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APPROPRIATIONS
BANKING, HOUSING, AND URBAN AFFAIRS
BUDGET
ENVIRONMENT AND PUBLIC WORKS

United States Senate

WASHINGTON, DC 20510

June 8, 2014

Hon. Janet Yellen, Chair
Hon. Dan Tarullo, Governor
Federal Reserve Board
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Advance Notice of Proposed Rulemaking regarding Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities (Docket No. 1479 AND RIN 7100 AE-10)

Dear Chair Yellen and Governor Tarullo:

I appreciate the opportunity to comment on whether our largest, most complex bank holding companies – designated as financial holding companies (FHCs) under the Gramm-Leach-Bliley Act – ought to be able to own, control, transport, or trade in physical commodities like oil, electricity, and metals. The answer, I believe, is simply "no." To the extent, however, that the Federal Reserve Board (the Board) believes it cannot implement a full prohibition, I urge it to protect our financial system from catastrophic risks and dangerous regulatory arbitrage by severely limiting the scope of those activities by our bank holding companies. Moreover, I urge the Board to establish additional protections to reinvigorate the separation between banking and commerce and ensure a fair and competitive market for ordinary commercial enterprises.

Ordinarily, bank holding companies are not permitted to own or control physical commodity assets or companies not engaged in financial services. However, the largest bank holding companies, as FHCs, have asserted their ability to pursue activities involving physical commodities under three separate exemptions: a provision permitting activities that are "complementary" to financial services,[1] merchant banking which is a form of on-balance sheet private equity,[2] and a clause that grandfathers certain firms' commodities activities that were in

[1] Complementary Activities: Section 4(k)(1)(B) of the Bank Holding Company Act (BHCA) allows FHCs to engage in any activity that the Board finds to be "complementary to a financial activity." Activities must produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency. The Board limited the value of all commodities held under this authority, including periodic payments under tolling agreements, to 5 percent of the FHC's tier 1 capital. The Board also prohibited FHCs from holding owning commodity transportation, storage, extraction, or refining facilities under this authority. FHCs must also demonstrate risk-management processes sufficient to support their activities.

[2] Merchant Banking: Section 4(k)(4)(H) of the BHCA allows FHCs to make "merchant banking investments" without prior Board approval, in companies engaged in activities not otherwise permitted for FHCs. However, these

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place prior to September 30, 1997.[3] As other commentators have noted, the original set of activities that were contemplated when those exemptions were adopted were much narrower than what FHCs are now engaged in, calling into question the legal basis for what the Board has permitted.[4] Moreover, new evidence from the financial crisis and afterwards strongly suggests that additional restraints are necessary.

Physical Commodity Activities by Bank Holding Companies Pose Significant Risks To Our Financial Stability and Economy

I am concerned that physical commodity ownership and trading by bank holding companies exposes the entire financial system and economy to significant systemic risks. Commodity activities pose a particular risk for a bank holding company because of the unique vulnerabilities of a bank. Were a major bank holding company to find itself at the center of a catastrophic incident, such as that which occurred off the Gulf Coast in 2010 or at Fukushima, Japan in 2011, the multi-billion dollar liabilities that would arise could easily land the firm in the middle of a run on its funding, a vulnerability that you and other regulatory leaders emphasize our financial system continues to face.[5] Banks and bank holding companies are regulated precisely to limit their exposure to these types of risks because they are so ill-positioned to bear them.[6]

That we should be debating whether our banks ought to be affiliated with the direct ownership of substances capable of extreme environmental disasters or materials with grave national security implications is simply incredible. Because the physical ownership of commodities, even at a small level, can create outsized financial and legal exposure, it seems plain to me that they pose serious and significant systemic risks to the banking system. Because the banking system is the

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investments must be disposed of within 10 years after purchase. The FHC must also not "routinely" manage or operate a merchant banking portfolio company.

[3] Grandfather Clause: Under section 4(o) of the BHCA, a company that was not a BHC and became an FHC after November 12, 1999, may continue to engage in activities for BHCs if the company was engaged in the United States in such activities as of September 30, 1997. This grandfather provision allows these activities up to 5 percent of the company's total consolidated assets.

[4] Better Markets Comment Letter to the ANPR, April 16, 2014 accessed via http://www.federalreserve.gov/SECRS/2014/April/20140417/R-1479/R-1479_041614_124558_481903138096_1.pdf

[5] Financial Stability Oversight Council 2014 Annual Report accessed via http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf ; Governor Daniel Tarullo's Speech at the 30th Annual National Association for Business Economics Economic Policy Conference, February 25, 2014 accessed via http://www.federalreserve.gov/newsevents/speech/tarullo20140225a.htm; Office of Financial Research 2013 Annual Report accessed via http://www.treasury.gov/initiatives/ofr/about/Documents/OFR_AnnualReport2013_FINAL_12-17-2013_Accessible.pdf; Commissioner Kara Stein's Speech at "SEC Speaks" Conference, February 21, 2014 accessed via http://www.sec.gov/News/Speech/Detail/Speech/1370540830487#.U4SV-_ldXjV.

[6] By contrast, ordinary commercial enterprises, such as oil companies or airlines, are structured differently, depend on unrelated funding and revenue streams for their operations, and ultimately can be restructured or liquidated without affecting their on-going operations or the rest of the economy. Of course, with the Dodd-Frank Act, bank holding companies can be wound down if they fail, but few would contest that the resolution process for large financial firms is untested, difficult, and potentially damaging economically.

financial plumbing of our entire economy, this is a risk we should not be asking the American people to bear.

Bank holding companies' ability to own, control, transport, and trade in commodities also undermines the ability for ordinary commercial businesses to compete in these fields. A bank holding company benefits from the extraordinary funding advantages and protections afforded to its bank from FDIC deposit insurance and access to the Federal Reserve System's discount windows. Indeed, it appears that many bank holding companies' physical commodity activities may actually be a form of regulatory and credit ratings arbitrage.[7] Not only does this limit fair competition in the marketplace, it also exposes our financial system to new and different risks that were historically absorbed by commercial companies. These trends are troubling.

The starting point for the Board ought to be the complete separation of the banking system from the ownership, control, transport, or trading of physical commodities. For decades, the U.S. economy performed well without the involvement by banks in commodities. Banks and their affiliates are supposed to extend loans and provide financial services, including hedges, to grow the economy. In a competitive marketplace, there is simply no reason that a bank holding company needs to be involved in transporting jet fuel, owning pipelines, or controlling oil tankers.

To the extent that the Board permits any physical commodity activities to continue, they should be narrowed to focus solely on providing truly financial *services* to clients, and not as independent investments of the banking group or functionally as commercial enterprises. One tool to accomplish that goal is the Volcker Rule, which prohibits a bank and its affiliates from making big bets for its own profits, and limits its trading and asset management positions to truly client services. If applied to any physical commodities activities that remain at the bank holding

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[7] In some instances, the buying and selling of physical commodities to end users appears economically to have replaced the lines of credit that banks would normally provide to commercial companies (either directly or through larger balance sheets of more integrated end users) that would be used to absorb the risk of acquiring or disposing of physical commodities. To the extent physical commodity trades require less capital than a line of credit, they mask the leverage that FHCs engaged in physical commodity activities (and end users) have exposed themselves to. The activities also may mask the real amount of debt that the end user has taken on, undermining the reliability of credit ratings for the rest of the company's debt. See, for example, IHS Global Inc., *The Role of Banks in Physical Commodities*, 2013, 16. It also appears that physical commodity trades are used to replace hedging through derivatives. To the extent that physical commodity trades are not subject to the same regulatory requirements as derivatives – in particular, central clearing and price transparency – then these physical commodity trades also appear to be an attempt at regulatory arbitrage, in particular the posting of collateral. See, for example, IHS Global Inc., *The Role of Banks in Physical Commodities*, 2013, 8-9, 11-12. "Credit extension [through physical commodity trades] allows the following key items: - Client does not have to post cash collateral like they do then hedging with futures . . . , and - Clients can post non-standard collateral." IHS Global Inc., *The Role of Banks in Physical Commodities*, 2013, 17. To the extent these trades avoid the margin requirements and counterparty reduction of central clearing as well as the price transparency of exchange-like trading, they increase the amount of leverage and risk in the financial system. Similar issues exist with respect to project finance and other physical commodity activities by FHCs.

company, as we have recommended before, it would significantly limit the exposure of bank holding companies to the risks of physical commodities.[8]

Moreover, I believe physical commodity activities must be evaluated from the perspective of high-risk trading strategies and high-risk assets under the Volcker Rule, which could effectively prohibit banks from engaging in some or all commodities activities.[9] For example, it would seem plain that yellowcake (uranium oxide) is a high-risk asset, which under the Volcker Rule would eliminate bank holding company involvement with it.[10] In addition, the Board should carefully evaluate the risks of regulatory and credit rating arbitrage in any physical commodity activities that it permits to remain, and it should increase the capital charges and use other tools to limit risk in the system and ensure a level playing field for commercial enterprises.

Disclosure can also be significantly improved. Disclosure of physical commodity activities today is limited, byzantine, and unhelpful, keeping the public from gathering a meaningful understanding of the scope of physical commodity activities and associated risks. For example, consolidated financial statements for bank holding companies (FR Y-9C) only provide aggregate numbers for physical commodities holdings combined with fixed income, derivatives, and other related income. This makes it nearly impossible to track commodities specifically. Securities and Exchange Commission filings have similar limitations. To the extent that the Board permits bank holding companies to continue to engage in physical commodity activities, it should mandate much more enhanced disclosure of specific positions and should also consider creating a special summary report similar to that of the Office of the Comptroller of the Currency for trading activities.

Physical Commodity Activities by Banking Institutions Can Create Serious Conflicts of Interest and Raise Costs for Real Economy Businesses and Consumers

I also remain deeply concerned about the serious potential for conflicts of interest, market manipulation, and price increases on real economy businesses and consumers when banks own, control, transport, or trade in physical commodities. Accordingly, from this perspective as well, I urge the Board to significantly limit bank holding companies' physical commodity activities.

It should be remembered that unlike securities, which provide returns based on the success of a business, or derivatives, which are insurance-like in their function, we are talking about physical commodities, like copper, wheat, and oil. These physical commodities are primarily valuable from a financial perspective *not* because of the way they deploy capital into the real economy but because of the demand for their *use* by the real economy. Thus, any investment in physical

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[8] For example, a firm's merchant banking portfolio, as a whole and any investment therein, should be considered a covered fund. I believe the Merkley-Levin Provisions have always provided you full authority to cover physical commodities trading and investing, but the Board can also rely on Volcker Rule anti-evasion authority, its organic safety and soundness authority, as well as other authorities to apply Volcker Rule restrictions for any physical commodity activities that remain at an FHC.

[9] See Bank Holding Company Act section 13(d)(2).

[10] Reuters, "Insight-Goldman Puts 'For Sale' Sign on Iran's Old Uranium Supplier," February 11, 2014. Accessed via http://www.reuters.com/article/2014/02/11/us-goldman-uranium-insight-idUSBREA1A0RX20140211

commodities that serves to hold commodities out of use is a tax on ordinary businesses and consumers.[11] This perspective should guide the Board's consideration of the role that banks play in the physical commodities markets, especially because the Board's mandate not only includes financial stability but also economic growth.

Indeed, in recent years, we have learned that:

- Banks, hedge funds, and financial investors, in part due to deeply flawed exchange rules, have driven up the cost of aluminum, costing brewers and beer drinkers a combined $3 billion.[12]
- Speculation in the oil market by banks and financial investors has been responsible for as much as $14 for every tank of gas purchased by American drivers.[13]
- Banks have manipulated electricity markets, costing ratepayers millions of dollars in higher utility bills.[14]
- The copper market is at risk of being dominated by a bank-sponsored investment fund.[15]
- Even the price of bread and rice – staple foods for American families and hungry children around the world – is being driven up by financial speculation in grain commodities.[16]

This track record raises significant questions as to whether physical commodity activities at banking institutions are justified as in the public interest.

Limiting bank holding companies' physical commodity activities would make an important dent in reducing the conflicts of interest and risks of market manipulation and price increases in physical commodities. Large bank holding companies present a particular confluence of risks with respect to physical commodities because the firm is also lending and advising, market-making in derivatives, and deploying asset management services, often to the same customers. With all at this happening under the same roof, there are unusually high opportunities for mischief, including using information flows to the disadvantage of customers. These risks are especially aggravated because of the ability for bank holding companies to deploy their large balance sheets to move what are often relatively small markets. At best, these conflicts of

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[11] See Better Markets, "Commodity Index Traders and Boom/Bust in Commodities Prices," 2011, accessed via https://www.bettermarkets.com/sites/default/files/Better%20Markets-%20Commodity%20Index%20Traders%20and%20Boom-Bust%20in%20Commodities%20Prices.pdf.

[12] Joe Richter, MillerCoors Sees Metal-Warehouse Delay Costing Buyers $3 Billion, Bloomberg, July 22, 2013 http://www.bloomberg.com/news/2013-07-22/lme-rules-seen-by-millercoors-costing-aluminum-buyers-3-billion.html.

[13] Bart Chilton, Speculators and Commodity Prices—Redux, Feb. 24, 2014, http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement022412; Speculators and the Gas Pump, N.Y. Times, April 18, 2012, http://www.nytimes.com/2012/04/19/opinion/speculators-and-the-gas-pump.html.

[14] Brian Wingfield & Danw Kopecki, JPMorgan to Pay $410 Million in U.S. FERC Settlement, Bloomberg, July 30, 2013, http://www.bloomberg.com/news/2013-07-30/jpmorgan-to-pay-410-million-in-u-s-ferc-settlement.html.

[15] Josephine Mason, SEC again rejects copper users' challenges to JPMorgan ETF, Reuters, March 29, 2013, http://www.reuters.com/article/2013/03/29/us-etf-copper-jpmorgan-idUSBRE92S0HV20130329.

[16] Kharunya Paramaguru, Betting on Hunger: Is Financial Speculation to Blame for High Food Prices? Time, (Dec. 17, 2012), http://science.time.com/2012/12/17/betting-on-hunger-is-financial-speculation-to-blame-for-high-food-prices/.

interest create the perception of a rigged market, and at worst they create real opportunities for market manipulation and cost increases that ultimately harm businesses and consumers.[17]

The recent track record of large bank holding companies suggests that their ability to manage risks and eliminate conflicts of interest is poor, in part because of their size and complexity. The "too big to manage" nature of many of these institutions, as well as their political heft, appear to have created a culture of impunity with respect to the law that further encourages and enables improper and illegal practices. Recent efforts by banking institutions to crack down on out-of-control trading cultures highlight the significance of this issue.[18] Removing or significantly curtailing physical commodity activities would go a long way towards simplifying their activities.

My starting point again is that bank holding companies should not be permitted to engage in physical commodity activities, which would be a clean and easy way to eliminate these conflicts of interest and risks of market manipulation. To the extent that the Board permits any physical commodities activities at FHCs, I believe significant effort should be expended to set out much clearer guidelines, including related to incentives in compensation and the internal use of trading flow and other customer information, to eliminate material conflicts of interest and reduce risks of market manipulation.

I believe part of the solution would be to ensure that any physical commodity trading or investing that is permitted to remain at a banking institution also is covered by the Volcker Rule, including the Volcker Rule's limits on material conflicts of interest.[19] Careful attention should be paid to ensuring that any customer-related activities facilitated in the physical commodity space are not undermined by trading or asset management activities that run contrary to customers' interests, including through the misuse of information. Additional efforts should also be made to ensure that risk management procedures are in place so that senior management can monitor and be held accountable for compliance with law and prevention of market manipulation by traders.

The Board Needs to Act

As noted above, I remain deeply troubled by bank involvement with physical commodities at all. I believe there is little reason for banks to own, control, transport, or trade in physical commodities, and that the systemic risks, unlevel playing field, and conflicts of interest strongly points towards eliminating those activities at bank holding companies. Although a handful of data points suggest some firms are reducing or eliminating their physical commodities activities, the Board should not rest on its laurels or delay action on this important matter.[20]

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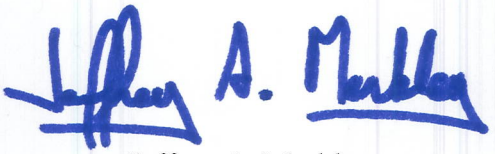
[17] For example, in their comment letter, the Wrought Copper Coalition called for an investigation into the ownership of LME warehouses and into any possible links to the commodity price volatility and physical metal availability.
[18] Financial Times, "Deutsche Bank warns traders in video over boasting and vulgarity," May 16, 2014. Accessed via FT.com, http://www.ft.com/intl/cms/s/0/6c71b3cc-dccb-11e3-b73c-00144feabdc0.html?siteedition=intl#axzz32H2kPv70.
[19] Exclusion creates serious Volcker Rule anti-evasion concerns.
[20] The Board should not accept the argument that limiting physical commodity activities at bank holding companies will push these activities into more lightly regulated firms. To begin with, the recent history of these activities by

At a minimum, the Board should interpret the scope of any grandfathered and complementary activities narrowly and add significant new safeguards to any activities that the Board permits FHCs to continue to engage in. Of particular value, I believe, are the restrictions embodied in the Volcker Rule, which I believe can and should be extended to any physical commodity investments made by bank holding companies. Disclosure can also be improved significantly.

Thank you for the opportunity to comment on this important issue, and I look forward to working with you to address it soon.

Sincerely,



Jeffrey A. Merkley
United States Senator

cc: Hon. Jack Lew, Chair, Financial Stability Oversight Council
Hon. Mary Jo White, Chair, Securities and Exchange Commission
Hon. Tim Massad, Chair, Commodity Futures Trading Commission

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bank holding companies does not reflect well upon Board supervision of these activities. More importantly, to the extent that nonbank commodity trading firms pose a systemic threat to the financial system, Title I of the Dodd-Frank Act empowers the Financial Stability Oversight Council to designate them for Board supervision. Ensuring that they are fully separate from the banking system remains an important way of reducing systemic risk.