



April 16, 2014

Via electronic submission

SAULE T. OMAROVA, J.D., Ph.D. (Political Science)
George R. Ward Associate Professor of Law

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

Re: Advance Notice of Proposed Rulemaking - Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities (Docket No. R-1479; RIN 7100-AE10)

Dear Mr. Frierson:

I appreciate this opportunity to comment on the Advance Notice of Proposed Rulemaking (ANPR) referenced above. In my scholarly capacity, I have examined the legal basis for, and the policy implications of, the recent expansion of large U.S. financial holding companies (FHCs) into the purely commercial businesses of trading, producing, processing, storing, transporting, and marketing physical commodities. The results of my research are presented in a recently published article, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, which is attached to this letter and incorporated by reference into my submission. I hope the Board of Governors of the Federal Reserve System (the Board) finds my article helpful in illuminating the wide range of legal and policy issues raised as a result of direct participation of FHCs in the physical commodity markets.

To supplement the article's substantive analysis, I would like to draw the Board's attention to the following three factors that have a direct bearing on *the integrity and efficacy of the Board's decision-making process*.

I. Inadequate and incomplete information hinders the American public's ability to participate effectively in the Board's decision-making process on this issue.

The ANPR poses questions, many of which require or presuppose commenters' knowledge of the inner workings of the highly complex commodities markets and, in some cases, the Board's own regulatory and supervisory processes. Yet, neither the industry nor the regulators have taken any meaningful steps to enable the broader American public to acquire such knowledge. Despite the heightened political and media interest in FHCs' physical commodities activities since July 2013, there remains a fundamental gap in publicly available information on this subject. There is currently no comprehensive, reliable, detailed, and fully accessible public information on the full scope of FHCs' commodity operations, the interplay between their physical commodities businesses and derivatives trading, or the precise effects of FHCs' access to explicit and implicit government support on their ability to intermediate

physical commodity transactions. There is also very little information about the Board's regulatory and supervisory actions, past or present, in this area.

Without access to such necessary information, the American public cannot be reasonably expected to make a meaningful impact on the Board's deliberations. Under these circumstances, the Board's request for public comments on the ANPR is structured in a manner that has the practical effect of conferring a disproportionate voice upon industry actors with the inside knowledge of the physical commodity markets, plentiful resources, and strong private incentives to advocate the status quo. Such commenters' technical fluency and market-insider status may give their one-sided comments an appearance of objectivity and pragmatism, while ordinary Americans' legitimate concerns about mixing finance with commodities are likely to be marginalized for lack of sufficient information, technical sophistication, and market credentials.

Given the severity and potentially damaging consequences of informational disparity in this case, I urge the Board to refrain from acting solely or mainly on the basis of, or in response to, industry comments on the ANPR. Any such action by the Board would be, functionally, *arbitrary and capricious*. An effective public consultation must give voice to the general public, and it is the Board's duty to provide the American public with the necessary means of making its voice heard.

II. To the extent that private parties with economic interests in the continuation of FHCs' activities in physical commodity markets – including financial institutions, their agents, and commercial clients advocating on their behalf – fail to address key policy issues at stake, their comments are fundamentally unresponsive and not directly relevant to the Board's decision-making.

Despite their apparent sophistication, FHCs and their advocates generally advance three fundamentally flawed arguments in favor of allowing FHCs to continue activities related to physical commodities. Each of these standard arguments diverts attention away from the substantive issues at hand and, therefore, should not be allowed to influence the Board's decision-making process.

Argument No. 1: "FHCs are necessary participants in physical commodity markets because they are uniquely suited to provide liquidity and other benefits to end-users."

This argument is unresponsive because it fails to address the crucial question at hand: Why are large FHCs able to provide such uniquely "efficient" (essentially, cheaper) intermediation services in physical commodities markets?

Undoubtedly, commercial companies often benefit from FHCs' commodity trading. However, what might be "efficient" (i.e., relatively cheap and more convenient) for the individual parties in a transaction might not be *socially efficient*, if a significant reason for such micro-efficiency is the existence of implicit *public subsidies* to large financial institutions. We need to understand and evaluate this critical link before concluding that FHCs are, in fact, the most efficient providers of financing and liquidity in commodity markets. Purely declaratory and generalized assertions of private benefits accruing to

individual end-users are neither responsive nor relevant to this inquiry and, therefore, should not be given a significant weight in the Board's deliberative process.

This argument, in any of its variations, can be relevant only if the commenters provide specific proof that the source of FHCs' superior ability to provide commodities intermediation services is entirely independent of their access to any form of public subsidy. Absent such specific proof, any claims about purported gains in efficiency, liquidity, or competition in commodity markets must be balanced against the danger of hidden transfers of public subsidy from FHCs to commodity end-users and counterparties – and the balance must be explicitly tipped in favor of avoiding the latter.

Argument No. 2: “Unregulated and less transparent entities could take FHCs’ place in commodities markets, which would make these markets less safe.”

This argument confuses two separate issues: (1) the need for greater transparency and regulatory oversight of physical commodity markets, and (2) the desirability of allowing U.S. FHCs to participate in such markets. Proponents of this argument erroneously equate FHCs' unique regulatory status as *financial institutions* with the regulatory status – or overall health - of *physical commodity markets* in general.

In reality, however, there is no logical connection between these two phenomena. U.S. banks and bank holding companies are heavily regulated and supervised under a system designed explicitly to address the risks of their financial activities. In fact, one of the principal tools for ensuring these institutions' safety and soundness is an imposition of severe restrictions on their non-financial activities. It is deeply ironic that this heavily restrictive regulation, designed fundamentally to keep banking organizations out of general commerce, is now being cited as a principal reason for allowing FHCs to function as global commodity merchants.

Because U.S. bank regulation is not designed specifically to address the risks associated with large-scale commodity merchanting, FHCs' participation in physical commodities markets cannot cure such markets' internal dysfunctions. In their capacity as physical commodity traders, FHCs are not necessarily more transparent or more effectively supervised than non-bank commodity trading houses. The fact that global commodity markets are opaque and dysfunctional is not an argument for allowing FHCs to participate in those markets but instead is an argument for bringing greater transparency and oversight to commodity markets. Therefore, comments containing any variations of this argument are irrelevant to the issue at hand and should not be given a significant weight in the Board's deliberations.

Argument No. 3: “There is no empirical evidence that FHCs’ physical commodities activities have caused, or are likely to cause, any systemic financial crisis.”

This argument, in effect, denies legitimacy to *prospective, preventative* regulation – an unsustainable position in the post-2008 world. As such, it merits no further rebuttal. Instead of demanding proof of a specific danger's having materialized, proponents of FHCs' physical commodities activities should be asked to produce empirical evidence

that none of these activities could ever create any serious risks to the long-term financial stability of the United States.

III. Given the significance and multi-faceted nature of the public interest in this matter, it is critical that the Board’s deliberations encompass the full range of potential policy concerns in connection with mixing finance and commodities, as well as potential policy responses to such concerns.

As discussed in greater depth in my article, U.S. banking organizations’ physical commodities activities raise a number of important public policy concerns. These include concerns about the safety and soundness of financial institutions and systemic risk associated with their commercial activities, potential leakage of the public subsidy beyond the banking sector, market integrity and consumer protection, and excessive concentration of economic and political power in the hands of financial conglomerates. In addition, there are serious reasons to doubt the actual capacity of large FHCs and financial regulators to monitor and effectively control potential risks posed by these activities – which raises a number of policy issues under the general rubric of “governability.”

In framing the Board’s line of inquiry, the ANPR focuses heavily on issues of FHCs’ safety and soundness. Despite the significance of these policy concerns, I would urge the Board to expand its policy focus and to give an equally great weight to each of the key policy concerns enumerated above. In particular, concerns with potential conflicts of interests and misuse of market power deserve the Board’s heightened attention, both because of their systemic implications and because of the traditionally central role of antitrust considerations to the U.S. regulation of bank holding companies.

The Board should adopt a similarly open-minded and proactive approach to designing a coherent set of regulatory responses to policy concerns raised by FHCs’ physical commodity activities. Limiting the range of potential choices to familiar, discrete, and narrowly tailored measures, such as capital surcharges or additional insurance requirements, may generate tangible regulatory benefits. At the same time, however, it may impede the search for novel, potentially more effective and comprehensive regulatory solutions to this complex problem.

Without purporting offer definitive solutions, I would like to highlight some of the potential focal points in the process of re-examining the practical operation of each of the three principal sources of legal authority for FHCs’ physical commodity activities.

Complementary Commodities Activities

Regulatory authorizations of individual FHCs’ physical commodities activities as “complementary” to their commodities derivatives businesses create a fundamental tension that, to date, has been consistently overlooked in policy discussions. On the one hand, the primary justification for the “complementarity” between commodity merchanting and derivatives businesses is the need for FHCs to access valuable proprietary information with respect to the pricing of physical commodities underlying their derivatives transactions. On the other hand, that same informational synergy creates a unique opportunity for an FHC to use its physical commodity operations to manipulate pricing and artificially boost profitability of its commodity derivatives trades. It gives large FHCs both the capacity and the incentives to

engage in sophisticated market manipulation that may be difficult to detect under the existing regulatory schemes.

It is obviously problematic when the same institutions that advocate seamless informational flow between physical and derivatives trading while petitioning for regulatory approval of their “complementary” commodity trading deny the very existence of such informational flows when questioned about the integrity of their market conduct. It is critical, therefore, that we have a full understanding of how this tension is resolved in practice before discussing specific regulatory measures applicable to FHCs’ activities in commodity markets. Either there is no real need for FHCs to trade physical commodities to support their derivatives operations, or the efficacy of internal “information firewalls” is inherently questionable. If the former is true, the Board should not permit FHCs to conduct physical commodity activities as complementary to their financial activities. If the latter is true, the Board should institute a strict and intrusive system of regulatory and supervisory controls over FHCs’ market conduct on both sides of the informational divide.

Because this goes directly to the fundamental issue of permissibility of FHCs’ complementary commodities trading, the Board cannot avoid making these determinations by claiming reliance on other regulatory agencies’ efforts to police manipulation in specific commodity markets. The Board’s review must target each FHC’s specific patterns of integrating physical commodities operations into its overall business model. To facilitate that review, each FHC conducting physical commodities activities should be required to furnish the Board (and other relevant regulators) with concrete and detailed explanations of how such activities affect, or are affected by, the rest of their business operations, transactions, and interests. The Board should scrutinize such evidence, on an ongoing basis, before making decisions on public benefits and risks of allowing any particular activity to continue.

Merchant Banking Activities

In the attached article, I discuss the legal and policy issues raised by the merchant banking provisions of the Bank Holding Company Act of 1956 (the BHCA). In my opinion, all of the actions currently under the Board’s consideration (as listed in the opening paragraph of Section III.C on page 17 of the ANPR) are potentially necessary and helpful to address the risks associated with FHCs’ merchant banking investments. I would like to emphasize, however, the particular significance of enhanced reporting and monitoring of merchant banking investments, especially in such an important sector as energy and commodities.

At the very least, the Board should collect more granular quantitative and qualitative data on each FHC’s merchant banking investments anywhere in the physical commodities supply chain, and monitor compliance with the statutory and regulatory requirements much more closely. The principal supervisory goal in this area should be to understand and evaluate not only each FHC’s full commercial-activity profile but also the overall pattern and potential effects (internal and external) of combining its commercial and financial activities.

Furthermore, in evaluating compliance, the Board’s examiners must not rely on review of FHCs’ corporate documents and formal “policies and procedures.” They should scrutinize the actual relationships between each FHC and its portfolio companies, in order to ensure that the FHC’s merchant banking portfolio contains only genuinely “financial-in-nature” investments,

as opposed to investments made for the purposes of conducting portfolio companies' commercial businesses. The examiners' task would be to monitor the relationship between an FHC and each of its merchant banking portfolio companies for indicia of *de facto* operational influence that potentially crosses the line between *financing* commerce and *engaging in* commerce.

Grandfathered Commodity Activities

In the attached article, I examine in depth the legislative history and problematic scope of Section 4(o) of the BHCA, which authorizes certain FHCs' pre-existing physical commodities operations. This special grandfathering clause does not directly condition its authorizations on additional regulatory approvals. Nevertheless, Section 4(o) is embedded within the broader framework of the BHCA and does not operate to exempt any grandfathered commodities activities from the Board's regulatory and supervisory oversight. Accordingly, the Board should aggressively use all of its formal and informal powers both as a systemic risk regulator and as the agency administering the BHCA, in order to prevent potential over-extensions of Section 4(o) authorizations and to minimize the unintended consequences of allowing some FHCs to run physical commodity businesses on a scale not anticipated by Congress in 1999.

In conclusion, I would like to urge the Board to develop a coherent, targeted, and factually-based regulatory and supervisory response to potential public policy concerns raised by FHCs' involvement in physical commodity markets. To ensure the integrity and efficacy of the Board's deliberative process, such process should encompass the following key stages:

Step 1: Targeted Data Collection

The Board should conduct a thorough and targeted fact-finding and data collection exercise, with the purpose of investigating the full extent and nature of U.S. FHCs' involvement in physical commodities markets. This information cannot be gathered by soliciting public comments but has to be collected directly from the regulated FHCs, perhaps as part of the Board's general supervisory or specialized reviews of their activities.

In particular, the Board's investigation should focus on two critically important questions:

- (1) To what extent are private efficiencies brought by FHCs' involvement in physical commodities trade attributable, directly or indirectly, to the public subsidy enjoyed by large U.S. FHCs?
- (2) How exactly do FHCs benefit from and manage the flow of vital market information between their commodity derivatives and physical commodity businesses?

Step 2: Analysis and Preliminary Policy Formulation

Using the data collected during the first stage in the process, the Board (in consultation with other relevant regulatory agencies) should conduct a thorough and open-minded analysis of all potential

regulatory and supervisory responses to the identified risks associated with FHCs' commodities activities.

Step 3: Public Consultation

Finally, the Board should (1) publish the key factual findings and policy recommendations developed on the basis of its findings, and (2) solicit public comments on the desirability of implementing its recommendations.

Following this procedural model is the only way to ensure meaningful public participation in this fundamentally important public policy debate. My hope is that the Board rises to the challenge of making it happen.

Sincerely,

A handwritten signature in black ink, appearing to read "S. Omarova", written over a horizontal line.

Saule T. Omarova

George R. Ward Associate Professor of Law