are commercial in nature, particularly their ownership of assets involved in the extraction, transportation, storage, and distribution of commodities and energy. We are concerned that commercial commodities and energy activities expose Board-regulated financial institutions to unprecedented and unmanageable financial, legal, environmental, and reputational risks.

The Banking, Housing, and Urban Affairs' Subcommittee on Financial Institutions and Consumer Protection (FICP) held two hearings on this issue.[1] The FICP Subcommittee's hearings identified a number of regulatory challenges and safety and soundness risks associated with FHCs' involvement in physical commodities and energy markets. Witness testimony discussed the important policy justifications for maintaining a legal separation between banking and commerce under the BHCA, identified potential safety and soundness risks associated with FHCs' direct ownership of physical commodity assets, and outlined the legal and regulatory context behind the erosion of the legal wall separating banking and commerce over the last two decades.

I. FHCs' Non-Financial Activities Have Expanded Significantly, Exceeding the Original Intent of Congress

FHCs' involvement in physical commodities has increased significantly since 2007, in part as a result of mergers and acquisitions of commodities assets by existing bank holding companies (BHCs), and securities firms becoming BHCs overnight during the financial crisis. At the time that Congress considered the Gramm-Leach-Bliley Act (GLBA) amendments to the BHCA, industry justified its expansion into commercial activities using the example of providing a travel

[1] Information related to the first hearing can be found here: http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=0e55dd8e-8589-4120-8c3e-2c6dc95f7f40; information related to the second hearing can be found here: http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=cca72cb5-a8fd-427a-978a-a51140a75cb0.

and food magazine along with a high-end credit card membership.[2] Since GLBA's passage, however, FHCs have expanded into activities that were not debated at the time, and may not have been intended by the law's authors.[3]

The Board issued its first order in 2003, when Citigroup received approval to engage in physical commodities trading as a "complementary activity."[4] Citigroup required the Board's approval for its oil- and gas-trading subsidiary Phibro, Inc., which it acquired in the 1998 merger between Citicorp and Travelers.[5]

In 2005, JPMorgan Chase & Co. (JPMC) received authority from the Board to engage in complementary activities, with restrictions upon its ability to extract, transport, store, process, and refine commodities.[6] In July 2010, JPMC bought Royal Bank of Scotland (RBS)-Sempra's global oil, global metals, and European power and gas businesses.[7] As part of its Sempra deal, JPMC acquired control of Henry Bath, a UK-based metals warehousing company that owns and operates one of the largest London Metal Exchange (LME)-approved global metal storage networks.[8]

Some current FHCs began buying power plants in the wake of the collapse of the energy trading firm Enron.[9] Others acquired their energy trading units as a result of more recent mergers.[10] These acquisitions resulted in FHCs' power trading units buying and selling electricity rights. In

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[2] *See* Saule Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265, 287 (2013)(" The industry's frequent references to Travel & Leisure and Food & Wine magazines effectively framed the congressional debate on 'complementary' activities as a debate about relatively low-risk, low-profile activities, such as publishing and financial data dissemination. In reality, however, the possibility of having a flexible, undefined statutory category of permissible commercial activities was especially attractive to financial institutions seeking to take advantage of the dot-com boom and potentially expand into far riskier Internet ventures.").

[3] *See* Matt Taibbi, *The Vampire Squid Strikes Again: The Mega Banks' Most Devious Scam Yet*, ROLLING STONE, Feb. 27, 2014 ("Moreover, [Congressman Jim] Leach was shocked to hear that regulators had pointed to this section of a bill bearing his name as the legal authority allowing banks to gain control over physical-commodities markets. 'That's news to me,' says the mortified ex-congressman, now a law professor at the University of Iowa. 'I assume no one at the time would have thought it would apply to commodities brokering of a nature that has recently been reported.'").

[4] *See* Order Approving Notice to Engage in Activities Complementary to a Financial Activity, Oct. 2, 2003 available at http://federalreserve.gov/boarddocs/press/orders/2003/20031002/attachment.pdf.

[5] *See id.* Citi sold Phibro to Occidental Petroleum in 2009. *See* David Enrich, Ben Casselman & Deborah Soloman, *How Occidental Scored Citi Unit Cheaply*, WALL ST. J., Oct. 12, 2009 available at http://online.wsj.com/news/articles/SB125509326073375979.

[6] *See* Order Approving Notice to Engage in Activities Complementary to a Financial Activity, Nov. 18, 2005 available at http://federalreserve.gov/boarddocs/press/orders/2005/20051118/attachment.pdf.

[7] *See* Press Release, J.P. Morgan Completes Commodities Acquisition from RBS Sempra, Jul. 1, 2010, available at https://www.jpmorgan.com/cm/cs?pagename=JPM_redesign/JPM_Content_C/Generic_Detail_Page_Template&cid=1277505237241.

[8] *See id.* Last month, JPMC announced plans to sell its commodities ownership and trading business to the trading firm Mercuria. *See* Press Release, J.P. Morgan Announces Sale of Its Physical Commodities Business to Mercuria Energy Group Limited, Mar. 19, 2014, available at https://www.jpmorgan.com/cm/cs?pagename=JPM_redesign/JPM_Content_C/Generic_Detail_Page_Template&cid=1394963095027&c=JPM_Content_C.

[9] *See* David Sheppard, Jonathan Leff & Josephine Mason, *Wall Street, Fed Face Off Over Physical Commodities*, REUTERS, Mar. 2, 2012 available at http://www.reuters.com/article/2012/03/02/us-fed-banks-commodities-idUSTRE8211CC20120302.

[10] *See* Dan Fitzpatrick, Rebecca Smith & Ryan Tracy, *J.P. Morgan Staring at Record Fine Over Energy*, WALL ST. J., July17, 2013, http://online.wsj.com/article/SB10001424127887323993804578611940638603204.html.

2007, the Board granted RBS' request to engage in complementary activities, for the first time allowing an FHC to engage in "energy tolling" arrangements – long-term energy supply contracts with large-scale commercial and industrial energy users.[11] In 2008, JPMC acquired a network of electric power generating facilities owned by Arroyo Energy Investors L.P., a subsidiary of the failing investment bank Bear Stearns.[12]

Physical commodity-based exchange-traded funds (ETFs) are trusts that invest in commodities and list their shares for purchase on regulated exchanges. The Securities and Exchange Commission (SEC) has approved JPMC's application for a copper ETF with the capacity to hold 61,800 tons for copper, equal to 27 percent of the copper held in the LME warehouse network.[13] JPMC announced that it would store the physical copper backing its ETF at a Henry Bath-owned warehouse.[14]

In 2008, the Board approved the applications of investment banks Goldman Sachs and Morgan Stanley to convert into BHCs.[15] Both institutions elected to become FHCs. Because Goldman Sachs and Morgan Stanley became BHCs after 1999, and were engaged in the trading, sale, or investment in physical commodities and assets prior to 1997, both institutions are eligible for an exemption for grandfathered activities under the BHCA.[16]

As investment banks, Goldman Sachs and Morgan Stanley had operated outside of the BHCA's structure and were actively engaged in the production, processing, transportation, storage, and trading of a wide range of physical commodities. Goldman Sachs' commodities trading business began in 1981 when it acquired J. Aron & Co., which at the time specialized mostly in trading futures and options on precious metals and coffee.[17] In February 2010, Goldman Sachs bought Metro International LLC, a privately owned global network for LME-approved warehouses with domestic facilities in Detroit, Michigan.[18] Goldman Sachs stated Metro would continue to operate independently, keeping its name, management, and Detroit headquarters, where a majority of domestic aluminum stockpiles are stored.[19] In September 2006, Morgan Stanley had

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[11] *See* Order Approving Notice to Engage in Activities Complementary to a Financial Activity, Mar. 27, 2008 available at http://www.federalreserve.gov/newsevents/press/orders/orders20080327b1.pdf.

[12] *See* Sheppard, Leff & Mason, *supra.*

[13] *See* Emiko Terazonon, *SEC Approves JPMorgan Copper ETF*, FINANCIAL TIMES, Dec. 17, 2012 available at http://www.ft.com/intl/cms/s/0/01525174-482e-11e2-8aae-00144feab49a.html.

[14] *See* Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change as Modified by Amendment No. 1 to List and Trade Shares of the JPM XF Physical Copper Trust Pursuant to NYSE Arca Equities Rule 8.201, Dec. 14, 2012 *at* 10-11, available at http://www.sec.gov/rules/sro/nysearca/2012/34-68440.pdf.

[15] *See* Order Approving Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities – Morgan Stanley, Sept. 22, 2008 available at http://www.federalreserve.gov/newsevents/press/orders/orders20080922a2.pdf; *see also* Order Approving Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities – Goldman Sachs, Sept. 22, 2008 available at http://www.federalreserve.gov/newsevents/press/orders/orders20080922a1.pdf.

[16] *See* 12 U.S.C. § 1843(o).

[17] *See* Sheppard, Leff & Mason, *supra.*

[18] *See* Nick Trevethan, *Goldman to Buy LME Warehouse Firm Metro*, REUTERS, Feb. 18, 2010, available at http://www.reuters.com/article/2010/02/19/us-goldman-metro-idUSTRE61I0ZH20100219.

[19] *See* Blas, *supra*, note 9. It has also been reported that Goldman Sachs is exploring selling its Metro warehouse. *See* Josephine Mason & David Sheppard, *Goldman Explores Sale of Metro Metals Warehouse Business*, REUTERS, Apr. 11, 2013 available at http://www.reuters.com/article/2013/04/11/us-goldman-metro-idUSBRE93A0IO20130411.

acquired TransMontaigne Inc., an oil-products transportation and distribution company, and Heidmar, a tanker operator.[20]

Goldman Sachs has also engaged in a variety of natural resources extraction, refining, storage, and transport. Through companies that it owned, Goldman Sachs purchased Colombian coal mines.[21] Its wholly owned subsidiary Colombia Natural Resources owns its own port and invested in a joint venture in a Colombian railroad company.[22] At one time, Goldman also owned a 19 percent interest in the pipeline provider Kinder Morgan.[23] Goldman Sachs also owns a unit that trades uranium and holds a $200 million stockpile of yellowcake uranium, though it has reportedly been put up for sale.[24]

II. FHCs' Non-Financial Activities Present Risks to the Institutions, Financial Markets, and the Financial System

The risks associated with, and liability arising from, FHCs engaging in commercial activities are wide-ranging in nature and unpredictable in their potential severity. Some FHCs may feel confident in their ability to survive either the financial damage from a catastrophic event, or the legal liability arising from risky or illegal acts. However, the outcome of such scenarios depends upon a specific analysis of the laws and the facts involved. This inherently exposes FHCs to risk and potential liability that could have profound effects upon the safety and soundness of financial institutions that rely upon a federal "safety net" because financial markets are viewed as more fragile than other industries.[25]

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[20] *See* Sheppard, Leff & Mason, *supra.* Morgan Stanley recently sold its oil trading unit to the Russian energy group Rosneft, including a variety of storage and shipping contracts, physical inventory, and a 49 percent stake in the oil tanker company Heidmar. *See* Gregory Meyer & Tom Braithwaite, *Rosneft Expands Oil Trading Arm with Morgan Stanley Deal*, FINANCIAL TIMES, Dec. 20, 2013 available at http://www.ft.com/intl/cms/s/0/55fec948-69a5-11e3-aba3-00144feabdc0.html. Morgan Stanley is also reportedly exploring selling its ownership interest in the oil terminal and transport company Transmontaigne. *See* Jonathan Leff & Michael Erman, *As Fed Looms, Morgan Stanley Sets Sale of U.S. Oil Terminal Business*, REUTERS, Dec. 11, 2013 available at http://www.reuters.com/article/2013/12/11/us-morganstanley-transmontaigne-sale-idUSBRE9BA16320131211.

[21] *See* Ajay Kamalakaran, *Coalcorp to Sell La Francia Mine to Goldman Unit*, REUTERS, Jan. 7, 2010 available at http://www.reuters.com/article/2010/01/07/coalcorp-idUSSGE6060ED20100107; *see also* Reese Ewing, *Vale Sells Colombia Coal Mines to GS-led Group*, REUTERS, May 28, 2012 available at http://www.reuters.com/article/2012/05/29/vale-coal-idUSL1E8GS0I520120529.

[22] *See* Peter Murphy, *Goldman Sachs Miner Halts Coal Exports from Colombia*, REUTERS, Jan. 9, 2014 available at http://www.reuters.com/article/2014/01/09/us-colombia-coal-cnr-exclusive-idUSBREA081CO20140109.

[23] *See In re El Paso Corporation Shareholder Litigation*, Civ. No. 6949-CS, Feb. 29, 2012 at 1, available at http://courts.delaware.gov/opinions/download.aspx?ID=169880.

[24] *See* David Sheppard, *Goldman Puts "For Sale" Sign on Iran's Old Uranium Supplier*, REUTERS, Feb. 11, 2014 available at http://www.reuters.com/article/2014/02/11/goldman-uranium-idUSL2N0LC0ZV20140211; *see also* Michael Moore, *Goldman Sachs Said to Seek Buyer for Uranium Unit*, BLOOMBERG, Nov. 22, 2013 available at http://www.bloomberg.com/news/2013-11-22/goldman-sachs-said-to-seek-buyer-for-uranium-unit.html.

[25] *See, e.g.*, Remarks by Paul A. Volcker Before the Statutory Congress of the European People's Parties, Bonn, Germany, Dec. 9, 2009 ("One consistent response has been to protect and support national commercial banking systems with a combination of regulation and a so-called 'safety net', including deposit insurance and a central bank able and willing to serve as a 'lender of last resort'. The central idea is to provide liquidity to troubled but solvent institutions while protecting individual depositors.").

A. Commercial Activities Create the Potential for Manipulation, Conflicts of Interest, Market Distortions, and Other Anticompetitive Behavior

Observers have raised concerns that FHCs' commercial activities create the potential for anti-competitive behavior – both in the financial markets and in the allocation of resources in commercial industries.[26]

The expansion of FHCs into physical commodity and energy operations received a great deal of attention when aluminum consumers voiced concerns that ongoing market irregularities in LME-regulated aluminum warehouses could be driving up aluminum prices.[27] Similar concerns have been raised by end users in the zinc markets.[28] Germany's top financial regulator raised concerns about manipulation in the gold and silver markets.[29] The European Union is investigating potential manipulation of benchmarks in the oil trading markets.[30]

In recent months, there have been concerns raised about manipulation in various commodities markets. The Federal Energy Regulatory Commission (FERC), the independent agency that regulates interstate transmission of electricity, natural gas, and oil, has accused several large FHCs of energy market manipulation.[31]

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[26] *See* Omarova, 98 MINN. L. REV. at 276 ("Traditionally, one of the key policy concerns in this area has been the prevention of potential conflicts of interest. Affiliation with commercial companies may create powerful incentives for banks to make important lending decisions on the basis of such decisions' potential impact on their commercial affiliates' financial condition or profitability. Price discrimination, unfair restriction of access to credit, and other anti-competitive banking practices may not only hurt the individual commercial companies not affiliated with banks, but also significantly undermine a nation's economic productivity and growth. To date, empirical research has not produced definitive evidence either to support or to defeat this argument. As a plausible prudential policy concern, however, it remains an important factor.").

[27] *See* David Kocieniewski, *A Shuffle of Aluminum, But to Bank, Pure Gold*, N.Y. TIMES, Jul. 20, 2013, available at http://www.nytimes.com/2013/07/21/business/a-shuffle-of-aluminum-but-to-banks-pure-gold.html. There have also been concerns raised that some warehouse companies have de-listed their LME warehouses, and that a significant portion of the world's metal supply is shifting to "shadow warehouses" not affiliated with any exchange, frustrating efforts to curb these alleged abuses. *See* Agnieszka Troszkiewicz, *JPMorgan's Henry Bath Delists 21 LME Storage Units Worldwide*, BLOOMBERG, June 27, 2013 available at http://www.bloomberg.com/news/2013-06-27/jpmorgan-s-henry-bath-delists-21-lme-storage-units-worldwide.html; *see also* Tatyana Shumsky, *Millions of Tons of Metals Stashed in Shadow Warehouses*, WALL ST. J., Dec. 26, 2013 available at http://online.wsj.com/news/articles/SB10001424052702304244904579276830893405644.

[28] *See* Eric Onstad, *Scramble For Zinc Finance Deals Drives Sharp Drop In Stocks*, REUTERS, May 13, 2013 ("Zinc, like aluminium, has been hit by long backlogs at LME warehouses due to LME rules that allow warehouse operators to release much less material per day than they take in. The lack of readily available metal has boosted premiums - the amount paid over the LME cash price for physical metal.") available at http://uk.reuters.com/article/2013/05/13/zinc-inventories-idUKL6N0DU26020130513.

[29] *See* Karin Matussek & Oliver Suess, *Metals, Currency Rigging is Worse Than Libor, Bafin Says*, BLOOMBERG, Jan. 17, 2014, available at http://www.bloomberg.com/news/2014-01-16/metals-currency-rigging-worse-than-libor-bafin-s-koenig-says.html.

[30] *See* Justin Scheck & Jenny Gross, *Traders Try to Game Platts Oil-Price Benchmarks*, WALL ST. J., June 19, 2013, available at http://online.wsj.com/news/articles/SB10001424127887324682204578517064053636892.

[31] *See* Fitzpatrick, Smith & Tracy *supra*; *see also* Press Release, FERC Approves Market Manipulation Settlement with Deutsche Bank, Jan. 22, 2013 available at http://www.ferc.gov/media/news-releases/2013/2013-1/01-22-13.asp; *see also* Press Release, FERC Orders $453 Million in Penalties for Western Power Market Manipulation, July 16, 2013 available at http://www.ferc.gov/media/news-releases/2013/2013-3/07-16-13.asp#.UenfP23viEg.

Some commodity exchanges require institutions to institute "Chinese walls" between their warehouse companies and trading operations.[32] There is clear evidence that using such measures to prevent conflicts of interest between their commercial investments and other financial activities is useful in theory, but ineffective in practice.[33]

For example, the lawsuit by shareholders of the energy company El Paso against Goldman Sachs arose from conflicts of interest in Goldman's role advising El Paso in its sale to Kinder Morgan, a subsidiary of Goldman Sachs. The court found that Goldman Sachs's Chinese walls were insufficient to prevent actual conflicts.[34] That case resulted in a $110 million settlement.[35]

In other cases – such as JPMC's role as sponsor, trustee, warehouse company, and underwriter of its copper ETF – institutions acknowledge that their conflicts are unavoidable, and disclosure appears to be the best, if not the only, solution.[36]

In another example, LME rules prevent warehouse owners from storing their own metals in their warehouses.[37] However, the parent company of a warehouse owner may store metals in a warehouse owned by one of its subsidiaries. For example, JPMC may store the physical copper backing its copper ETF at a Henry Bath-owned warehouse.[38]

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[32] *See* London Metal Exchange, Notice 11/334, Nov. 17, 2011 available at http://www.lme.com/~/media/Files/Notices/2011/2011_11/11_334_A326_W173_Information_Barriers_Between_Warehouse_Companies_and_Trading_Companies.pdf.

[33] *See* Andrew F. Tuch, *Financial Conglomerates and Information Barriers* 3-4, Washington U. in St. Louis Legal Studies Research Paper No. 13-11-01, Feb. 17, 2014 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2363312.

[34] *See In re El Paso Corporation Shareholder Litigation*, at 12 ("Although it is true that measures were taken to cabin Goldman's conflict (for example, Goldman formally set up an internal 'Chinese wall' between the Goldman advisors to El Paso and the Goldman representatives responsible for the firm's Kinder Morgan investment) – which was actual and potent, not merely potential – those efforts were not effective").

[35] *See* Jef Feeley, *Kinder Morgan's $110 Million El Paso Settlement Approved*, BLOOMBERG, Dec. 4, 2012, available at http://www.bloomberg.com/news/2012-12-03/kinder-morgan-s-110-million-el-paso-settlement-approved.html.

[36] *See* Amendment No. 5 to Form S-1, JPM XF Physical Copper Trust, July 12, 2011 *at* 87 ("The Sponsor has not established formal procedures to resolve potential conflicts of interest with shareholders. Consequently, investors may be dependent on the good faith of the respective parties subject to such conflicts to resolve them equitably. Although the Sponsor attempts to monitor these conflicts, it is extremely difficult, if not impossible, for the Sponsor to ensure that these conflicts do not, in fact, result in adverse consequences to the Trust.") available at http://www.sec.gov/Archives/edgar/data/1503754/000095010311002761/dp25142_s1a.htm.

[37] *See* London Metal Exchange Warehouse Agreement § 1.5.2 ("A Warehouse may not deal directly or indirectly in Contracts, and shall observe such other requirements contained in any Exchange notice relating to the separation of Warehouses from Members and the maintenance of confidentiality in respect of price sensitive and customer confidential information.") available at http://www.lme.com/~/media/Files/Warehousing/Warehouse%20consultation/Proposed%20revised%20Warehouse%20Agreement.pdf.

[38] *See* Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change as Modified by Amendment No. 1 to List and Trade Shares of the JPM XF Physical Copper Trust Pursuant to NYSE Arca Equities Rule 8.201, Dec. 14, 2012 at 10-11, available at http://www.sec.gov/rules/sro/nysearca/2012/34-68440.pdf. JPMorgan Chase's copper ETF has the capacity to hold 61,800 tons for copper, equal to 27 percent of the copper held in the LME's warehouse network. *See* Emiko Terazonon, *SEC Approves JPMorgan Copper ETF*, FINANCIAL TIMES, Dec. 17, 2012 available at http://www.ft.com/intl/cms/s/0/01525174-482e-11e2-8aae-00144feab49a.html.

All of these issues arise at a time when both the London Interbank Offering Rate (LIBOR) and foreign exchange markets are being manipulated.[39] Indeed, regulators may have known about these harmful and anticompetitive practices and failed to act – in some cases they may even have condoned them.[40] Regulators should not repeat such oversights in the commodities markets.

Institutions' physical commodities activities have also been compared to their packaging, dealing, and proprietary investing activities related to mortgage securities.[41] One observer noted that these conflicts "were not managed so well by the regulators."[42] It should go without saying that allowing financial institutions to repeat the sort of behavior that gave rise to the 2007-08 financial crisis should be unacceptable to regulators, Congress, and the American public.

Finally, the three Federal banking agencies have acknowledged that the perception that some large financial institutions may be "too big to fail" (TBTF) allows them to fund themselves at lower cost, creating competitive distortions.[43] Several academic studies have sought to calculate the precise borrowing advantages enjoyed by the largest banks, with some estimates exceeding 80 basis points (bps).[44] TBTF institutions may use their funding advantage to gain competitive

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[39] *See, e.g.*, Daniel Schäfer & Sam Fleming, *Forex Probes Set to Dwarf Libor Cases*, FINANCIAL TIMES, Mar. 9, 2014 available at http://www.ft.com/intl/cms/s/0/fb320746-a626-11e3-9818-00144feab7de.html; *see also* Tom Braithwaite & Kara Scannell, *FDIC Sues Banks Over Libor Manipulation*, FINANCIAL TIMES, Mar. 14, 2014 available at http://www.ft.com/intl/cms/s/0/c267c63a-abad-11e3-aad9-00144feab7de.html.

[40] *See* Chiara Albanese, *Fed Looked at Currency Trading in 2012, Didn't Act*, WALL ST. J., March 12, 2014, available at http://online.wsj.com/news/articles/SB10001424052702303546204579435494023302968?mg=reno64-wsj; *see also* Shahien Nasiripour, *Congress Starts Inquiry Into US Libor Links*, FINANCIAL TIMES, July 10, 2012 ("The New York Fed said it received 'occasional anecdotal reports from Barclays of problems with Libor; in 2007. It did not respond to questions about whether it was aware of other institutions having problems with Libor during this period.") available at http://www.ft.com/intl/cms/s/0/3d35e646-ca99-11e1-89f8-00144feabdc0.html; *see also* Suzi Ring, Gavin Finch & Liam Vaughan, *BOE Staff Said to Have Condoned Currency Traders' Conduct*, BLOOMBERG, Feb. 7, 2014 available at http://www.bloomberg.com/news/2014-02-07/boe-staff-said-to-have-condoned-currency-traders-conduct.html.

[41] *See* U.S. Senate, Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions and Consumer Protection, *Examining Financial Holding Companies: Should Banks Control Power Plants, Warehouses and Oil Refineries?*, S. Hrg. 113-67, July 23, 2013 *at* 25 (testimony of Joshua Rosner, Managing Director, Graham Fisher & Co.)("[I]f we think about it more fully, just even looking at the various businesses that come off of this—let us take that mortgage period as an example. So the banks made loans to third-party mortgage originators and they got paid for warehouse lines from those. One distinct business opportunity. They took the mortgages they received. They pooled them, they packaged them, and they securitized them. They sold them to investors. Second distinct line of business. Then they were able to trade them in a secondary market on behalf of those customers. Third income stream. They also were able to trade them on a prop basis. Fourth income stream. They had servicing businesses that they owned and were able to glean informational advantage both in advance of their customers, it turns out, and also for the income streams provided by that servicing.") available at http://www.gpo.gov/fdsys/pkg/CHRG-113shrg82568/pdf/CHRG-113shrg82568.pdf.

[42] *Id.*

[43] *See* Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions*, 78 FED. REG. 51101, 51103 (Aug. 20, 2013) available at http://www.gpo.gov/fdsys/pkg/FR-2013-08-20/pdf/2013-20143.pdf.

[44] *See, e.g.*, International Monetary Fund, Global Financial Stability Report 104, Apr. 2014 (estimating that the largest U.S. banks have a funding advantage of 15 basis points (bps), worth between $15 billion and $70 billion per year) available at http://www.imf.org/External/Pubs/FT/GFSR/2014/01/pdf/text.pdf; *see also* Andrew G. Haldane, Executive Director, Financial Stability, Bank of England, "The $100 Billion Question", Comments at the Institute of Regulation & Risk, Hong Kong, Mar. 30, 2010 at 5; *see also* International Monetary Fund, *A Fair And Substantial Contribution By The Financial Sector: Final Report For The G-20*, June 2010, at 55-56 (estimating that government

advantages over smaller financial institutions, financial institutions that do not have access to the Federal safety net, and nonfinancial institutions trading in these markets. One witness noted that the funding advantage enjoyed by these institutions interferes with competition and the facilitation of price discovery in the commodities markets.[45]

Regulators should be concerned about the integrity of both the financial and commodities markets, when large financial institutions act as dealers, traders, and suppliers of physical goods. They should learn from past experiences and take actions to restore integrity to financial markets and commodities markets by eliminating the view – whether reality or merely perception – that they are "rigged" in favor of a few financial institutions.[46] This dynamic creates safety and soundness concerns because of the significant legal and financial risk for institutions.

B. Commercial Activities Expose Financial Institutions to Other Legal and Reputational Risks

In addition to financial and market risks, FHCs' commodities activities are subject to a variety of geopolitical and other risks that can expose them to both financial and reputational harm. Commodities trading firms are subject to significant non-financial risks, including: 1) geopolitical risks; 2) compliance with various laws and regulations, including bribery and anti-corruption, environmental protection, management and use of hazardous substances and explosives, management of natural resources, licenses over resources owned by various governments, and labor and occupational health and safety standards; 3) environmental hazards; 4) resource unavailability; 5) catastrophic risks from explosions, fire, vandalism, and crime; 6) availability of commodity supplies; and 7) supply chain issues and availability of infrastructure.[47]

The examples of such risks have resulted in minimal damage – for now. Tankers owned by the trading firm Trafigura were intercepted in the Caribbean in 2001 under suspicion of carrying

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support provides "too big to fail" institutions with a funding benefit between 10 and 50 bps, with an average of about 20 bps); *see also* Santiago Carbo-Valverde, Edward J. Kane & Francisco Rodriguez-Fernandez, *Safety-Net Benefits Conferred On Difficult-To-Fail-And-Unwind Banks in the US and EU Before and During the Great Recession*, Paolo Baffi Centre Research Paper Series No. 2011-95, at 9-10 (finding that "too big to fail" banks receive a safety net subsidy between 10 and 22 bps per dollar of assets); *see also* A. Joseph Warburton & Deniz Anginer, "The End of Market Discipline? Investor Expectations of Implicit State Guarantees" 4 (Nov. 18, 2011) (finding that large banks had an annual funding cost advantage of approximately 16 bps before the financial crisis, increasing to 88 bps during the crisis, and peaking at more than 100 bps in 2008); *see also* Dean Baker & Travis MacArthur, *The Value of the "Too Big to Fail" Big Bank Subsidy*, Center for Economic and Policy Research (2009) (estimating that, at the time of the financial crisis, banks with assets in excess of $100 billion had an average borrowing advantage of 78 bps).

[45] *See* S. Hrg. 113-67 at 27 (testimony of Joshua Rosner) ("When you have institutions that have access to the Fed window, and that may well be the basis of their cheaper financing, it is anti-competitive. It prevents Wall Street, and I am talking about investors, I am talking about where price discovery happens, where people buy and sell securities, trying to bring price and value in line. You are distorting the ability of markets to function, and I think that really needs to be front in people's minds here.").

[46] William Alden, *Michael Lewis Views Market as 'Rigged' in Favor of High-Speed Traders*, N.Y. TIMES DEALBOOK, Mar. 30, 2014 available at http://dealbook.nytimes.com/2014/03/30/michael-lewis-views-market-as-rigged-in-favor-of-high-speed-traders/.

[47] *See* GlencoreXstrata, Annual Report 2013 at 18-31, available at http://www.glencorexstrata.com/assets/Investors/GLEN-2013-Annual-Report.pdf.

Iraqi oil.[48] In 2006, Trafigura tankers spilled toxic waste in the Ivory Coast.[49] Goldman Sachs' mining subsidiary Colombia Natural Resources was recently forced to stop exporting coal for 16 to 18 months because it does not comply with a new environmental law meant to ensure that loading procedures prevent coal lumps and dust from contaminating any bodies of water.[50] Goldman's La Francia mine was taken out of commission when it flooded.[51] Some would argue that these institutions have been fortunate to date. The CEO of one FHC reportedly told his employees that the potential for a catastrophe, such as an oil tanker spill is, "a risk we just can't take[.]"[52]

Commodities activities present risks that are different from financial market risks, are idiosyncratic, and have the potential to disrupt more than just the financial system. Global supply chain disruptions can affect industries in the broader economy that rely upon raw materials.[53] For example, a significant amount of commodities activities are conducted in regions that are experiencing political turmoil.[54] Also, by operating in industries like mining, and in countries with troubling human rights records like Colombia,[55] FHCs expose themselves to legal and reputational risk that may be difficult to fully understand, appreciate, and ultimately value.[56] This creates significant safety and soundness concerns.

C. Commercial Activities Present Systemic Risks

The Board says that "there have been a variety of events and developments involving physical commodity activities that suggest that the risks of conducting these activities are changing, and … recent catastrophes accent that the costs of preventing accidents are high and the costs and liability related to physical commodity activities can be difficult to limit and higher than expected."[57] We agree.

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[48] *See* Joshua Schneyer, *Commodity Traders: The Trillion Dollar Club*, REUTERS, Oct. 28 2011 available at http://www.reuters.com/article/2011/10/28/us-commodities-houses-idUSTRE79R4S320111028.
[49] *See id.*
[50] *See* Murphy, *supra.*
[51] *See id.*
[52] Christian Berthelsen & Justin Baer, *Morgan Stanley Scales Down Commodities*, WALL ST. J., Dec. 13, 2013 available at http://online.wsj.com/news/articles/SB10001424052702304173704579264452411520552.
[53] *See* Javier Blas, *Has Glencore Become "Too Big to Fail"?*, FINANCIAL TIMES, Oct. 9, 2012 available at http://www.ft.com/intl/cms/s/0/f3fcf1c8-11e6-11e2-b9fd-00144feabdc0.html.
[54] *See, e.g.,* Danske Bank, "Research Commodities: Ukraine Crisis Puts Commodity Markets on Alert," Mar. 3, 2014 available at http://danskeresearch.danskebank.com/link/ResearchCommodities030314/$file/ResearchCommodities_030314.pdf.
[55] *See* U.S. Office on Colombia, Large-Scale Mining in Colombia: Human Rights Violations Past, Present and Future, May 2013, available at http://www.usofficeoncolombia.org/docs/large-scale-mining-full-report.pdf. In another example, the oil company Exxon Mobil is being sued in the U.S. under the Alien Tort Statute for acts of torture committed in Indonesia between 1999 and 2001. *See* Jonathan Stempel, *Indonesia Torture Case vs. Exxon Mobil Revivied*, REUTERS, July 8, 2011 available at http://www.reuters.com/article/2011/07/08/us-exxonmobil-indonesia-idUSTRE7676I120110708.
[56] In another example of potential reputational risks, Citi's sale of Phibro was reportedly caused in part by a conflict with the Troubled Asset Relief Program's (TARP) Special Master for Compensation over an excessive compensation package owed to one of Phibro's traders. *See* Enrich, Casselman & Soloman, *supra.*
[57] *See* Board of Governors of the Federal Reserve System, Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 3329, 3331 (Jan. 21, 2014) available at http://www.gpo.gov/fdsys/pkg/FR-2014-01-21/pdf/2014-00996.pdf.

Several FICP hearing witnesses raised concerns about the threats that allowing financial institutions backstopped by the Federal government to engage in commercial activities could pose to both individual institutions, and the system as a whole, potentially requiring financial assistance from the Board.[58] The risks are particularly acute when concentrated in large, complex financial institutions – the six largest U.S. banks have a combined 14,420 subsidiaries.[59] Supervising such complex, sprawling institutions is difficult enough when they only engage in financial activities. Permitting them to engage in commercial activities – activities that supervisors are likely less familiar with – multiplies the chances that supervisors will not be able to identify sources of systemic risk.[60] This should be of utmost concern when members of the Board have acknowledged that the largest financial institutions are still TBTF.[61]

III. The Board Has Considerable Authority to Limit Non-Financial Activities

Ambiguities in the GLBA's complementary, merchant banking, and grandfather exemptions have resulted in unnecessarily broad and permissive interpretations of these provisions. The Board should use its legal authority to clarify and narrow its prior interpretations. While some institutions may be exiting various activities, legal and regulatory reforms are still necessary and appropriate because these institutions will continue to engage in the storing and trading of precious metals and other commodities-related activities, some institutions are not leaving the business, and any FHC could elect to return to physical commodities in the future.[62]

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[58] *See* S. Hrg. 113-67 at 20 (testimony of Joshua Rosner)("The problem ends up being that with the backstop of the Federal Reserve, with the backstop of insured deposit regimes through the FDIC, there will always be an ultimate call on the system … [T]he reality is, if we had a catastrophic risk in one of these infrastructure businesses, the counterparty exposure would lead to exactly the same outcome, the calls for more collateral, the risk of contagion, counterparties backing away, liquidity leaving the system, and ultimately the Government being called in to stabilize against the risk of contagion.")

[59] *See* Dafna Avraham, Patricia Selvaggi and James Vickery, *A Structural View of U.S. Bank Holding Companies*, FRBNY ECONOMIC POLICY REVIEW 71, July 2012, available at http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf.

[60] *See* S. Hrg. 113-67 at 8 (testimony of Joshua Rosner)("Appreciate how difficult it is to oversee a bank holding company with $2 trillion in assets and businesses in 160 countries. Now add oil tankers, coal mines, electrical generating plants, and zinc warehouses. As we have seen, even top bank managers cannot keep track of everything a big bank does. Before you know it, $6.2 billion is gone and the reputational damage is irreparable."); *see also id.*, at 8 (testimony of Professor Saule Omarova)("The fact that there are many regulators looking at various aspects of this sprawling enterprise that JPMorgan or Goldman Sachs are becoming does not necessarily mean that, as a whole, as a team, they are looking at the right things. That is the most important issue. We need to be able to say that our regulators are actually capable of overseeing and monitoring these risks and I have serious doubts they can do it.").

[61] *See Fed's Tarullo Says Need More Work on Too-Big-to-Fail Banks*, REUTERS, Feb. 25, 2014 available at http://www.reuters.com/article/2014/02/25/usa-fed-tarullo-banks-idUSL1N0LU1B420140225; *see also* Pedro da Costa, *Fed Nominees Vow to Fight for Recovery*, WALL ST. J., Mar. 12, 2014 ("'At the heart of these broad reforms is the project of ending the practice of protecting creditors and sometimes equity holders of large global financial institutions in extremis—too big to fail. There has been significant progress, but more work is left to do,' Mr. Powell said in his prepared remarks.") available at http://online.wsj.com/article/BT-CO-20140312-708313.html.

[62] *See* Press Release, J.P. Morgan Announces Sale of its Physical Commodities Business to Mercuria Energy Group Limited, Mar. 19, 2014 available at http://investor.shareholder.com/jpmorganchase/releasedetail.cfm?releaseid=833987. The ability of FHCs to trade in the financial equivalents of physical commodities presents additional complexities – for example, some have suggested that one FHC may have used swap arrangements to engage in energy trading during a FERC-imposed energy trading suspension. *See* Lynn Doan, *JPMorgan May Evade Power-Trading Ban With Swaps, ISO Says*, BLOOMBERG, May 10, 2013 available at http://www.bloomberg.com/news/2013-05-10/jpmorgan-may-be-evading-power-trading-ban-with-swaps-iso-says.html.

A. The Board Should Remedy Inadequate Disclosures

Eliciting public comment on the risks and benefits of allowing FHCs to conduct physical commodity activities under the three BHCA provisions is of limited value without meaningful disclosure of these activities.

In his testimony, the Board's Bank Supervision and Regulation Director Mike Gibson cited FR Y-9 reports as the best disclosure of physical commodities holdings, but he acknowledged that they only provide aggregate numbers – they are not broken down by individual commodities. In fact, commodities are reported along with fixed income, derivatives, and other related income, making it even more difficult to track physical commodities specifically.[63] Mr. Gibson also pointed to SEC filings, but 10-Qs and 10-Ks possess the same shortcomings as other reporting requirements.[64]

To better understand the scope and breadth of the FHCs' physical commodity and energy assets, some of our staff reviewed the FR Y-10 *Changes in Organizational Structure* reports filed with the Board to map individual FHCs' physical commodity holdings. In order to generate a complete picture of FHCs' activities one must combine the FR Y-10 filings with the FR Y-6 *Annual Report of Bank Holding Companies*.[65]

While some of the FR Y-10 filings are public, some are not. These filings are not user-friendly, and do not enable the public to gain a meaningful understanding of the scope these activities and associated risks. The Board should develop policies that improve transparency and disclosures that enable the public to engage in this important issue. Currently, the FHC knows what is occurring in this area, and it is the Board's responsibility to make this information accessible to the public. Eliciting input from the public on the appropriateness of these activities is a one-sided exercise, and of limited value, when one party has a full view of its activities but others do not.

The diverse nature of the activities also raises questions about the ability of regulators to comprehensively track activities and markets. Specifically, the diverse nature of commercial activities has been likened to the various and fragmented financial markets in which institutions traded mortgage-related derivatives prior to the financial crisis of 2008.[66] The range and complexity of the activities involved, and the institutions conducting them, requires heightened information sharing and coordination.

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[63] *See* Omarova, *supra*, at 294-95.

[64] For example, the SEC's disclosure requirements for BHCs, known as Guide 3, requires disclosures of Treasuries, agencies, other securities, deposits, and loans, but does not require detailed commodities reporting. *See* Securities & Exchange Comm'n, Industry Guides 6-12 available at https://www.sec.gov/about/forms/industryguides.pdf.

[65] *See* Avraham, Selvaggi & Vickery, *supra*, at 69.

[66] *See* S. Hrg. 113-67 at 25-25 (testimony of Joshua Rosner) ("To suggest that regulators have the ability to manage these is to ignore all of the areas directly related to banking and investment banking businesses that the regulators failed to oversee or manage leading to the crisis. In fact, as I warned in 2006, regulators did not even have access to underlying CDO data, okay, collateralized debt obligation data, and, therefore, could not really look at the underlying collateral or the risks posed to the institutions by those exposures. To expect the regulators to have working knowledge and to expect the regulators to be able to understand the web of relationships that exist here is not rational.").

B. The Board Should Limit the Scope of Grandfathered Activities

Section 4(o) of the BHCA provides a statutory exemption for certain eligible institutions to engage in physical commodities activities and asset ownership. Staff at the Federal Reserve Bank of New York has observed that this provision is "widely seen as ambiguous."[67] Mr. Gibson's written responses to questions for the record of the FICP subcommittee's January 2014 hearing acknowledge that "[t]he scope of section 4(o) of the BHC Act is an issue of statutory interpretation[,]" and that "there are multiple possible interpretations of section 4(o) of the BHC Act."[68] Industry argues that the terms of section 4(o) should allow institutions to engage in all commodities activities if they engaged in any activities whatsoever prior to the applicable date, while the language of the statute could limit eligible institutions to only the particular activities that they were engaged in prior to such date.[69]

While some may argue that the language ties the Board's hands, the statutory scheme appears to provide flexibility.[70] The Board should interpret this provision in as narrow a manner as possible, permitting grandfathered institutions to only engage in the specific activities in which they were engaged prior to 1997. Additionally, in light of the broad exemption that this provision provides, the Board should apply heightened prudential standards to grandfathered activities to ensure that such activities do not pose risks to the institution, its subsidiaries and affiliates, or the financial system more broadly.

C. The Board Should Impose Greater Oversight of Complementary Activities and Merchant Banking Investments

The concerns regarding competition and manipulation, whether real or perceived, highlight the need for regulatory action to limit the scope of permissible commercial activities. The Board can, and should, do more to address these concerns.

1. <u>The Board Should Limit Complementary Activities By Order</u>

The Federal Reserve has issued an estimated 15 orders permitting FHCs to engage in complementary nonfinancial activities.[71] The 2003 Citigroup order stated that the FHC was not authorized to (i) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities; or (ii) process, refine, or otherwise alter commodities.[72]

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[67] Avraham, Selvaggi & Vickery, *supra*, at 68.
[68] Responses of Michael S. Gibson to Written Questions for the Record, Mar. 18 2014 at 10.
[69] *See id.*, at 8-9.
[70] *See* S. Hrg. 113-67 at 31 (testimony of Professor Saule Omarova) ("So while the text of the Gramm-Leach-Bliley Act that created that grandfathering exemption for newly registered bank holding companies after 1999 technically does not require the Fed to approve the use of this particular exemption—on its face, the statute does not do that. However, the same statute also says that within 5 years at the maximum, right, these institutions have to be, in effect, approved by the Fed as being fully in compliance with the Bank Holding Company Act prohibitions on their activities.").
[71] The Board's orders are available at http://www.federalreserve.gov/bankinforeg/legaldevelopments/ordersbhc2013.htm .
[72] *See* Order Approving Notice to Engage in Activities Complementary to a Financial Activity, Oct. 2, 2003 available at http://federalreserve.gov/boarddocs/press/orders/2003/20031002/attachment.pdf.

As part of the complementary exemption, the Board must find that the non-financial activity does not pose a substantial risk to the safety and soundness of depository institutions or the financial system.[73] The Board must also consider whether the activity may 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.[74]

FHC involvement in commodities and energy does not appear to pass these tests. Aluminum users have raised concerns about unusual increases in the price of raw materials that may have been caused by bank-owned warehouse systems.[75] End users of copper have brought a legal challenge to the creation of the JPMorgan copper ETF alleging that "'it will lead to an investor-financed squeeze of the market' for available copper."[76] As one hearing witness testified, "so far, that grand experiment [of allowing FHCs to engage in commercial commodities activities] has gone better for the banks than it has for consumers."[77]

Mr. Gibson has acknowledged that the Board's complementary orders "are specifically conditioned on compliance with all the commitments made in connection with each company's notice to the [Board]."[78] The Board should review all complementary orders and narrow the scope of permissible activities to those which have not been shown to have negative impacts on consumers, end users, and the functioning of commodities markets generally, consistent with section 4(j).

In addition, the Board should either require institutions to conform to their applicable orders, or rescind any orders that have been violated and require violating institutions to reapply for the authority to engage in complementary activities.

2. The Board Should Ensure That Limits on Merchant Banking Are Meaningful

While GLBA does not define merchant banking, it does impose conditions on the merchant banking investments of FHCs to help maintain the separation of banking and commerce and promote safety and soundness.

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[73] *See* 12 U.S.C. § 1843(k)(1).
[74] *See* 12 U.S.C. § 1843(j)(2)(A).
[75] *See* Statement of Tim Weiner, Global Risk Manager, MillerCoors LLC before the Subcommittee on Financial Institutions and Consumer Protections, Senate Committee on Banking, Housing, and Urban Affairs, "Examining Financial Holding Companies: Should Banks Control Power Plants, Warehouses and Oil Refineries?", July 23, 2013 available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9b58c670-f002-42a9-b673-54e4e05e876e; *see also* Statement by North American Die Casting Association before the Subcommittee on Financial Institutions and Consumer Protections, Senate Committee on Banking, Housing, and Urban Affairs, "Regulating Financial Holding Companies and Physical Commodities", Jan. 15, 2014 available at http://www.diecastingdesign.org/newsletter/2014/feb1/lme.pdf.
[76] Matt Day, *Producers Head to Court to Battle J.P. Morgan Copper ETF*, WALL ST. J., Feb. 12, 2013 available at http://online.wsj.com/article/SB10001424127887323511804578300511850210602.html.
[77] *See* Josh Rosner written testimony from July 23, 2013 FICP Subcommittee hearing, available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=cca72cb5-a8fd-427a-978a-a51140a75cb0
[78] Responses of Michael S. Gibson to Written Questions for the Record, Mar. 18, 2014 at 12.

One of the three conditions stipulates that FHCs may not "routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition."[79] This requirement was designed to ensure that FHCs use the merchant banking powers to facilitate their financial intermediation activities, as opposed to involving themselves in the commercial business of the companies in which they invest. However, in practice, FHCs were able circumvent this barrier. One large FHC placed the head of its commodities trading unit, as well as other executives, on the board of its warehouse company subsidiary, which is an example of how permissive the "passive" nature of these relationships can be.[80]

The Board should conduct a thorough review of institutions' merchant banking activities to ensure that they adhere to all statutory and regulatory requirements. Institutions that fail to do so should be penalized using the Board's full civil and criminal penalty authority under section 8 of the BHCA.[81]

Furthermore, some institutions have sought to use merchant banking authority to engage in otherwise impermissible activities or investments.[82] The Board should institute specific safeguards to ensure that FHCs cannot use the merchant banking authority to circumvent the spirit or intent of the law.

3. FHCs Should Be Prohibited from Owning Physical Assets

After speaking with numerous subject matter experts, only one expressed the belief that FHCs' ownership of physical assets provided any particular benefit to customers and end users. As a general matter, FHCs should be prohibited from owning physical assets like warehouses, pipelines, and tankers. These activities pose significant safety and soundness, legal, and reputational risks to institutions.

D. The Board Should Use Its BHCA Authority to Address Systemic Risk

When reviewing use of BHCA provisions, the Board should make use of the full statutory authority that it has been granted by the United States Congress. Under section 5 of the BHCA, the Board may require a BHC to terminate any activities, or terminate control of a subsidiary, if such activity or subsidiary, "constitutes a serious risk to the financial safety, soundness, or stability of a subsidiary bank of the bank holding company and is inconsistent with the sound banking principles or purposes of the BHC Act or the Financial Institutions Supervisory Act of 1966[.]"[83]

It is disconcerting that the Board omitted any discussion of this authority from the ANPR. The risks, stated above and acknowledged by the Board in its own ANPR, are real and significant.

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[79] 12 C.F.R. § 225.171(d)(1).

[80] *See* David Sheppard, *Insight: Wall Street Reshapes Commodities Business to Fend Off Regulation*, REUTERS, July 22, 2103 available at http://www.reuters.com/article/2013/07/22/us-commodities-banks-insight-idUSBRE96L0BY20130722.

[81] *See* 12 U.S.C. § 1847.

[82] *See* David Sheppard & Josephine Mason, *JPMorgan Tried But Failed to Satisfy Fed on Metals Warehousing: Letters*, REUTERS, Nov. 27, 2013 available at http://www.reuters.com/article/2013/11/27/us-jpmorgan-fed-henrybath-idUSBRE9AQ04R20131127.

[83] 12 C.F.R. § 225.4(a)(2).

We urge the Board to take appropriate action to resolve this threat to the safety and soundness of the financial system, and to use sections 5 to fulfill its responsibilities in this area.

E. The Board Should Not Be Concerned That Activities May Migrate to Non-Banks

Some have argued that it is preferable to allow commodities activities and physical asset ownership within the regulated banking system, rather than at more lightly regulated commodities trading houses. This should not be a significant concern. As a general matter, the CFTC maintains authority to police fraud and manipulation in the commodities markets, regardless of the party engaging in such behavior.[84] Should the activities of non-bank commodities trading firms create systemic risk, the Financial Stability Oversight Council (FSOC) has the authority to designate firms or activities as systemic, subjecting them to enhanced prudential regulations.[85] If these tools are insufficient regulators should seek additional authorities, or restrictions on activities, rather than allowing a regulatory race to the bottom among financial institutions and non-financial commodities traders.

Thank you for considering our views on this important matter.

Sincerely,

Sherrod Brown
United States Senator

Elizabeth Warren
United States Senator

[84] The Commodity Exchange Act (CEA) provides the CFTC with authority to monitor the futures and swaps markets, for both on exchange and off-exchange products (including "over-the-counter" (OTC) derivatives). *See* 7 U.S.C. § 2. The CFTC's primary mission is to protect market participants from fraud, manipulation, abusive practices, and systemic risk related to derivatives – both futures and swaps. *See* 7 U.S.C. § 5. CFTC oversight also extends to processing plants or warehouses that have been approved as acceptable to store and deliver commodities against futures contracts by the CFTC-regulated exchanges. *See* 7 U.S.C. § 7(d); 17 C.F.R. § 38.1 *et seq.* In July 2013, then-CFTC Chairman Gary Gensler testified before the Senate Banking Committee that the CFTC is the "market regulator overseeing the commodity futures, swaps markets," and has "clear authority to police markets for fraud, manipulation and other abuses." Cheyenne Hopkins & Silla Brush, *Banks Commodity Business Drawing Sharper U.S. Regulator Scrutiny*, BLOOMBERG, July 30, 2013 available at http://www.bloomberg.com/news/2013-07-29/regulators-face-scrutiny-on-banks-commodities-at-senate-hearing.html. Using this authority, the press reported that the agency issued subpoenas to Goldman Sachs, JPMorgan, and Glencore in August 2013 seeking all documents and communications related to the LME since January 2010. *See* Josephine Mason, *CFTC Subpoenas Glencore, Others as Metals Inquiry Heats Up*, Reuters, Aug. 12, 2013 available at http://www.reuters.com/article/2013/08/12/us-cftc-warehousing-idUSBRE97B04R20130812.

[85] The Dodd-Frank Act empowers the FSOC to monitor potential threats to the financial system and provide for more stringent regulation of bank and nonbank financial companies and financial activities that the FSOC determines, based on consideration of risk-related factors, pose risks to financial stability. *See* P.L. NO. 111-203 § 112. The FSOC is also charged with making recommendations to financial regulators to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading throughout the financial system. *See id.*, at § 120.