AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

S. HRG. 113–67

EXAMINING FINANCIAL HOLDING COMPANIES: SHOULD BANKS CONTROL POWER PLANTS, WAREHOUSES, AND OIL REFINERIES?

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER
PROTECTION

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING PERMISSIBLE BANKING ACTIVITIES UNDER THE BANK HOLDING COMPANY ACT (BHCA)

JULY 23, 2013

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

82–568 PDF WASHINGTON : 2014

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TIM JOHNSON, South Dakota, *Chairman*

JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
ROBERT MENENDEZ, New Jersey
SHERROD BROWN, Ohio
JON TESTER, Montana
MARK R. WARNER, Virginia
JEFF MERKLEY, Oregon
KAY HAGAN, North Carolina
JOE MANCHIN III, West Virginia
ELIZABETH WARREN, Massachusetts
HEIDI HEITKAMP, North Dakota

MIKE CRAPO, Idaho
RICHARD C. SHELBY, Alabama
BOB CORKER, Tennessee
DAVID VITTER, Louisiana
MIKE JOHANNS, Nebraska
PATRICK J. TOOMEY, Pennsylvania
MARK KIRK, Illinois
JERRY MORAN, Kansas
TOM COBURN, Oklahoma
DEAN HELLER, Nevada

CHARLES YI, *Staff Director*
GREGG RICHARD, *Republican Staff Director*

DAWN RATLIFF, *Chief Clerk*
KELLY WISMER, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

SHERROD BROWN, Ohio, *Chairman*
PATRICK J. TOOMEY, Pennsylvania, *Ranking Republican Member*

JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
ROBERT MENENDEZ, New Jersey
JON TESTER, Montana
JEFF MERKLEY, Oregon
KAY HAGAN, North Carolina
ELIZABETH WARREN, Massachusetts

RICHARD C. SHELBY, Alabama
DAVID VITTER, Louisiana
MIKE JOHANNS, Nebraska
JERRY MORAN, Kansas
DEAN HELLER, Nevada
BOB CORKER, Tennessee

GRAHAM STEELE, *Subcommittee Staff Director*
TONNIE WYBENSINGER, *Republican Subcommittee Staff Director*
KATHRYN MILANI, *Legislative Fellow*

C O N T E N T S

TUESDAY, JULY 23, 2013

	Page
Opening statement of Chairman Brown	1

WITNESSES

Saule T. Omarova, Associate Professor of Law, University of North Carolina at Chapel Hill	3
Prepared statement	35
Response to written questions of:	
Chairman Brown	81
Randall D. Guynn, Partner & Head of the Financial Institutions Group, Davis Polk & Wardwell LLP	5
Prepared statement	60
Response to written questions of:	
Chairman Brown	82
Joshua Rosner, Managing Director, Graham Fisher & Co.	7
Prepared statement	69
Response to written questions of:	
Chairman Brown	88
Timothy Weiner, Global Risk Manager, Commodities and Metals, MillerCoors LLC	9
Prepared statement	76
Response to written questions of:	
Chairman Brown	90

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

ALCOA prepared statement	103

EXAMINING FINANCIAL HOLDING COMPANIES: SHOULD BANKS CONTROL POWER PLANTS, WAREHOUSES, AND OIL REFINERIES?

TUESDAY, JULY 23, 2013

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee convened at 10:05 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Senator BROWN. The Subcommittee will come to order.

Thank you to the four witnesses. Thank you for those of you in attendance for being here and part of this interesting hearing. I will begin. Senator Toomey will join us in a few moments, and I understand a couple of other Members will likely be here.

In 1913, former Supreme Court Associate Justice Louis Brandeis voiced concerns about the growth of trusts in the United States. He said:

> Investment bankers became the directing power in railroads, public service, and industrial companies through which our great business operations are conducted. They became the directing power also in banks and trust companies. Distinct functions each essential to business and each exercised originally by a distinct set of men became united in the investment banker. It is to this union of business functions that the existence of the money trust is mainly due.

Today, large, complex, opaque, diverse corporations, we know, of course, are no longer called trusts. Instead, we have financial holding companies, large conglomerates combining banks and trading firms and energy suppliers and oil refiners and warehouses and shipping firms and mining companies.

The question is, how did we get here? For years, our Nation had separated banking from traditional commerce. But in 1999, after years of eroding that protection, finally, Congress tore down that wall. Beyond just combining commercial banking with insurance and investment banking, banks were now allowed to trade in commodities and to engage in a variety of nonfinancial activities.

Four years later, the Federal Reserve enabled the first financial holding company to trade in physical commodities. The justification

for allowing this activity is a familiar one. Other companies were doing it. Banks were at a competitive disadvantage.

Over the next 6 years, the rules became looser and looser. Goldman Sachs, in its own words, now engages in the production, storage, transportation, marketing, and trading of numerous commodities, including crude oil products, natural gas, electric power, agricultural products, metals, minerals, including uranium, emission credits, coal, freight, liquefied natural gas, and related products. This expansion of our financial system into traditional areas of commerce has been accompanied by a host of anti-competitive activities, speculation in oil and gas markets, inflated prices for aluminum and, we learned, potentially copper and other metals, and energy manipulation.

It has also been accompanied by important and troubling questions. Do the benefits of combining these activities outweigh the harm to consumers and to manufacturers? Can regulators or the public fully understand these large and complex financial institutions and the risks to which these firms are exposing themselves and, importantly, the rest of society? Are the laws and regulations sufficiently stringent and transparent, and are regulators enforcing them aggressively enough? And what do we want our banks to do, to make small business loans or refine and transport oil? To issue mortgages or corner the metals market?

There has been little public awareness of or debate about the massive expansion of our largest financial institutions into new areas of the economy. That is in part because regulators, our regulators, have been less than transparent about basic facts, about their regulatory philosophy, about their future plans in regards to these entities.

Most of the information that we have has been acquired by combing through company statements in SEC filings, news reports, and direct conversations with industry. It is also because these institutions are so complex, so dense, so opaque that they are impossible to fully understand. The six largest U.S. bank holding companies have 14,420 subsidiaries, only 19 of which are traditional banks. Their physical commodities activities are not comprehensively or understandably reported. They are very deep within various subsidiaries, like their fixed-income currency and commodities units, Asset Management Divisions, and other business lines. Their specific activities are not transparent. They are not subject to transparency in any way. They are often buried in arcane regulatory filings.

Taxpayers have a right to know what is happening and to have a say in our financial system because taxpayers, as we know, are the ones who will be asked to rescue these megabanks yet again, possibly as a result of activities that are unrelated to banking.

I thank the witnesses for being here. I look forward to their testimony, and I will introduce the four of them now for your opening statements.

Saule Omarova is an Associate Professor of Law at the University of North Carolina at Chapel Hill Law School. Prior to joining the Law School, Professor Omarova practiced law in the Financial Institutions Group of Davis Polk and Wardwell, where she specialized in a wide variety of corporate transactions and advisory work

in the area of financial regulation. In 2006 and 2007, she served at the U.S. Department of Treasury as a Special Advisor for Regulatory Policy to the Under Secretary for Domestic Finance.

Randall Guynn has served as partner and head of Davis Polk's Financial Institution Group since 1993. Coincidentally, or perhaps not so, he was Professor Omarova's supervisor while she worked at the firm. I noticed the glancing look there when I said Davis Polk. They will agree on everything today, I understand.

[Laughter.]

Senator BROWN. His practice focuses on providing bank regulatory advice and advising on M&A and capital markets transactions. He has advised all the United States' six largest banks and many non-U.S. banks on Dodd-Frank and its regulatory implementation.

Joshua Rosner is Managing Director at independent research consultancy Graham Fisher and Company. He advises regulators and institutional investors on housing and mortgage finance issues. Mr. Rosner was among the first analysts to identify operational and accounting problems at the Government-Sponsored Enterprises and was one of the first to identify the peak in the housing market and the weaknesses in the credit rating agencies' rating of collateralized debt obligations. Mr. Rosner co-authored Reckless Endangerment with New York Times columnist Gretchen Morgenson, which traces the beginning of the housing crisis.

Tim Weiner is the Global Risk Manager of Commodities and Metals for MillerCoors. With 29 years of risk management, commodity training, and fund management in many globally exchanged, traded, and over-the-counter futures and options, including interest rate, agricultural currency, metals, and energy commodities for the last 7 years, he has managed commodity price risk at MillerCoors for multiple commodities with a primary focus on global aluminum.

So, we will start with Ms. Omarova. Please proceed. And thank you all four for joining us, and please proceed.

STATEMENT OF SAULE T. OMAROVA, ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

Ms. OMAROVA. Thank you for the opportunity to testify on this important issue today. You have my written statement that lays out the details of what I have to say, so let me focus on a few key points.

I am an academic and my job is not to represent the interests of any particular industry. My job is to ask questions that need to be asked. One such question which I have been researching for some time concerns the legal and policy implications of what appears to be a significant expansion over the past decade or so of large U.S. banking institutions into physical commodity and energy markets.

These bank holding companies, or BHCs, own federally insured banks, and as a result are subject to the Bank Holding Company Act of 1956 that significantly limits their ability to conduct nonfinancial commercial activities. Yet, these companies through their nonbank subsidiaries currently own and operate metals warehouses, oil pipelines and terminals, tankers, electric power plants,

and coal mines. This phenomenon raises potentially significant regulatory and policy questions.

The foundational principle underlying U.S. bank regulation is the principle of separation of banking from general commerce. Since at least 1863, federally chartered banks have been allowed to engage only in the business of banking and, therefore, prohibited from trading physical commodities other than gold and bullion.

In 1956, Congress extended the same principle to banks' parent companies, BHCs, and generally limited their activities to those closely related to banking. The Gramm-Leach-Bliley Act of 1999, which partially repealed the Glass-Steagall Act, also allowed certain qualified BHCs or financial holding companies to expand their commercial activities, subject to certain limits.

Since the early 2000s, several large firms have availed themselves of these newly created statutory powers to grow physical commodity operations. Now, depending on the nature and magnitude of these operations, which we currently do not have the means of tracking, this trend potentially undermines the principle of separation of banking from commerce and implicates specific policy concerns behind that principle.

Let me give you a few examples of such potential concerns, including safety and soundness of financial institutions, potential systemic risk, market integrity and consumer protection, firm governability, regulatory capacity, and concentration of financial and economic power.

Safety and soundness. Financial institutions may argue that allowing them to trade crude oil will enhance their safety and soundness by diversifying their sources of income. However, it will also expand the sources of risk to these institutions. What if the Deepwater Horizon disaster happened on an oil-rig-owned and operated by JPMorgan? How would that affect Chase's deposit base?

Systemic risk. In the same example, how would the news about JPMorgan's oil spill affect the financial markets in which JPMorgan is a major dealer and counterparty? Would that also rattle, for example, Citigroup and Bank of America, who have huge exposures to JPMorgan?

Market integrity and consumer protection. If the same financial institution, for example, Goldman Sachs, is a major dealer and trader in both oil derivatives and underlying physical oil, the potential for market manipulation and artificial inflation of consumer prices is obvious.

Leakage of public subsidy. The financial industry often asserts that banks' entry into commercial sectors provides public benefits by increasing competition and by enabling them to provide better, more efficient services to their clients. What these claims leave out, however, is the potential competitive advantage that the Federal subsidy of banking institutions gives them when they act in commodity markets. An oil refinery may very well benefit from a low cost of its crude inventory supplied entirely by Morgan Stanley. But is Morgan Stanley able to offer the low price because its own cost of funding is partly subsidized by the taxpayer?

Institutional governability. Allowing large financial conglomerates to grow commodity merchant operations may make their internal risk management much more challenging. These institutions

already are enormous and complex, and making them even bigger and more complex may make the next "London Whale" episode much more likely to happen.

Regulatory capacity. Even more troubling is the fact that bank regulators, including the Fed, may be incapable of effectively monitoring and overseeing complex financial industrial conglomerates. Bank regulation is simply not geared toward controlling the risks of banking institutions acting like Enron. Other regulators cannot fill that gap effectively, as each one may be looking only at the slice of the conglomerate's activities where the essence of the problem is the whole.

Finally, political economy. It has been a venerable American tradition to view large aggregations of economic and financial power in the hands of a few money trusts with great suspicion and fear of this power translating into political influence. If the same institutions that control the flow of credit throughout the economy also control the flow of raw materials, these fears are greatly exacerbated.

In conclusion, let me emphasize that I am not arguing that any of these policy concerns actually presents an imminent danger and must be acted upon in a hurried manner. At this point, we simply lack the necessary data on what exactly is happening in this space and how risky it all may be. If sunlight is the best disinfectant, however, it will do us good to shine some intense light on BHCs' commodity activities.

Thank you.

Senator BROWN. Thank you very much, Ms. Omarova.

Mr. Guynn.

STATEMENT OF RANDALL D. GUYNN, PARTNER AND HEAD OF THE FINANCIAL INSTITUTIONS GROUP, DAVIS POLK & WARDWELL LLP

Mr. GUYNN. Thank you, Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee.

The regulation of our financial system is a serious matter. Having rules and regulations that ensure an appropriate level of financial stability while allowing the financial system enough flexibility to innovate, meet ever changing client needs, and otherwise adjust to ever changing market conditions is essential.

A longstanding principle of our banking laws is that banking should generally be separate from commerce. Thus, our banking laws generally do not allow the Wal-Marts of the world to own a bank or vice-versa. But our banking laws have allowed banks to buy and sell gold, silver, and other precious metal commodities since at least 1863. They have also allowed them to buy and sell a wide variety of derivative contracts, including contracts for physical commodities, for many decades, as long as these contracts have been traded on recognized exchanges or have otherwise been sufficiently liquid to be appropriate banking assets.

The connection between banking and commodities is not a new development. It has very ancient roots. Physical commodities, such as grain and salt, were among the first forms of money in ancient Mesopotamia, Egypt, China, Japan, and even the colonies that became the United States. These physical commodities have the es-

sential characteristics that we have come to associate with money: Fungibility, divisibility, and relative liquidity.

Indeed, the modern history of banking began with grain merchants in Lombardy. Many of the merchants of the 19th century in the United States similarly started as dry goods and commodity traders, including Lazard Brothers and Brown Brothers. The private banking partnership of J.P. Morgan engaged in a wide variety of activities, including investing in physical commodities and related facilities. In short, U.S. banks and other financial institutions have long been actively involved in the physical commodities markets.

Congress understood this history when it enacted the Gramm-Leach-Bliley Act in 1999 and expressly authorized financial holding companies to engage in merchant banking and permanently grandfathered the commodities activities of investment banks that were not yet bank holding companies. Congress clearly understood and expected the Federal Reserve to permit the new Citigroup to retain its physical commodities affiliate, Phibro. Indeed, the only issue in controversy was whether Congress would allow the new Citigroup to rely on the commodities grandfathering provision. Ultimately, Congress revised the grandfathering provision to exclude the new Citigroup, but did so fully understanding and expecting that Citi would be able to obtain these powers through the new complementary powers provision.

Thus, when Professor Omarova and Mr. Rosner describe the physical commodities powers in modern banks and bank holding companies as a radical departure from the traditional separation of banking and commerce, or that the Federal Reserve somehow went rogue to the surprise of Congress when it allowed Citigroup to retain Phibro, they are engaging in revisionist history. This was not radical. It was not a breach of the traditional principles separating banking from commerce. And it was not unexpected by Congress.

The problem with treating the general principle of separating banking from commerce as a strict legal wall is that reasonable people disagree over where the line between banking and commerce should be drawn. Professor Omarova believes that it should exclude physical commodities activities. But former Congressman Jim Leach of Gramm-Leach-Bliley fame, one of the most ardent and consistent champions of the separation of banking from commerce, would disagree. As recently as 2008, former Congressman Leach said that the merchant banking, complementary powers, and commodities grandfathering provisions of the Gramm-Leach-Bliley Act did not breach this principle.

In their written testimony, Professor Omarova and Mr. Rosner identify a long list of potential—and I stress "potential"—dangers of allowing financial holding companies to continue to engage in physical commodities activities, but they do not provide a shred of evidence to support the view that these potential dangers are likely to be realized. In contrast, both the Congress that enacted the Gramm-Leach-Bliley Act and the Federal Reserve Board that granted the complementary powers to Citigroup concluded that the public benefits of allowing financial holding companies to engage in physical commodities activities were likely to outweigh their potential adverse effects. I refer the Subcommittee to my written testi-

mony outlining the numerous public benefits and the safeguards that are designed to prevent any potential adverse effects.

In conclusion, it is certainly appropriate for this Committee to review whether our banking laws, including the extensive amendments made by the Dodd-Frank Act, reflect an appropriate balance between financial stability and operating freedom. But in light of the history of the longstanding connection between banking and commodities activities, the extensive public benefits of allowing financial holding companies to engage in these activities, and the relevant safeguards, my view is that this Subcommittee should not seek to repeal or curb these powers unless and until substantial evidence is provided that these commodities powers cannot, in fact, be exercised without creating a substantial risk to the safety or soundness of depository institutions or the financial system generally.

Thank you.

Senator BROWN. Thank you, Mr. Guynn.

Mr. Rosner, please proceed. Thank you for joining us.

STATEMENT OF JOSHUA ROSNER, MANAGING DIRECTOR, GRAHAM FISHER & CO.

Mr. ROSNER. Thank you. Chairman Brown, Ranking Member Toomey, Members of the Subcommittee, thank you for having me here to testify this morning. I would hope that you would read my written testimony.

My name is Josh Rosner, and a an independent bank analyst, I saw the mortgage crisis firsthand. I warned it was coming, but too few listened. It resulted in the loss of $7 trillion in real estate wealth. The recession that followed still shackles a generation of our fellow Americans, many of whom lost jobs, lost homes, lost hope.

Mixing banking and commerce will not bring these trillions back. It will not help the working class, the middle class, the upper-middle class, or the investor class. In fact, it has already cost them billions. It will not help anyone but those bankers.

What I see now in the mixing of commerce and banking is the dawn of a new Gilded Age, where the fruits of all are enjoyed by a few, where competition in the real economy is stifled by the advantages bestowed by a generous Federal Reserve, and where we will forever be one small tragedy away from another financial crisis that will dwarf 2008.

Since 2003, our Government and central bank have allowed the unprecedented use of insured deposits for speculation and the expansion of far-flung business interests. This is partially the result of unilateral decisionmaking by Congressionally empowered and unelected officials at the Federal Reserve. Only Congress can prevent this unfortunate consolidation of American business and act to prevent the Federal Reserve from continuing its coddling of these biggest banks. Only Congress can put the brakes on a handful of firms that nearly ruined the American economy in 2008 because it could not police itself and may well wreck the economy again. Congress did not hold the line. Congress did not protect the American people.

Regulators remain unprepared. 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.

We have been lucky so far, but a regime based on luck is not sustainable. Now the banks, having received approval or exemption for whatever they wish to do, seek to control nonfinancial infrastructures all over the world. They have already taken control of ports, airports, electric utilities, water utilities, sewer utilities, wind power farms, parking meters, solar power generation, parking garages, rail leasing, charter schools, and more. These activities create significant conflicts of interest, may be anti-competitive, and certainly engender operational and reputational risks that can lead to systemic failure. This is not hypothetical nor is it hyperbole. We have seen it happen.

Mortgages were once the boring way banks made money. But the conflicts of interest resulting from the combination of commercial and investment banking laid bare what compliant regulators had never dreamed would happen. The banks went too far. As a result, bank counterparties began to question toxic mortgage exposures of firms and their ability to cover losses on those exposures. As questions of solvency arose, demands for more collateral ensued and liquidity was withdrawn from those firms, leading to failures contagion and the need for Federal backstops.

Think of a scenario, not farfetched, of a disaster befalling a bank-controlled pipeline or oil tanker. The outcomes would be similar to the mortgage meltdown, when banks funded by the Fed protected their reputations by bailing out affiliated hedge funds and legally isolated investment vehicles. The possibility that such events could threaten the flow of money and bring the financial system to a standstill again should not be tolerated. These risks should stay outside the banking system, with its call on the Fed's window and the FDIC's insurance guarantee.

Executives of dominant firms can convince captured regulators that whatever they do is in the national interest. This is not true. These executives are correctly motivated by real obligations that do not allow them to sacrifice returns in consideration of the common good, even if they would be so personally inclined.

Congress has the power to rein in the Federal Reserve. Congress has the power to mandate the biggest, most complex banks' businesses get narrower and easier to resolve should they collapse. Congress has the power to protect industry in the biggest and potentially best economy in the world and to stand up for ordinary Americans who pay more for aluminum and gasoline simply because banks and investment banks take a cut.

Historically, Congress has acted when a few large firms exploited their advantage and sought to control too much. Congress must honor that history and curtail big banks' activities in commercial business or else we are destined to view 2008 as the first financial crisis and not the worst.

Thank you.

Senator BROWN. Thank you, Mr. Rosner.
Mr. Weiner.

STATEMENT OF TIMOTHY WEINER, GLOBAL RISK MANAGER, COMMODITIES AND METALS, MILLERCOORS LLC

Mr. WEINER. Good morning, Mr. Chairman and Members of the Committee. My name is Tim Weiner and I am the Global Risk Manager of Commodities and Metals for MillerCoors. Thank you for letting me testify today. My written statement and my comments are supported by a group of companies, including the Coca-Cola Company, Novelis, Ball Corporation, Rexam, Dr. Pepper Snapple, Yuengling, North American Breweries, Rogue Brewery, and Reynolds Consumer Products, just to name a few.

Mr. Chairman, my statement is neither an indictment of the free market principles nor the existing exchange traded futures system here in the United States, which we use regularly to hedge our commodity price risks and volatility. In fact, it is our hope that the LME system could one day function in a manner equally as transparent and efficient as the exchanges here in the United States.

MillerCoors will produce this year in excess of 60 million barrels of beer in the United States. Over 60 percent of our beers are sold in aluminum cans, bottles, and kegs. Aluminum is critical to our supply chain and our single largest commodity risk.

In my written statement, I provided the Committee an in-depth look at how the LME functions and how their system negatively impacts our ability to manage and secure aluminum we have purchased with associated costs we must pay under this system. It has cost MillerCoors tens of millions of dollars in excess premiums over the past several years, and billions to the entire industry, with no end in sight.

Mr. Chairman and Members of the Committee, I am a beer guy that simply buys critical materials for our business. I manage a comprehensive portfolio of commodities for brewing, packaging, and shipping of our fine beers, like corn, barley, natural gas, and diesel fuel.

Mr. Chairman, let me give you a snapshot of how we buy barley. Senator Tester, who serves on your Subcommittee, knows we are one of the largest grain purchasers in the State of Montana. We contract with our barley growers and we pay for our harvested crop. We receive delivery of that crop. It is immediate. It enters our grain elevators in Huntley and Power, Montana. The same can be said for the delivery of corn from the CME and natural gas from the NYMEX. But not so for aluminum under the LME warehouse rules.

Mr. Chairman, in a nutshell, here is how the LME warehouse system works. Banks and trading companies pay an incentive to aluminum producers to attract and store the majority of global aluminum production directly to their own warehouses. In the United States, it is mainly drawn into warehouses located in Michigan, but also other locations throughout the United States. Just imagine a warehouse with a huge door marked "in" and a tiny door marked "out."

The banks pay an incentive because they receive rent each day the aluminum stays in the warehouse. This makes it harder and

more expensive for MillerCoors and other aluminum consumers to get the aluminum we need to make the fine products we sell to keep our employees working.

So let us take the LME system and apply it to, let us say, buying a case of beer in a store in Trenton, Ohio. I am one of your constituents and I go into a store to buy a case of Miller Lite—of Coors Lite. I pay in full. As I reach for my beer, the cashier grabs the case and tells me I need to go around back and pick it up from the warehouse. "Not to worry," says the cashier. "Just present your receipt and you will get your beer in a timely manner." So I go around back, present the receipt, and the warehouse manager informs me that due to the warehouse constraints, I will have to come back in 16 months to pick up my beer. He then tells me that my beer will be kept safe in storage, but that I will have to pay for rent each and every day that my beer sits in his warehouse. Can you imagine the revolt that would create with your constituents, not to mention what that Congressional hearing would be like?

My point is how absurd it is to buy a commodity, in our case aluminum, and then have to wait an average a year to 18 months to obtain our physical possession of the purchased metal from the LME warehouses. The current LME warehouse system is not functioning as other futures exchanges do.

Mr. Chairman, we have tried to resolve this problem directly with the LME, and you will probably hear that some minor changes have been made to their operations over the past few years and that they are investigating additional minor changes that, at the earliest, would not go into effect until April of 2014. In our view, these changes do not go far enough, fast enough, nor do they correct the underlying problem.

In my testimony, I recommend very specific changes to the LME rules and we simply ask for the same regulatory and legislative oversight of the LME that other U.S. futures exchanges receive in order to level the playing field and ensure a transparent, balanced, and functional market for both buyers and sellers. This oversight will restore the free market functioning of the LME, which will regain our confidence in the institution and permit us to successfully brew, ship, and sell our fine beers.

I thank the Committee for allowing me to appear to testify here today and I am happy to answer any questions that you may have. Thank you.

Senator BROWN. Thank you, Mr. Weiner. I really appreciate it.

I am going to turn it to Senator Toomey, who has to leave early, but I want to ask one real quick question first. Mr. Guynn, what was "you are not fair or not correct" about the story that Mr. Weiner just told about the consumer in Trenton, Ohio, walking in to buy a case of beer? What was either misleading, incorrect, or not fair about his story as an example of what has happened in aluminum?

Mr. GUYNN. Just as a prelude, just so you know, I do not represent either JPM or Goldman on the LME situation, so I have no facts to add other than what is in the public record. But what I understand is that the LME metals warehouses only hold about 5 percent of the aluminum that is actually bought and sold globally

annually, that, in fact, 95 percent of the aluminum is bought directly from the producers. So I cannot quite understand where the market share issue is here.

Also, I think the LME warehouse owner is only a custodian, so it is not as if they are the owner of the metals in the warehouse.

Lastly, I think the CFTC has announced they are going to do an investigation. So, to the extent there are issues with the warehouse owners' violating any laws, contracts, or rules, presumably, that will be dealt with in that investigation.

Senator BROWN. OK. Thank you. I would only illuminate on that by saying that while it is a small part of the whole aluminum market, what the LME pricing structure is, as peculiar as it is and circuitous as it is, that affects price for all aluminum sold in the market, but we will get to more of those questions in a moment.

We are setting the clock for 7 minutes for each Member and we will do second or third round as long as Senator Merkley and Senator Toomey, if he can come back and stay. So thank you.

Senator TOOMEY. Thank you very much, Mr. Chairman, and thank you for your kind accommodation of my challenging schedule this morning. I appreciate that very much.

I appreciate the testimony. Let me just say briefly, Mr. Weiner, I read your testimony last night and it certainly does seem rather odd that a large buyer of any commodity cannot access that commodity in a timely fashion. That is—I just do not know of any other precedent for that. It strikes me, as your testimony suggests, that there are some problems with the rules by which the warehouse operates. It strikes me that it may be more specific to the rules than it is to whoever happens to own the warehouse, but the rules by which they operate are strange, it seems. I would like to learn more about this, but I think it is a little bit tangential to some of the things I would like to explore. So I would like to follow up with you on another occasion on some of the particulars there.

I would like to address my first question to Mr. Guynn, and I read your testimony, as well. Some of this gets a little bit confusion. There has been discussion about whether the Fed would revisit some rules in September. Could you just briefly summarize the actual legal authority by which bank holding companies engage in dealing in physical commodities as opposed to a regulatory discretion. But what is the legal authority?

Mr. GUYNN. It is actually important to distinguish between different types of banking entities. Insured banks can buy and sell precious metals commodities under the National Bank Act. They can also trade in commodities contracts where the underlying commodity is a variety of things, including the energy and physical commodities we talked about here, as part of their core banking powers. That is, again, an interpretation of the National Bank Act.

Bank holding companies and the nonbank affiliates of banks, are also able to do similar trading, again, limited to contracts.

Then Gramm-Leach-Bliley added a provision that said that financial holding companies—special bank holding companies that meet certain capital and management requirements—would be able to engage in expanded powers, including these complementary powers. And it is pursuant to that provision that the Federal Reserve authorized Citigroup and other financial holding companies, start-

ing in 2003, to trade in physical commodities as a complement to their financial activities of trading in the contracts.

And then there is a separate provision, there is a grandfathering provision in Section 4 of the Bank Holding Company Act that was actually designed to provide a two-way street for investment banks and commercial banks so that if Goldman Sachs and Morgan Stanley, for instance—who were not bank holding companies in 1999—became bank holding companies later on, their commodities activities would be grandfathered.

Senator TOOMEY. OK. Thank you.

Let me just ask you—this may be a judgment call, an opinion call on your part, Mr. Guynn. Do you think part of the motivation for banks to engage in this is that it is profitable for banks?

Mr. GUYNN. That certainly is part of the motivation, certainly, because when things are profitable——

Senator TOOMEY. Right.

Mr. GUYNN.——it helps their balance sheet.

Senator TOOMEY. So, this has been going on a long time, that banks have engaged in various levels of physical commodity dealing. Can you point to any time in which large financial company trading in physical commodities created a systemic risk for our financial system?

Mr. GUYNN. I cannot think of a single example.

Senator TOOMEY. Let me ask you this. Well, that might be because it is a profitable line of business, and, as such, might actually diminish risk rather than enhance risk.

But let me ask you this. Could you give us an example of how a large, sophisticated commodity trading operation—it could be a bank holding company—provides a service that might actually be valuable to consumers?

Mr. GUYNN. Sure. So, a good friend of mine founded JetBlue. JetBlue is a discount airline that obviously consumes a lot of jet fuel. They need to be able to manage the price risk of that jet fuel. As we know, jet fuel has been fairly volatile in recent years. And so they can enter into long-term fixed price contracts with Goldman Sachs, Morgan Stanley, JPMorgan, Citi, others who have the power to enter into those sort of contracts, in order to fix that price or manage their price risk. And then the financial institutions can go long in the physical commodity to hedge their risk in the contract, or go short, depending on how they are otherwise positioned.

That reduces the cost for JetBlue and other airline companies and, presumably, those reduced costs are passed on to consumers in the form of lower traveling costs, or at least avoid higher travel costs.

Senator TOOMEY. Or maybe greater job security on the part of their employees?

And does it work in the opposite direction? In other words, you just gave an example where a buyer of a commodity benefits from the assurance of a known fixed price into the future. But what if you are in—say you are a silver miner. You mine silver and you sell it. You have got a lot of sunk costs, heavy capital investment. It seems to me your biggest variable cost is probably labor. If the price of silver collapses, you are probably going to lay off a lot of workers. If you could sell it at a known price in advance, would

that give you some more stability, some more security for your workforce, for your business?

Mr. GUYNN. Obviously, and that is why it is important to have strong, deep, liquid markets if we can have them in those sort of commodities, so that the silver miner or other miners will be able to buy or sell their goods in large quantities, very quickly, without causing price movements.

Senator TOOMEY. And this example that you gave with JetBlue and that we discussed with, say, a silver miner, does that actually happen? Are there consumers who do, in fact, engage in these medium- and longer-term contracts for commodities?

Mr. GUYNN. I think that is actually most of the business, that, in fact, these financial institutions engage in.

Senator TOOMEY. OK. Thank you very much, and again, Mr. Chairman, I really appreciate your cooperation.

Senator BROWN. Sure. Thanks for joining us.

Mr. Weiner, I will start with a series of questions for you, if I could. I want to be clear exactly how this works. Is it correct, the warehouses pay premiums to aluminum producers to store the metal in their warehouses and then that they also charge purchases like yourselves and the companies you are representing today, that you said, rents to store the aluminum there after you have purchased it? Is that my understanding?

Mr. WEINER. Yes, that would be correct. They actually pay an incentive to the producers to attract the metal to their warehouses and then store that metal in that warehouse and they do charge rent for the period of time that that metal stays in that warehouse.

Senator BROWN. And Goldman Sachs is entitled—you mentioned, I am not sure you called it by name, but the Michigan warehouses, many of them owned by Metro—Goldman Sachs bought Metro. They are entitled to hold it for 10 years as a merchant banking investment. Mr. Guynn explained sort of the legal parts of this, and that term, merchant banking investment, is what Goldman Sachs supposedly operates under, although as Ms. Omarova pointed out, we do not have enough data to know nearly all of what we need to know.

At current capacity, our estimates are that Goldman Sachs could earn $26 billion in rental income over that period. My question is, is it correct that four of the six largest LME, London Metal Exchange, warehouses are owned by Goldman Sachs and JPMorgan and the commodity trading firms Trafigura and Glencore so that there is limited competition in the warehouse business?

Mr. WEINER. Yes. There are limited owners of the warehouses. I am not sure on the exact numbers. I can get that back to you. But they are—the two that you mentioned are some of the largest warehouse owners and it is limited to a small number, group of people.

Senator BROWN. Both the banks that own the warehouses and the London Metal Exchange acknowledge that the aluminum held for companies like yours, companies that actually make things from aluminum, the manufacturers themselves, are given secondary status. This means that aluminum bought by people who buy aluminum as investments are given priority in the queue. One, is that true? Second, what effects do those delays have upon consumers

and businesses like MillerCoors? What does it do to the price of your, ultimately, of your product?

Mr. WEINER. I cannot speak to that particular point on the banks, but I can say that as far as the effect to us as a consumer of aluminum, it has a great effect, and also the companies that I mentioned. The increased cost that we incur takes away from innovation and new products that we can come up with, other qualities that we may be able to offer to our consumers, not only for us but for the companies that I mentioned here on this list.

Senator BROWN. Well, you said you cannot speak to the question of whether they are given priority in the queue, the people who buy aluminum as investments. But the fact is, you cannot get the quantity of aluminum you want, apparently, correct?

Mr. WEINER. If a buyer buys aluminum through the LME system, buys aluminum, cancels, gets a warrant, and goes to the warehouse to get his metal, if he gets his metal, for example, use Detroit for an example if you are in the United States, it can take up to 18 months to receive your——

Senator BROWN. Which would lead me to think, and you do not need to necessarily acknowledge this, but it would lead me to think that you are not a very high priority compared to those—because of, I mean, the New York Times said delays have increased from 6 weeks not that long ago to 7 months in 2011 to 16 months today.

Mr. WEINER. Mm-hmm.

Senator BROWN. That would imply you are not a very high priority.

Mr. WEINER. You could take that implication.

Senator BROWN. Now, Goldman Sachs and JPMorgan are reportedly exploring selling the warehouses. The LME has proposed new warehouse rules. Reuters is saying the CFTC could investigate this issue. The Fed is reportedly reconsidering its policies. Are those actions sufficient to address this problem?

Mr. WEINER. No. They are all wonderful ideas. They are all proposals——

Senator BROWN. It is necessary for intervention. You want these things to happen, but you think they are not sufficient?

Mr. WEINER. Yes, we do. In fact, this is—we are going down the right path. This is a great beginning, but these are not sufficient to resolve the problem. We have heard about the warehouses selling—or the banks selling the warehouses. We have heard about all these other promises of new changes in the rules. And they are all wonderful ideas. They are all in the right direction. But they do not resolve the situation.

Senator BROWN. What——

Mr. WEINER. It will take, as I mentioned in my testimony, the new rules that they have proposed, even if they go into effect, could not take effect any earlier than April of 2014, if that.

Senator BROWN. If they could take effect immediately, would that solve your problem?

Mr. WEINER. It could. It depends upon which rule changes they make. We gave a list of rule changes in my testimony. If they were to take some of those rule changes, it might have a much quicker effect as far as changing the current situation and status and the functioning of the LME warehouses.

Senator BROWN. As your company and others have talked to Graham Steele and Katie Malone in my office and talked to us, you have made clear that you have done a number of other things. Could you describe your efforts to engage U.S. and LME? I mean, I know there has been a problem. LME says it does not have jurisdiction in Detroit and the United States says U.S. regulators—I guess CFTC, right—says it does not have jurisdiction with LME because the "L" stands for London. Talk to me about your interaction, working with both U.S. and U.K. regulators.

Mr. WEINER. We met with the LME and we made some very serious proposals, the same proposal we listed in our written statement, and they were shrugged off. We went to the FSA at the time, which is now the FCA, that is the——

Senator BROWN. That is the British regulators.

Mr. WEINER. It is the regulator over the LME. And we were informed that the LME is a self-regulated entity and the FCA now has oversight over that.

Senator BROWN. Well, who owns the LME?

Mr. WEINER. The Hong Kong Exchange now owns the LME.

Senator BROWN. But they bought them from——

Mr. WEINER. They bought them from a large group of owners in December of 2012, so about 6, 7 months ago.

Senator BROWN. So they are a self-regulating exchange with no real government with teeth oversight?

Mr. WEINER. That would be correct, yes.

Senator BROWN. OK. So before—I am sorry to interrupt. Before Hong Kong, this company in Hong Kong bought them, they were almost a co-op of sorts? They were the aluminum producers, sellers, brokers——

Mr. WEINER. Yes. I mean, the exchange was owned by banks, by producers, by warehouse owners, by traders——

Senator BROWN. And they were partly funded by the rents charged in Detroit?

Mr. WEINER. Yes. Well, by rents charged all over the world.

Senator BROWN. In Detroit and elsewhere. But——

Mr. WEINER. Yes. Right.

Senator BROWN.——the money that Goldman was making in Detroit, the bountiness—no, I will not judge this—the money made in Detroit, the more that was, the more the LME got paid.

Mr. WEINER. No. Actually, the more that was, the more it went to the warehousing company, Metro, that owns those warehouses.

Senator BROWN. But then LME got a percentage——

Mr. WEINER. The LME gets a small one or one-and-a-half percent of all the metal——

Senator BROWN. Continue on your efforts with U.S. and U.K. regulators, if you would.

Mr. WEINER. Yes. So we then came back to the United States. We went to the CFTC, who felt for us and understood our cause but said that they really had no regulatory power over the LME warehouses here in the United States or the LME, which is a foreign exchange. We have gone to several other regulatory agencies to see what they would do and now we are here today and this is just the next step in hopefully resolving this problem.

Senator BROWN. One more question and then I will turn to Senator Merkley. I want to read you the response of Goldman Sachs to the complaints about the role of their warehouse in aluminum prices. Roughly 95—and this echoes a little bit of what Mr. Guynn said. Roughly 95 percent of metal sold every year does not pass through the warehouse system and it all goes straight from producers to consumers. Metro, Goldman's company, does not own or control the metal in its warehouses. That is up to its consumers and subject to LME rules. So the extent that metal flows inside the warehouse system on and off warrant there is a function of consumer demand. As you might expect, the vast majority of the build-up in inventories at warehouses is a result of the financial crisis and the subsequent lack of demand.

Goldman continues, the warehouses absorbed excess production, but the macro picture is one of soft demand and excess supply, which is why aluminum prices have come down substantially over past years, roughly 40 percent lower since pre-crisis level, Goldman says, another factor the New York Times failed to mention. As with other global commodity markets, prices are only driven by supply and demand. There has been significant over-capacity in the global aluminum market for years now, thus the need for storage, thus the role the warehouses have increasingly played.

Your response?

Mr. WEINER. I can respond to a couple things in there. Number one, I can respond to the fact that the real crux of the problem here in the LME is the fact that up through December of this past year, the owners of the LME warehouse sat on all the committees to make the rules for the warehouses that they own, are really the backing or the real problem here, because you have people setting up rules for themselves under a self-regulated exchange. And this is what I talked about in my testimony. I would like to get transparent and a functioning LME market, just like we have here in the United States, and that is really the problem that we have here today. It is not that demand has dropped or supply has increased, because when demand drops, prices usually—should go down and should disincentivize producers from producing, and that has not happened because there have been incentives to have the producers continue producing in a significantly over-supplied market.

Senator BROWN. The incentives come from Metro, for instance, paying a premium to bring the aluminum there.

Mr. WEINER. Yes. Otherwise, why would you produce aluminum in an over-supplied market and deliver it into a warehouse?

Senator BROWN. Any other comments on Goldman's statement?

Mr. WEINER. Well, the 9 and 95 percent. All of our contracts, and all the contracts of the companies that I mentioned here in my statement, all of our contracts are linked to the price of the LME plus a premium that we pay, and the way that we buy the metal through the LME, which we pay the LME plus the premium or the time that it sits in a warehouse, or we go to a warehouse outside of the LME, we still pay the same price. It is kind of like if I went to you to sell you an apple for $100 and someone came and they offered you something for $50, you would go and buy it for $50, but you are not going to offer it cheaper to somebody else. It is just not going to happen.

Senator BROWN. So you are saying that only—if you agree that 5 percent of this aluminum is in the warehouse only, 5 percent——

Mr. WEINER. Using that as an example. I cannot——

Senator BROWN. OK, but, I mean, that is what Goldman said, 5 percent. If that is, in fact, true——

Mr. WEINER. Yes.

Senator BROWN.——the price charged in the warehouse for that aluminum affects the other 95 percent of the market because of LME, perhaps arcane, obscure, hard to understand, but because of LME rules, correct?

Mr. WEINER. Absolutely correct.

Senator BROWN. OK. All right.

Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you all for testifying.

I wanted to follow up, Mr. Weiner, on the point that if demand is dropping, it would seem like it would take less time to get your aluminum out of the warehouse because you have fewer customers knocking on the door, if you will. Would that not be the logical conclusion if demand was diminishing?

Mr. WEINER. Absolutely.

Senator MERKLEY. OK. This whole discussion is fascinating. I think that the general picture is one in which you can make a lot of money by manipulating a market. Now, if you can put a thumb on the scale, you can do a number of things. You can make bets on the future price. That is one way of making a lot of money, if you can influence the supply and demand and make bets on the supply and demand. In addition, you can charge customers more for getting their product by charging rent, as you have pointed out, on the warehouse.

So which is the bigger issue here? Is the bigger issue that by controlling the warehouses, you can influence the prices and thereby make a lot of money by adjusting the outcome for bets you are making, or is the bigger issue the rent, the additional rent being charged that seems so unjustified?

Mr. WEINER. It is a combination of both——

Senator MERKLEY. OK.

Mr. WEINER.——because—I am sorry. Go ahead.

Senator MERKLEY. I wanted to turn to Ms. Omarova.

Ms. OMAROVA. Yes.

Senator MERKLEY. Thank you for your testimony. I think what is being presented here is a pattern. We have JPMorgan being involved in the supply of electricity, and I believe you have done work on Morgan Stanley's involvement in oil, petroleum markets.

Ms. OMAROVA. Only research work, not the real involvement.

Senator MERKLEY. Research work. And then we have this case of aluminum, and then we have a conversation about coming ownership through electronic traded funds in copper. And so is really what we see—is this a vast strategy employed by large financial institutions that are theoretically banks that take deposits and make loans, but really, they are giant firms dedicating themselves to be able to make bets on prices and then control behind the scenes, help control those prices?

Ms. OMAROVA. You are asking a very important question, actually. Is there a vast pattern of these large financial institutions turning into effectively trade and financial super-intermediaries? I believe there is a reason to suspect that there is, in fact, such a pattern emerging.

My point is that we really do need to get more specific data, specific information, to assess the vastness of this pattern, because this trend has enormous implications for the rest of the economy and the rest of our country.

Now, in this connection, let me just make a clarifying point further to Randy's testimony. It has been said here today that what is happening in the physical commodities markets with JPMorgan and Morgan Stanley and Goldman Sachs accumulating these physical assets is, in effect, nothing new. It is just sort of incremental continuation of what banks have been doing since ancient Egypt. That is true and yet not exactly true. At least, it is not helpful.

First of all, the relevant history here is not what happened in ancient Egypt. The relevant history here is what has been happening since 1956, when Congress made an explicit decision that bank holding companies should not be engaged in commodities or other commercial activities unless specifically permitted. And although in 1999 Congress did, in fact, create the merchant banking authority, the complementary authority, and the grandfathering exception, there is no evidence that Congress meant for these exceptions to swallow the rule. Whether or not in reality the law has been effective in preventing such swallowing of the rule by the exceptions is precisely the issue at stake today. We need to figure that out. I do not have substantial evidence of whether or not it happened, but it is not my position to present such evidence.

Now, history has also—you know, history can prove too much and too little, right. Just because some bank somewhere in the past did something and that was OK does not mean necessarily that it is OK today. For example, I am sure that some time, some bank has financed slave trade, right? That does not mean that JPMorgan today should be financing human trafficking based on some historical tradition. So that is basically my point on history.

With respect to the law, and especially the Gramm-Leach-Bliley Act provisions, it is one thing to say that the law, as written, technically allows for these types of investments to be conducted as long as they comply with certain requirements. My concern is how that law is implemented. Has it worked in reality?

Let me give you a quick example. For example, merchant banking authority, right, it was meant to allow banking institutions to make purely financial private equity, very passive, investments for financial appreciation, right. We invest in the company, then we resell it and make money on it. And there is an important requirement for such a merchant banking investment, for example, that Goldman Sachs as the financial holding company cannot participate in the routine management of an oil company or Metro International, the warehousing company it owns. And it all sounds really important, right. No routine management. That means they directly cannot participate in that business.

But in reality, what it means is that, for example, Goldman Sachs' managing director cannot be the CEO of Metro, or that

Goldman Sachs cannot formally obligate Metro International to check with Goldman Sachs every time they want to hire a janitor, for example. But, Goldman Sachs has the full right under the law, as written, to appoint all directors on the board of directors of that company. They can engage in extensive consultations with the managers of Metro International with respect to the business.

And it is very hard to tell how much of informal influence Goldman Sachs, for example, exerts over Metro International's management decisions. They may not exert any influence. It may, in fact, be a purely financial investment. But I wonder if the Federal Reserve, for example, is actually doing its job, asking those kinds of questions and looking in what is happening on the ground instead of just referring us to the letter of the law.

Senator MERKLEY. Thank you.

Mr. Rosner, to my broader question here, if I want to be in the business of making a lot of profits on placing bets on the price of commodities, owning a fair amount of the commodity itself and owning the pipelines or the ships, in the case of oil, or owning the warehouses, in the case of aluminum and copper, do not those things give me significant ability to manipulate the market?

Mr. ROSNER. Well, of course they do. And, in fact, we should be expanding this just beyond the warehouses. The example was given about the delivery of metals by the miner. Well, there is nothing that prevents through the Asset Management Division one of these banks from becoming the general partner, the control over a mine, OK, which creates other problems.

Look at what we saw, as an example, in California, where the government demanded that AES bring two power plants back online to make up for lost capacity and we saw JPMorgan attempt to block that. FERC ended up intervening and overruling them, but there were attempts. One has to ask if they were driven by profit motives on the desk, keeping prices up in the market for their benefit, and, frankly, one has to ask and go further, what would happen if, in fact, through the Asset Management Division they had control of a generating facility on that grid. Again, that would end up helping their pricing. So, I think these are very real.

Now, add one more level, which I really think needs to be stressed. If, in fact, we saw a catastrophic event at any of these owned facilities, nonfinancial facilities, the impact, reputationally and operationally, not only to the institution but to the Federal Reserve, would be catastrophic.

Senator MERKLEY. Thank you very much. Thanks.

Senator BROWN. Thank you, Senator Merkley.

Senator Warren, and we are setting the clock at 7 minutes. Please proceed.

Senator WARREN. Thank you, Mr. Chairman, and I apologize. We are having simultaneous hearings and I was off at an NLRB hearing. But I appreciate your having this hearing, Mr. Chairman.

An interesting conversation about the history. The way I sort of see this is that, you know, the turn of the 20th century, the biggest banks, and JPMorgan was one of the prime examples, played an active role in the management of many of the Nation's key industrial companies. JPMorgan partners, for example, sat routinely on the boards of railroad companies, steel companies, other large cor-

porations. Now, it began to change leading up to the Great Depression as reformers like Louis Brandeis warned again and again and again about the dangers of both conflicts of interest and the concentration of power and as they generated greater and greater public support for the notion that these should be separated.

After the 1929 crash, the Glass-Steagall Act clamped down on the banks' interconnectedness with industry by separating boring banking, like checking and savings accounts, from the high-risk gambling found on Wall Street.

So I am glad we are having this hearing today because our banks and industrial have changed, but the dangers of concentration and the principles at stake have not, and that is why I share the concern of many of my colleagues about asset managers at huge Wall Street banks exercising control over key parts of America's infrastructure.

So I thought I would start my questions with you, Mr. Rosner. If we ever experience again a crisis like the crisis in 2008, how do you think Wall Street control over electric plants or seaports or airports could factor into the systemic risk confronted by the Department of Treasury and the Fed and, ultimately, the taxpayer?

Mr. ROSNER. Right. As I said in my testimony, I think that those are very real risks that need to be considered. The situation is not terribly different than in 2008, where we watched the industry go from originally making mortgage loans to taking over through investment banking the entire mortgage complex, from front, hiring third-party mortgage originators, pooling and packaging securities, making money on the sale and trading of those securities, proprietary trading on those securities, owning the servicing and, in some cases, we watched the servicing companies that they purchased run not by separate divisions but actually be owned and operated by the trading desk, creating significant opportunities for informational advantage of the firm over its customers, and incentives that, frankly, led to many of the outcomes that we have seen and losses, OK.

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. Now, one institution theoretically could be resolved under Dodd-Frank. I do not believe that Title I, Title II works. But even assuming that it could, the 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.

Senator WARREN. Or to say this another way, the interconnectedness——

Mr. ROSNER. Absolutely.

Senator WARREN.——increases the likelihood——

Mr. ROSNER. Absolutely.

Senator WARREN.——that these institutions——

Mr. ROSNER. That is right.

Senator WARREN.——remain too big to fail.

Mr. ROSNER. That is right. And as I said before, you know, one does have to question what would have happened if, in fact, the Exxon Valdez was owned by one of these bank holding companies.

Senator WARREN. Yes. Good. Thank you.

I have another question for you. I do not think there is any question that institutional investors, like pension funds, hope that asset managers at a big bank will return solid profits over time. But I also do not think that most retirees realize that their pension or retirement savings are used to pave the way for big banks to be able to control an electric plant or an oil refinery. So, Mr. Rosner, what dangers do you think result from big banks spending, as Brandeis put it, other people's money to amass this kind of power and control?

Mr. ROSNER. Well, I mean, I think we saw this with JPMorgan's ownership and control of U.S. Steel, one-sixth of the Nation's railroad, rail lines, General Electric and Edison, and we saw some of the outcomes, the consolidation of the power, the impact on pricing.

I think it is also, though, important to really think about, and if you have any questions about the strategy here, look at some of the footnotes in my written testimony. The statements, the language used by these asset managers, these bank-run asset managers in pitching to those firms include the advantages of controlling monopolistic and quasi-monopolistic assets as an inflation hedge because of the ability to negotiate long-term leases with riders that allow pricing to rise even when demand falls.

Senator WARREN. So say this one again, Mr. Rosner. I mean, I just want to make sure you put the right summary on this. These people are out amassing this power. They are using the money that people invest, for example, in their pension plans. They are using it to amass this power and then they are selling, in effect, themselves on the notion that if you will invest with their company, they are going to have the benefits of having created this powerful and interconnected sort of corporate and banking conglomerate that will be able not only to produce big returns because you have figured out the right things to invest in, but produce big returns because they will have, as you describe it, monopoly control——

Mr. ROSNER. As they describe it.

Senator WARREN. As you described their describing it——

Mr. ROSNER. Correct.

Senator WARREN.——because they will have monopoly control.

Mr. ROSNER. That is correct.

Senator WARREN. Thank you, Mr. Rosner. I think that is clear. Mr. Chairman, thank you.

Senator BROWN. Thank you, Senator Warren.

I want to pursue, and I will start with you, Mr. Guynn, more on the oil, gas, and energy markets that both my colleagues touched on. Before Morgan Stanley converted in 2008, largely to get access to the window, apparently, it was one of the leading investment banks directly involved in the physical commodities and energy sectors. That would lead you to think they would be grandfathered.

They currently own TransMontaigne, a petroleum and chemical transportation and storage company, and Heidmar, Inc., which reportedly manages some 100 oil tankers, 80 of which might be at sea on a given day. Bloomberg reported on Friday that a spokes-

man for Morgan Stanley said the bank did not expect, quote, "to have to divest any of its activities after the grace period ends in September." That was the grandfather issue, I believe.

In a 2012 Reuters story, one expert said that owning physical assets in trading financial markets, quote:

> gives you the visibility of the market to make far more successful proprietary trading decisions in both physical and financial markets. It is trading with material nonpublic information. The difference compared with equity markets is that it is perfectly legal.

So, as they know the markets so much better because of their control of some of these assets—it could be Metro, it could be something else—they have an advantage, purportedly, in the marketplace in terms of proprietary trading. There are not conflicts of interest in the insider trading issues with equity markets. The laws do not apparently apply the same way.

So my question, Mr. Guynn, are there concerns when a financial company that is wagering on oil prices also controls a fleet of over 100 tankers that it can hold back from delivering to a port to influence prices? So you own 100 tankers for a period of time. You scale back the number of those tankers delivering oil. And you are also in a position to wager on oil prices. Is that a concern to you?

Mr. GUYNN. So, I think all of these things—trading in material nonpublic information, having and abusing market power—are serious concerns. Obviously, if they had a large enough market share to give them market power, and they abused that power, they would presumably be violating the antitrust laws. I am not sure that it is actually quite accurate to describe the sharing of information between these two markets—the cash and derivatives markets—as sharing material nonpublic information. I think the better analogy is a bank buys the bonds or trades in the bonds of a company. It also enters into swaps with the company and uses the information from each market in the other market. I think that is the better analogy.

In fact, actually having knowledge of both markets helps price discovery and helps the prices in the derivatives markets and the prices in the physical markets to converge, which is actually a good thing. It helps the markets. It helps the liquidity of the markets. It helps the miner in Senator Toomey's example to be able to sell his product very quickly with a known and expected price.

Senator BROWN. But this situation, you do not think is a particularly serious potential problem?

Mr. GUYNN. The situation——

Senator BROWN. With owning oil tankers and also wagering on the price of oil.

Mr. GUYNN. Well, I mean, if they own oil tankers and they participate in the markets—the spot market and the futures market for oil—and they had market power and they abuse it, I suppose that could be a problem. Presumably, the antitrust authorities would look at that, however. Unlike the 19th century, we have the Sherman Act and the Clayton Act now and we have the U.S. Department of Justice and the Federal Trade Commission that survey that. We have bank regulators that look at that. We also have securities and commodities regulators that look at insider trading or misuse of information. If there are any gaps in the regulations, I

would have thought that it would be a legitimate thing to fill any gaps and to make sure that any sort of bad behavior of the sort you are suggesting as potential did not occur.

Senator BROWN. I would like to think that we have regulators in the Justice Department that would be as aggressive as you suggest they might.

Ms. Omarova, comment on Mr. Guynn's comments, please.

Ms. OMAROVA. Well, I think oil market and the way price is, quote-unquote, discovered in oil markets is in itself a very interesting and complicated question. The term "price discovery" sounds very neutral, and it generally refers to this very liquid, very public market, lots of buyers and sellers come independently and somehow in that wonderful process the fair price for particular goods is established.

But in these markets, for example, over-the-counter oil derivatives markets, Goldman Sachs is not just doing price discovery in that traditional sense. I suspect they are actually able to form the price, to set the price, because they are a major dealer in these markets.

Now, is that an issue, that not only can they set the price or affect the price in these financial markets, but they can also influence the price of the physical oil if they own the fleet of tankers or contractually have access to the physical barrels of oil? I think it is a far more important issue than the traditional antitrust DOJ concerns with just the market share calculated based on some definition of a market, for example.

I am all for the DOJ to actually conduct a serious antitrust investigation of these issues. But recently, there have been attempts internationally to figure out, to investigate how the global oil prices are actually discovered or established and that investigation did not go anywhere because the oil industry basically refused to cooperate, it is my understanding. So if this is the market in which Morgan Stanley and Goldman Sachs are playing, it makes me uncomfortable as a banking law person.

Senator BROWN. The response of the panel to my colleagues' questions about a potential Exxon Valdez or BP oil spill, if the banks had ownership in those companies, begs the question, can bank examiners, already overworked, already underfunded, sometimes too captured by the people whom they regulate—perhaps leave that part of it out—but can these bank examiners fully appreciate and understand the kind of environmental potential impact on some of these commodities?

Ms. OMAROVA. Well, if there are actually bank examiners that realistically can do that, then probably they should be running the world, because it is extremely difficult to imagine a human being—and I do not know what kind of professional qualifications bank examiners must have to get the job, right. I assume that even if they had a Ph.D. in economics or finance or anything like that, they might still have a difficulty figuring out exactly the dynamics of a market as globalized and as complicated and as nontransparent as oil, for example.

Now, on top of that, if you move to electricity, that is a whole different market with its own factors shaping the prices and shaping the behavior of market actors, and so on and so forth. There

is no such thing as a single unified commodity sector that one can study and understand and then say, well, everything is under control.

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.

Senator BROWN. Thank you.

I am sorry. Let me do one more question and then turn it again to Senator Warren.

Morgan Stanley also markets energy and owns energy generation facilities in the United States and Europe. JPMorgan has similar authority. JPMorgan said that power has monopolistic pricing power and demand that is relative insensitive to price, which essentially is saying that you can charge what you want for electricity and people will pay for it.

I want to quote from Mr. Rosner's testimony. You said, FERC took action against JPMorgan for its attempts at preventing the implementation of State sequestered changes to Huntington Beach, California, power plants owned by AES Corporation. The State deemed the work necessary to replace lost power capacity that resulted from the shutdown of a nuclear plant. JPMorgan sought to prevent the changes and claimed its marketing contract with AES gave them the right to veto the work.

While the bank's motives were not stated, it is reasonable to consider that the firm sought to profit from the higher peak energy prices that would have resulted from its actions to prevent new capacity from coming online. Media reports are that there is a $400 million settlement around that, a payment from JPMorgan. It suggests heightened risks of conflicts of interest, anti-competitive practices, market manipulation that can arise when a company controls the supply of a commodity and trades in financial markets for that commodity as a market maker and as a principal.

Mr. Rosner, I mean, I quoted you, but expand on that, if you would, or how concerned you are with this, and do regulators have the ability or the authority to regulate these sorts of arrangements?

Mr. ROSNER. No. I mean, look, even the information advantage that comes from their knowledge of what their intent is has real impact in the marketplace and has real benefits that it can provide in the marketplace.

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, OK, 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 relation-

ships that exist here is not rational. And, in fact, if 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.

The conflicts of putting together all of these business lines, even within financial services, need to be managed. They were not managed so well by the regulators. And to expect that we can see the expansion into far more lines of business, far more far-flung infrastructure assets, I think, is unrealistic and, as I said, poses a very different level of catastrophic risk. No one should suggest that private industry should be prohibited from owning businesses. But when you have the backstop, implied or explicit, of the Federal Government, it changes the equation, and I would contend that these institutions have become today's equivalent of the Government-Sponsored entities that we saw fail in the mortgage crisis.

Senator BROWN. Mr. Guynn, why is he wrong? You seemed—the look on your face suggests you think he is.

Mr. GUYNN. So, first of all, I think the riskiest thing that financial holding companies do is actually lend money on a long-term basis. That is actually the asset that tends to fall in prices, it tends to result in runs. It actually is probably the riskiest thing they do.

The bank regulators are not omniscient. They are human beings. They make mistakes. They made lots of mistakes in the financial crisis. So did lots of other people. And they are not going—and my guess is it would be the unusual bank examiner who understands the commodities markets or the oil markets or oil tankers and so forth. But they do have tools that they have used, can use and have used, to try to control this risk and have safeguards.

So, for instance, in the complementary powers orders, they only allow activities by bank holding companies. It is important to know that the banks themselves cannot do it. We often sort of mix those up. So the separately capitalized, insulated nonbank affiliates can buy and sell physical commodities, but it is limited to physical commodities where there is a contract that is authorized for trading on an exchange by the CFTC, which means that they are sufficiently liquid, or if there is not a contract that is authorized, that the Federal Reserve has specifically determined is sufficiently fungible and liquid to be an appropriate banking asset. Then they have volume limits.

They also have capital and liquidity requirements. There is no question that the bank regulators are not going to be able to calibrate the risk of these activities any more than they have been able to calibrate the risks of lending. And so the way they manage—the way they sort of put safeguards in place to manage all of the risks

of the financial services industry is to have limits, capital requirements, liquidity requirements, surveillance, examinations, and so forth.

Senator BROWN. Thank you.

Ms. Omarova, do you want to just respond?

Ms. OMAROVA. Just a quick note on this, that I do agree that lending in and of itself is an extremely risky activity and I do not think anybody seriously is aiming at eliminating risk entirely from the banking business. That is just impossible.

However, it is important to understand that the entire system of banking law and regulation is built on an assumption that these are the kinds of risks banks generate for themselves, it is built on an assumption of what that business is about. And so, poorly or effectively, but that regulatory scheme actually targets those risks.

Now, when that regulatory scheme has to deal with risks that are completely outside of that type of business and, therefore, were not even meant to be addressed, then this is an issue of legal efficiency and regulatory efficiency.

Senator BROWN. Thank you.

Mr. Rosner, last comment, then Senator Warren. Sorry.

Mr. ROSNER. I just want to go back and point out that on September 27, 2012, the CFTC issued an order against JPMorgan for violations of 4(a)(b)(2) of the Commodities Exchange Act, finding deficiencies in newly created automated position limit monitoring system for the commodities business used by commodities traders to track their current positions, in particular, futures contracts. After learning of this deficiency, JPMCB utilized a manual position limit monitoring procedure pending correction of the automated monitoring system. Despite adoption of this manual position limit monitoring procedure, JPMCB violated its short side speculative position limits on several occasions.

So, first of all, we find in that statement internal control failures. The company themselves could not manage those controls.

More importantly to this point, those were uncovered by the CFTC. We are not talking about the bank examiners. We are not talking about the Federal Reserve. We are talking about the CFTC, OK. The primary regulator clearly does not have the capacity to manage all of the risks. Otherwise, we would not have seen one of these institutions spend 12 percent of net income between 2009 and 2012 on settlements for various operational failures across their business lines.

Senator BROWN. Thank you.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

Professor Omarova, you have written about how regulators began chipping away at Glass-Steagall starting in the early 1980s and began breaking down the wall between commercial banking and investment banking. So, I want to ask you the other part of the question. What do you think is the impact of a financial institution being able to take consumer deposits while also being able to control, say, an electric plant or an oil refinery through its Management Division? Professor Omarova.

Ms. OMAROVA. That is a very important issue that needs actually further significant research, and I am hoping that this hearing will

start the process of asking the questions of the people who can provide us with information for us to be able to arrive at the full conclusion on that.

But, as a preliminary matter, right, as a person sort of applying common sense and some knowledge of what has been happening in the past, I would say that there are some serious concerns with that situation. We have talked today a lot about potential, for example, for manipulating prices in either market. Now, it may or may not hurt the individual consumers, but that raises an issue of market integrity in the financial markets, also in the underlying commodities markets, right. It also interferes with the traditional supply and demand dynamics that typically form prices in a variety of markets.

So, do we want that to happen? Of course not. Is it happening? It is hard to tell. But might it happen? Of course, it can happen, and that is the issue to be asked.

Then there is this whole another problem with the systemic risk and what not. We have already talked about it.

But then, ultimately, if you think about it from the point of view of a regular person, you know, if these trends were to continue without any kind of principled limitation on what should be allowed to banks, simply because they can afford to do it maybe cheaper than others, then probably at some point in the future, we will find ourselves in a situation where we—not only do we buy our house with the money borrowed from a big bank, not only that house was built maybe by a subsidiary of that big bank, it is heated and electrified and provided with water that is also distributed and perhaps produced by that same bank, and who knows what else. In fact, you know—this is hyperbolic hypothetical, of course, being a law professor, I cannot resist that——

[Laughter.]

Ms. OMAROVA.——but one could envision JPMorgan's new slogan as, "Get Everything You Need From Your Friendly Local Global Financial Conglomerate."

And perhaps that is OK. Perhaps that is the kind of a future for this country that we should be prepared to live with, because JetBlue or an oil refinery in Pennsylvania actually gets cheaper financing of its inventories, right. But if that is the case, what I am asking for is a chance for a public deliberation. We have to be able to make that decision.

Senator WARREN. Mr. Rosner, did you want to weigh in on that?

Mr. ROSNER. Yes, only in the discussion of cheaper financing, because I think it needs to be, again, stressed. There is nothing wrong with vertical integration of industries. There is nothing wrong with investors owning those assets, investing in those assets, controlling those assets within the confines of regulation.

When you have institutions that have access to the Fed window, and that may well be the basis of their cheaper financing, it is anticompetitive. 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.

This is not about liking or disliking Wall Street's investments in infrastructure assets. That is a clear driver of our economy. The question is tying those to competitive advantage of the Federal funds.

Senator WARREN. Well, it is both. It is competitive advantage and it is risk——

Mr. ROSNER. Right.

Senator WARREN.——that we are talking about.

Mr. ROSNER. No, that is right.

Senator WARREN. So let me ask the question, then, from the other direction, and that is that Senator McCain, Senator Cantwell, Senator King, and I recently introduced a 21st century Glass-Steagall Act. So, what impact do you think a new Glass-Steagall Act would have on the developments you have seen in the marketplace? Mr. Rosner.

Mr. ROSNER. Well, so, first of all, I have not read the text, so I cannot comment on the specifics.

Senator WARREN. Fair enough, but I will tell you, it is short.

Mr. ROSNER. I do worry that, given the complexity of these institutions, it may be difficult to achieve, and even if we did have the Congressional intent to do so. We have got institutions whose derivative books themselves are enormous. And, frankly, there are real questions as to what they know of their thresholds within those businesses. And so I think to expect the quick dismantling of those would be difficult——

Senator WARREN. Fair enough, although I will tell you, in the bill, there is a 5-year period, because it acknowledges exactly that point, that we have created a tangle and it takes time to undo that. But at least in terms of the direction we are trying to head, and that is to say that commercial banking, boring banking, should be separated from these other functions.

Mr. ROSNER. Well, we certainly have seen negative outcomes from the broader economy and, frankly, for financial markets as a result of the combination of those businesses. Now, we often hear, well, our largest institutions will be less competitive globally, to which I would usually respond, one, we have—first of all, I would be very happy if this gentleman was able to secure cheap funding because a German bank had a cheaper cost of funds because it had a backstop of the German government. I would actually find that to be OK, if we outsourced that risk, prevent our largest institutions from underpricing risk to be competitive, because in Europe, through actions——

Senator WARREN. Let me just make sure I am following. You would be glad to shift that risk——

Mr. ROSNER. Absolutely.

Senator WARREN.——over to the German taxpayers——

Mr. ROSNER. That is right.

Senator WARREN.——so long as the American taxpayers do not take it on.

Mr. ROSNER. Well, that is the point, right? So we have in our country Dodd-Frank. The intent was to make sure that our largest financial institutions are not sovereign obligations. In Europe, they have accepted them as sovereign obligations. And so that competitive issue really suggests that we are willing to say, let business

get funding from capital markets, where, by the way, most of it comes from, or where foreign banks are willing to underprice risk, because lending is very risky, as we discussed, let them do so without creating the race to zero, bringing our institutions down that road.

Senator WARREN. OK. Or, to say it another way, but not the American taxpayer.

Mr. ROSNER. That is right.

Senator WARREN. And, Professor Omarova, would you like to weigh in on that?

Ms. OMAROVA. Well, personally, I think that the proposed bill on the 21st century Glass-Steagall Act is a move potentially in the right direction. What I want to emphasize, though, is that just by separating boring banks from the rest of the financial system, we may not completely, of course, resolve the issue we are talking about today, because, ultimately, this is about financial institutions that are also dealers and traders in financial markets, capital markets, and credit markets, being engaged on such a large scale in the physical trading of commodities. That is the combination that worries us here today, and that does not necessarily depend on the actual charter.

So I would urge you, Senator Warren, and your colleagues to perhaps, you know, think more in terms of perhaps expanding the——

Senator WARREN. I think it is fair to say that many of us are very well aware of the need for multiple tools in the toolbox and looking for more ways to move us in the right direction, that Glass-Steagall is not designed to solve every problem, but it helps move us in the right direction, helps reduce risk, helps, at least to some extent, disentangle what has become a mess that is both hard to regulate and is creating additional risk on its own. So thank you very much.

Thank you, Mr. Chairman.

Senator BROWN. Thank you, Senator Warren.

This is a picture of the ownership structure of an exchange traded fund, a so-called ETF, established by JPMorgan to invest in copper. In documents filed with the SEC, JPMorgan acknowledges, as you can see from this chart, and I will quote:

> The trust, the sponsor, the administrative agent, the warehouse keeper, the JPMorgan Securities LLC, the initial authorized participant are all affiliates of JPMorgan Chase. Although the sponsor attempts to monitor these conflicts, it is extremely difficult, if not impossible, for the sponsor to ensure that conflicts of interest do not, in fact, result in adverse consequences to the trust.

They note the sponsor has the authority to fire the warehouse, their own Henry Bath subsidiary, but they have an incentive not to exercise this authority even when it may be in the best interest of shareholders to do so because of the affiliation among the entities. I would also point out, Reuters reported that JPMorgan added commodity chief Blythe Masters and some other JPMorgan executives to Henry Bath's board.

Reading on, "JPMorgan Chase Bank currently engages in and in the future expects to engage in trading activities related to copper." Much talk about aluminum and energy in this discussion today, less so about copper, but my guess is, a year from now, we might

be talking a lot more about copper. And I spoke to a labor official today who represents industrial workers and he talked about how important copper is in so many of the products that his workers and the companies they work for make.

Futures contracts in copper and other copper-related investments for its accounts or for the accounts of its clients. Essentially, other parts of the bank may bet against investors in the copper ETF. This structure is eerily reminiscent of Mr. Rosner's comments about the subprime collateralized debt obligation arrangements that we saw before the financial crisis, and I have a series of questions for Mr. Rosner.

We know, first of all, we know the three largest ETFs could control up to 80 percent of the copper available in the market. Mr. Weiner pointed out the problems they faced in aluminum. This could be, perhaps, worse. So, questions, Mr. Rosner. Are you troubled by the effects that this could have for end users of copper? Should regulators share your concern? Should consumers? Should investors? Are you troubled by the ETF structure and the conflicts of interest involved?

Mr. ROSNER. Well, of course. Look, in the industry, the financial service industry, whether it is commercial banking or investment banking, there will always be conflicts and those conflicts must always be managed. And so if we had confidence that the regulators could appropriately manage those conflicts or that the companies themselves could appropriately manage those conflicts, there would be no reason for us to be here today.

I do not suggest that any of the activities that we are talking about today are being run by people who are malicious, malevolent, or have particular schemes to intentionally harm the public. Functionally, though, we have businesses where those conflicts of interest are driven by management who have obligations to their investors. That is their primary obligation. And so to make sure that the public is not harmed, we need to make sure that those are fully private industries without Government support, to Senator Warren's point.

We had Wall Street function, frankly, for generations, effectively, both in doing lending functionally through syndicates—financing, I should say, through syndicates—and investment banking businesses. All of those activities are fine. They just should not be tied to the Government support.

And so where they are, yes, all of these activities should raise concern, should raise questions, and the conflicts of interest become all the more meaningful specifically because the U.S. taxpayer is functionally on the hook.

Senator BROWN. Does anyone else wish to comment on that?

OK. Let me go to another line of questions on transparency. Ms. Omarova, you, in your opening statement, you talked about lacking the necessary data generally to address so many of these issues. We have talked about the lack of transparency on both the regulators and the institutions. We do not even know what the regulators seem to be doing. There is no easy way for Senator Merkley or Senator Warren or me or Senator Toomey, any of us, to learn about practices that these banks are undertaking or if the process, even the process, most egregiously in my mind, by which the Fed-

eral Reserve reviews and approves these activities, we do not even know if, in fact, they have a deadline, when that deadline might be, although we think we can calculate it, but the Fed will not acknowledge it, that September deadline. It might apply to Goldman and Morgan Stanley, but we do not know.

The Fed says that there is no deadline. Morgan Stanley's public filings say it has 5 years from September of 2008. It is not hard to add 5 years and come up with 2 months from now that they have to comply with the Bank Holding Company Act. Other companies say they expect the Federal Reserve to clarify the scope of permissible grandfathered activities sometime this fall.

Ms. Omarova, should Members of the Banking Committee, should the public generally be forced to feel around in the dark in order to figure this stuff out?

Ms. OMAROVA. Well, of course, we should not. Being in the dark about this issue may in some ways make our lives easier, right, because we do not—you know, what we do not know does not hurt us, supposedly. But it still might hurt us and it is better to be prepared for what is going on and weigh into that conversation before it is too late.

Now, with respect to that September deadline, the banking statutes, and the Bank Holding Company Act is no exception, are frequently written in such an unclear manner that it is very difficult to figure out what exactly is required and what exactly is discretionary.

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.

So as a practical matter, as a procedural matter, it is up to the Fed at some point to weigh in on the question that after you have become a bank holding company now and now are subject to these limitations, what did you do with those assets that you held prior to such conversion and at the time did not have to comply with the limitations of the Bank Holding Company Act? And that is the decision that is made by the Fed in negotiation with these companies.

Now, what I would like to do, or what I would like you to do, I suppose, is to ask the Fed these questions. Has the Fed been looking into this issue, what kind of criteria the Fed is using when it talks to these institutions, and how specifically does the Fed arrive at its conclusions, for example, that a particular type of an investment or activity is, in fact, consistent with the public interest. And, again, this is a very important inquiry.

Senator BROWN. Well, and we have asked those questions. We have not asked them in a public forum. They have been less than forthcoming. We will do a hearing probably in September, and I hope it is before the deadline, but we do not know when the deadline is because they will not tell us when the deadline is, if that sounds a bit circuitous. But we will continue this, and it was not just Morgan Stanley and the Fed. It has also been JPMorgan.

For instance, Reuters, in a different situation but still leaving Fed involvement, is attempting to convert its ownership of the Henry Bath warehouse into a merchant banking investment, as you know, allowing them to hold it for 5 more years beyond the 2015 cutoff. Goldman Sachs apparently—apparently—also holds its Metro warehouse system under this provision. They elect to do so using a Federal Reserve form that is not necessarily available to the public.

So the Fed, again, has not been forthcoming in showing us this form, discussing the deadline, allowing us a schedule on how the form is filled out and when it is due. Surely, and I will not even pose this question because the answer is so obvious, that this information should be available to Members of Congress, to the public, to all of us.

Senator Warren.

Senator WARREN. Thank you.

So, Mr. Weiner, I read your testimony about what happened in the market for aluminum as a result of the activities of the large financial institutions. I thought it was pretty alarming, and I just wanted to ask you, can you describe specifically how you think the market developments here have affected consumers.

Mr. WEINER. We are the ultimate consumers here of aluminum. It affects all of us. What it does is it takes away our opportunity to give the consumers what they want. Our consumers, in our particular case, 60 percent of our products are packaged in aluminum. We would like to give them what they ask for and they want aluminum. We give them the punch-top can. We give them the aluminum pint. We give them all these innovations, which creates jobs so we can buy new can lines to promote and push our business forward. These are the things that are held back from us that we cannot offer to the general public.

Senator WARREN. Thank you. That is very useful.

And, Professor Omarova, you wrote last year that big banks began actively seeking expanded authority to conduct physical commodities and energy trading activities in the early 2000s, shortly after the fall of Enron, the pioneer in financializing commodity and energy markets.

Now, you said in this paper that it is difficult to draw causal connections here because of the timing, but you also seem to have a hunch that this was not a coincidence. Would you be willing to expand on that a little?

Ms. OMAROVA. Well, again, let me reiterate, I do not—I have not done research to substantiate the link between the fall of Enron and the rise of Morgan Stanley and Goldman Sachs as this kind of integrated super-intermediary derivatives/physical commodities traders. But, you know, there is at least a plausible, a very plausible argument that Enron was the pioneer in discovering a business model that brought together the ability to move physical commodities, like oil, gas, and other things, right, through a network, vast network of commodity infrastructure throughout the entire Nation and a major derivatives platform that is tied to the price of those commodities that Enron was moving.

Now, it is important to understand that in that model, it is not really even the key to own any particular producing company in

that chain or any particular distributor. Through contractual networks, Enron was able, or at least it was seeking the ability, to establish this kind of vast network of kind of trade intermediation plus financial intermediation.

What happened to Enron, we all know. Now, once that model, though, was discovered, that model was up for the taking, and I think that the early 2000s is a particularly important threshold because that was the beginning of the major, unprecedented global commodities boom. And, again, it is hard to draw any kind of causal connections. Was the boom at least in part facilitated by the influx of the financial institutions into the commodities market and financialization of commodities markets? Perhaps, at least partly, the answer is yes.

Or was it the other way around? Was it that when Citigroup, for example, and JPMorgan saw that physical commodities have become the next hot asset class after the dot-com boom ended, they have decided that they should use this sort of ability in the statute to actually start getting into that physical commodities game? I am sure, partly, at least, the answer is yes.

Senator WARREN. So, I do have to say here, whichever way the causation era runs, the notion that two of our largest financial institutions in this country are adopting a business model that was pioneered by Enron suggests that this movie does not end well and that we are now pulling more and more risk into the system, and that what happened with Enron at least should stand as a cautionary tale as we look forward to the integration of these larger financial institutions and the commodities market. So, thank you very much.

Mr. Rosner, did you want to comment on that?

Mr. ROSNER. No.

Senator WARREN. Good. Thank you very much. I appreciate it.

Mr. Chairman, thank you.

Senator BROWN. Thanks, and I want to just close with a couple of comments.

One, to be fair, I mentioned Morgan Stanley and JPMorgan Chase in terms of the failure or the inadequacy of the Fed response. I would add that Goldman's investment in Metro and energy company Kinder Morgan are both merchant banking and tended to be passive investments. Two managing directors of Goldman Sachs serve on Kinder's board of directors, owning a 19 percent stake in the company. So that, I think—that is another place where the Fed should look a little more carefully, we think.

We primarily learned three things, I think, from this hearing. We learned that this kind of ownership of a whole part of the real economy can potentially be a risk for the banking system.

We learned that the banks, when they own, they can get less expensive financing because of their access to the window, can get less expensive financing to capitalize their commodity holdings.

And we learned that there is an advantage because of their knowledge of the buying and selling and storing and transporting of commodities. These banks get an advantage for proprietary trading.

None of those seem to fit, in my mind, with the history of financial regulation in this country, but they are two sides of debate.

Mr. Guynn argued that we should not be that troubled that banks are recreating the old model of the original JPMorgan. Mr. Rosner cited Mr. Morgan as a reason to be wary. We should ask ourselves what it does to the rest of our society, to our businesses, to our consumers, to our manufacturers, to taxpayers, when wealth and resources are diverted into finance that way.

The issue needs more explanation. The Federal Reserve and the banks themselves are in the best position to provide it. Stay tuned.

I so appreciate the four of you being here. I appreciate Senator Warren's and Senator Toomey's and Senator Merkley's questions. If the Members of the Subcommittee may have questions of you, they will have a week to get them to you. Please respond as quickly as you can.

Thank you all very much. The hearing is adjourned.

[Whereupon, at 11:53 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SAULE T. OMAROVA

ASSOCIATE PROFESSOR OF LAW
UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

JULY 23, 2013

I am an Associate Professor of Law at the University of North Carolina at Chapel Hill, where I teach subjects related to U.S. and international banking law and financial sector regulation. Since entering the legal academy in 2007, I have written articles examining various aspects of U.S. financial sector regulation, with a special focus on systemic risk containment and structural aspects of U.S. bank regulation. For 6 years prior to becoming a law professor, I practiced law in the Financial Institutions Group of Davis Polk & Wardwell and served as a Special Advisor on Regulatory Policy to the U.S. Treasury's Under Secretary for Domestic Finance.

For the past 14 months, I've been working on a research project examining the involvement of large U.S. banking organizations in physical commodities and energy markets. The working draft of my article, entitled "The Merchants of Wall Street: Banking, Commerce, and Commodities" is available on the Social Science Research Network, at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647*. This written testimony represents an abbreviated version of that article. For further details and full citations, please see the text of the article.

I. The Legal Background: Separation of Banking from Commerce

One of the core principles underlying and shaping the elaborate regime of U.S. bank regulation is the principle of separation of banking and commerce. Pursuant to that principle, U.S. commercial banks generally are not permitted to conduct any activities that do not fall within the relatively narrow band of the statutory concept of "the business of banking."[1] In addition, under the Bank Holding Company Act of 1956 ("BHCA"), all bank holding companies ("BHCs")—*i.e.,* companies that own or control U.S. banks—are generally restricted in their ability to engage in any business activities other than banking or managing banks, although they may conduct certain financial activities "closely related" to banking through their nondepository subsidiaries.[2] The Gramm-Leach-Bliley Act of 1999 ("GLBA") amended the BHCA to allow certain BHCs qualifying for the status of "financial holding company" ("FHC") to conduct broader activities that are "financial in nature," including securities dealing and insurance underwriting.[3] All BHCs (including their subset, FHCs) are subject to extensive regulation and supervision by the Board of Governors of the Federal Reserve System (the "Board"), an agency in charge of administering and implementing the BHCA.

In effect, the entire system of U.S. bank and BHC regulation is designed to keep institutions that are engaged in deposit-taking and commercial lending activities from conducting, directly or through some business combination, any significant nonfinancial activities, or from holding significant interests in any general commercial enterprise. The main arguments in favor of maintaining this legal wall between the "business of banking" and purely commercial business activities have traditionally included the needs (1) to preserve the safety and soundness of insured depository institutions, (2) to ensure a fair and efficient flow of credit to productive economic enterprise (by, among other things, preventing unfair competition and conflicts of interest), and (3) to prevent excessive concentration of financial and economic power in the financial sector. The BHCA, which was originally envisioned as explicitly anti-monopoly legislation, embodies and seeks to implement these policy objectives.

Of course, in practice, the relationship between banking and commerce in the United States has never been simple, as the legal wall separating them has never been completely impenetrable. Numerous exemptions from the general statutory restrictions on affiliations, such as the exemption for unitary thrift holding companies or companies controlling certain State-chartered industrial banks, historically have allowed a wide variety of commercial firms to own and operate deposit-taking institutions. Banks and BHCs, in turn, have always been allowed at least some degree of involvement in nonfinancial activities, subject to various statutory and regulatory conditions and limitations. For example, BHCs are generally permitted to invest in up to 5 percent of any class of voting securities of any nonfinancial company—an

[1] 12 U.S.C. § 24 (Seventh).
[2] 12 U.S.C. §§ 1841–43.
[3] 12 U.S.C. § 1843(k)(1)(A).

exception designed to allow banking organizations to take small, noncontrolling stakes in commercial businesses as passive investors.[4]

In the last decade, however, there has been a qualitative change in the practice of mixing banking and commerce, at least within the structure of large, systemically important FHCs. Thus, large U.S. FHCs—including Goldman Sachs, Morgan Stanley, and JPMorgan Chase & Co. ("JPMC")—have emerged as major merchants of physical commodities and energy, notwithstanding the legal wall designed to keep them out of any nonfinancial business. As explained in greater detail below, these three FHCs currently own and operate what appear to be significant businesses trading in crude oil, gas, refined petroleum products, electric power, metals, and other physical commodities. In conducting these activities, they function as traditional commodity merchants rather than purely financial intermediaries. That's why it is important to understand how the law has failed to prevent, and apparently has enabled, this extensive entry of banking organizations into the sphere of general commerce.

In an important sense, the story begins with passage of the GLBA in 1999. The GLBA is best known for partially repealing the Glass-Steagall Act and thereby opening the door to a mixing of commercial with investment banking. More significantly for present purposes, however, the GLBA also opened the door to a greater mixing of banking with commerce. Under the BHCA, as amended by the GLBA, there are currently three main sources of legal authority for FHCs (but not all BHCs) to conduct purely commercial activities, despite the general separation of banking from commerce: (1) merchant banking authority; (2) "complementary" powers; and (3) "grandfathered" commodities activities. In order to engage, directly or through any subsidiary, in any nonfinancial, commercial activity—including producing, refining, storing, transporting, or distributing any physical commodity—an FHC has to "fit" that activity within the legal confines of at least one of these three statutory exceptions created by the GLBA.

A. Merchant Banking Powers

The merchant banking authority permits an FHC to acquire or control, directly or indirectly, up to 100 percent of any kind of ownership interest—including equity or debt securities, partnership interests, trust certificates, warrants, options, or any other instruments evidencing ownership—in any entity that engages in purely commercial, as opposed to financial, activities.[5] By creating this new investment authority, the GLBA sought to enable FHCs to conduct a broad range of securities underwriting, investment banking, and merchant banking activities, subject to statutory conditions and limitations. At the height of the high-tech stock boom, the GLBA's grant of merchant banking powers allowed FHCs to compete with securities firms and venture-capital funds by investing in technology startups.

The statute, however, does not define the term "merchant banking." In 2001, the Board and the Department of Treasury jointly issued a final rule implementing Section 4(k)(4(H) of the BHCA (the "Merchant Banking Rule").[6] The Merchant Banking Rule defines "merchant banking" activities and investments as those activities and investments that are not otherwise authorized under Section 4 of the BHCA.[7] In effect, the merchant banking power serves as a catch-all authority for FHCs to invest in commercial enterprises, as long as any such investment meets the following key requirements:

(1) the investment is not made or held, directly or indirectly, by a U.S. depository institution (such as a bank subsidiary of the FHC);

(2) the investment is made "as part of a bona fide underwriting or merchant or investment banking activity," which includes investments made for the purpose of appreciation and ultimate resale;

(3) the FHC either (i) is or has a securities broker-dealer affiliate, or (ii) has both (A) an insurance company affiliate that is predominantly engaged in under-

[4] 12 U.S.C. § 1843(c)(6),(7).

[5] 12 U.S.C. § 1843(k)(4)(H).

[6] 12 C.F.R. Part 225, Subpart J.

[7] The Merchant Banking Rule provides the following definition:

Section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) and this subpart authorize a financial holding company, directly or indirectly and as principal or on behalf of one or more persons, to acquire or control any amount of shares, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for the financial holding company under section 4 of the Bank Holding Company Act. For purposes of this subpart, shares, assets or ownership interests acquired or controlled under section 4(k)(4)(H) and this subpart are referred to as "merchant banking investments." 12 C.F.R. § 225.170.

writing life, accident and health, or property and casualty insurance (other than credit-related insurance), or providing an issuing annuities and (B) a registered investment adviser affiliate that provides investment advice to an insurance company;

(4) the investment is held "only for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the [FHC's] merchant banking investment activities;" and

(5) the FHC does not "routinely manage or operate" any portfolio company in which it made the investment, except as may be necessary in order to obtain a reasonable return on investment upon resale or disposition.

At least in theory, the requirement that a permissible merchant banking investment be made as part of a *bona fide underwriting or investment banking activity* imposes an important functional limitation on merchant banking activities. Even though an FHC is permitted to acquire full ownership of a purely commercial firm, the principal purpose of its investment must remain purely financial: making a profit upon subsequent resale or disposition of its ownership stake. The Board made clear that merchant banking authority was *not* designed to allow FHCs to enter the nonfinancial business conducted by any portfolio company. This explicitly stated statutory requirement "preserves the financial nature of merchant banking investment activities and helps further the [ ] purpose of maintaining the separation of banking and commerce."[8]

Another important requirement that shapes the practical usefulness of the merchant banking authority to FHCs investing in commercial companies is *the holding period* for merchant banking investments, which is generally limited to a maximum of 10 years. If the investment is made through a qualifying private equity fund, the maximum holding period is fifteen years. In certain exigent circumstances, the FHC may petition the Board to allow it to hold the investment for some limited time in excess of the applicable holding period. Explicit limits on the duration of merchant banking investments underscore the principally financial nature of this activity.

Finally, the prohibition on FHCs' involvement in the *routine management and operation* of portfolio companies they own or control under the merchant banking authority is designed to serve as an additional safeguard against mixing banking and commerce. The Merchant Banking Rule lists the indicia of impermissible routine management or operation of a portfolio company, which include certain kinds of management interlocking[9] and contractual restrictions on the portfolio company's ability to make routine business decisions, such as hiring non-executive officers or employees or entering into transactions in the ordinary course of business.[10] Arrangements that do not constitute routine management or operation of a portfolio company include contractual agreements restricting the portfolio company's ability to take actions not in the ordinary course of business;[11] providing financial, investment, and management consulting advice to, and underwriting securities of, the portfolio company;[12] and meeting with the company's employees to monitor or advise them in connection with the portfolio company's performance or activities.[13] Importantly, the Merchant Banking Rule specifically allows an FHC to elect any or all of the directors of any portfolio company, as long as the board of directors does not participate in the routine management or operation of the portfolio company.[14]

---

[8] 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001).

[9] 12 C.F.R. § 225.171(b)(1). An FHC is deemed to be engaged in the routine management or operation of a portfolio company if (1) any director, officer, or employee of the FHC or certain of its subsidiaries (including depository institutions, securities broker-dealers, and merchant banking subsidiaries) serves as, or has the responsibilities of, an executive officer of a portfolio company; or (2) any executive officer of the FHC or any of the same subsidiaries as mentioned above serves as, or has the responsibilities of, an officer or employee of the portfolio company. *Id.* An FHC is presumed to be routinely managing or operating a portfolio company if (1) any director, officer, or employee of the FHC serves as, or has the responsibilities of, a non-executive officer or employee of a portfolio company; or (2) any officer or an employee of the portfolio company is supervised by any director, officer, or employee of the FHC (other than in that person's capacity as a director of the portfolio company). 12 C.F.R. § 225.171(b)(2). An FHC may rebut these presumptions by providing the Board with sufficient information showing the absence of routine management or operation. 12 C.F.R. § 225.171(c).

[10] 12 C.F.R. § 225.171(b)(1).

[11] 12 C.F.R. § 225.171(d)(2).

[12] 12 C.F.R. § 225.171(d)(3)(i),(ii).

[13] 12 C.F.R. § 225.171(d)(3)(iii).

[14] 12 C.F.R. § 225.171(d)(1). The portfolio company must employ officers and employees responsible for routinely managing and operating its affairs. An FHC may engage, on a temporary basis, in the routine management or operation of a portfolio company only if such actions are

Continued

B. Activities "Complementary" to a Financial Activity

As discussed above, the main justification for allowing FHCs to own or control commercial companies under the merchant banking authority is the notion of merchant banking as a fundamentally financial activity. However, the GLBA also contains a separate grant of authority for FHCs to conduct activities that are clearly not financial in nature but are determined by the Board to be "complementary" to a financial activity. The statute requires that the Board also determine that any such complementary activity "not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[15]

Procedurally, the Board makes these determinations on a case-by-case basis. Any FHC seeking to acquire more than 5 percent of the voting securities of any class of a company engaged in any commercial activity that the FHC believes to be complementary to a financial activity must apply for the Board's prior approval by filing a written notice. In the notice, the FHC must specifically describe the proposed commercial activity; identify the financial activity for which it would be complementary and provide detailed information sufficient to support a finding of "complementarity;" describe the scope and relative size of the proposed activity (as measured by the expected percentages of revenues and assets associated with the proposed activity); and discuss the risks the proposed commercial activity "may reasonably be expected" to pose to the safety and soundness of the FHC's deposit-taking subsidiaries.[16]

The notice must also describe the public benefits that engaging in the proposed activity "can be reasonably expected" to produce. In making its determination, the Board is required to make a specific finding that the proposed activity would produce public benefits that outweigh its potential adverse effects.[17] The statutory list of such public benefits includes "greater convenience, increased competition, or gains in efficiency."[18] The Board must balance these benefits against such dangers 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."[19]

The legislative history of this provision shows that the industry deliberately sought the inclusion of the "complementary" clause as an open-ended source of legal authority for banking organizations to engage in any commercial activities that may become feasible or potentially profitable in the future. In congressional hearings, financial services industry representatives stressed "the importance of having the flexibility to engage in nominally commercial activities, particularly those related to technology and telecommunications, that support and complement [their] core business."[20] This is how the then Vice-Chairman of J.P. Morgan & Co. described the industry's vision of "complementary" business activities:

> The world of finance has changed. Information services and technological delivery systems have become an integral part of the financial services business. Financial firms use overcapacity in their back office operations by offering services to others such as telephone help lines or data processing for commercial firms. These activities may not be strictly 'financial,' yet they utilize a financial firm's resources and complement its financial capabilities in a manner that is beneficial to the firm without adverse policy implications.
>
> Financial firms also engage in activities that arguably might be considered nonfinancial, but which enhance their ability to sell financial products. One example is American Express, which publishes magazines of interest to cardholders—*Food & Wine and Travel & Leisure. Travel & Leisure* magazine is complementary to the travel business (an activity permitted within the definition of financial in H.R. 10) in that it gives customers travel ideas which the company hopes will lead to ticket purchases and other travel ar-

---

necessary to save the economic value of the FHC's investment and to obtain a reasonable return on such investment upon its resale or disposition. 12 U.S.C. § 1843(k)(4)(H)(iii); 12 C.F.R. § 225.171(e).

[15] 12 U.S.C. § 1843(k)(1).

[16] 12 C.F.R. § 225.89(a).

[17] 12 C.F.R. § 225.89(b)(3).

[18] 12 U.S.C. § 1843(j)(2)(A).

[19] *Id.* This list essentially reiterates the policy concerns underlying the principle of separation of banking from commerce.

[20] *The Financial Services Act of 1998—H.R. 10: Hearing before the S. Comm. on Banking, Housing, and Urban Affairs,* 105th Cong. 172 (1998) (prepared statement of John G. Heimann, Chairman, Global Financial Institutions, Merrill Lynch & Co., Inc., on behalf of the Fin. Servs. Council).

> rangements through American Express Travel Services. Similarly, *Food & Wine* promotes dining out, as well as purchases of food and wine, all of which might lead to greater use of the American Express Card. These activities are complementary to financial business and thus should be permissible for financial holding companies.[21]

The industry's frequent references to *Travel and Leisure and Food and 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.[22] From the industry's perspective, an intentionally open-ended "complementary" authority was the key to such an expansion.

In April 1999, the Senate introduced its version of the reform bill that for the first time included the "complementary powers" provision. In June 1999, the House bill was amended to incorporate a similar authorization of "complementary" activities but only "to the extent that the amount of such complementary activities remains small in relation to the authorized activities to which they are complementary."[23] This express limitation disappeared from the final version enacted into law as part of the GLBA, leaving the Board free to set its own conditions for FHCs' complementary activities.

The Board has described the intended scope and purpose of its own authority to approve certain activities as complementary to an FHC's financial activity in relatively cautious terms, as allowing individual FHCs "to engage, *to a limited extent,* in activities that appear to be commercial if a *meaningful connection* exists between the proposed commercial activity and the FHC's financial activities and the proposed commercial activity would not pose *undue risks* to the safety and soundness of the FHC's affiliated depository institutions or the financial system."[24]

Curiously, between 2000 and 2012, the Board used its authority almost exclusively to approve physical commodity and energy trading activities as complementary to FHCs' financial activity of trading in commodity derivatives.[25] It seems that, after the GLBA was enacted, FHCs discovered that trading crude oil and wholesale electricity "complemented" their traditional financial activities much better than publishing travel and culinary magazines. This phenomenon raises critical questions about the scope and practical operation of the undefined and intentionally broad statutory concept of "complementarity."

C. Grandfathered Commodities Activities

In addition to granting FHCs potentially broad and vaguely defined merchant banking and "complementary" powers, the GLBA contains a special grandfathering provision for commodities activities. Section 4(o) of the BHCA explicitly authorizes any company that becomes an FHC after November 12, 1999, to continue conducting "activities related to the trading, sale, or investment in commodities and underlying physical properties,"[26] subject to the following conditions:

---

[21] *H.R. 10—The Financial Services Modernization Act of 1999: Hearings Before the Comm. On Banking and Fin. Servs.,* 106th Cong. 294–95 (1999) (prepared testimony of Michael E. Patterson, Vice Chairman, J.P. Morgan & Co., Inc., on behalf of the Financial Servs. Council).

[22] As the CEO of Bank One Corp. put it, "The area on the commerce side that is most interesting to me is what is happening on the Internet." *H.R. 10—The Financial Services Modernization Act of 1999: Hearings Before the Comm. On Banking and Fin. Servs.,* 106th Cong. 18 (1999) (testimony of John B. McCoy, President and CEO, Bank One Corporation).

[23] H.R. 10, 106th Cong. § 102 (as reported by H. Comm. on Banking & Fin. Servs., June 15, 1999) (internal citations omitted).). An earlier House Committee Report included a similar provision. *See* H.R. Rep. No. 106–74, pt. 1, at 5 (Mar. 23, 1999).

[24] 68 Fed. Reg. 68,493 (Dec. 9, 2003) (emphasis added).

[25] As of mid-2012, the Board approved only one other type of activity—certain disease management and mail-order pharmacy services—as complementary to a financial activity of underwriting and selling health insurance. Wellpoint, Inc., 93 Fed. Res. Bull. C133 (2007). Wellpoint, which was not a BHC, submitted an application to the FDIC to obtain deposit insurance for its new Utah-chartered industrial bank. Although owning an industrial bank would not make Wellpoint a BHC subject to the BHCA's activity restrictions, Wellpoint had to request the Board's determination because, at the time, the FDIC-imposed temporary moratorium on providing deposit insurance to new industrial banks prohibited approval of any such applications unless the applicant (Wellpoint, in this instance) engaged exclusively in FHC-permissible activities. *See* Moratorium on Certain Industrial Bank Applications and Notices, 72 Fed. Reg.5290 (Feb. 5, 2007).

[26] 12 U.S.C. § 1843(o).

(1) the company "lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States;"

(2) the aggregate consolidated assets of the company attributable to commodities or commodity-related activities, not otherwise permitted to be held by an FHC, do not exceed 5 percent of the company's total consolidated assets (or such higher percentage threshold as the Board may authorize); and

(3) the company does not permit cross-marketing of products and services between any of its subsidiaries engaged in the grandfathered commodities activities and any affiliated U.S. depository institution.

The vague phrasing of this section seems to allow a qualifying new FHC to conduct not only virtually any kind of commodity trading but also any related commercial activities (for example, owning and operating oil terminals and metals warehouses), if it engaged in any commodities business—even if on a very limited basis and/or involving different kinds of commodities—prior to the 1997 cutoff date. Potentially, so broadly stated an exemption may open the door for large financial institutions to conduct sizable commercial activities of a kind typically not allowed for banking organizations.[27]

To date, the outer limits of the commodities grandfathering clause have not been tested. It is difficult to assess, therefore, whether and to what extent this seemingly inconspicuous provision may be used to deal the final deathblow to the principle of separation of banking and commerce. The legislative history of this special grandfathering clause, however, provides valuable context in which to place analysis. It is also highly instructive from the point of view of the political economy of U.S. financial services regulation.

The grandfathering of pre-existing commodities trading activities was originally proposed in 1995 by Congressman Jim Leach as part of a broader set of provisions establishing a new charter for "wholesale financial institutions" ("WFIs"), which could conduct a wide range of banking activities but, importantly, *could not take federally insured retail deposits.*[28] Under the proposal, companies that owned or controlled one or more WFIs (but not FDIC-insured banks)—Wholesale Financial Holding Companies ("WFHCs")—would be regulated and supervised by the Board but less stringently than regular FHCs.[29] These provisions of the House bill were designed specifically to create a so-called "two-way street" for investment banks, to enable them to acquire commercial banks and offer their institutional clients wholesale banking services, without becoming subject to the full range of activity restrictions under the BHCA.[30] Because WFIs and their parent-companies—dubbed "woofies"—would not have access to Federal deposit insurance and, therefore, were not likely to pose any significant potential threat to the deposit insurance fund, the proposal authorized them to engage in a broader set of nonfinancial activities than regular FHCs backed by FDIC insurance. One of these explicit tradeoffs involved the grandfathering of woofies' pre-existing commodities trading and related activities.[31]

---

[27] The statutory 5 percent limit on the FHC's total consolidated assets attributable to the grandfathered commodities activities is designed to prevent a dramatic shift in the business profile of such an FHC from financial to purely commercial commodities activities. In absolute terms, however, even such a small fraction of total consolidated assets of a large FHC may allow for a considerable expansion of its commercial business of owning, producing, transporting, processing, and trading physical commodities. Such an expansion may very well implicate the fundamental policy concerns underlying the principle of separation of banking and commerce.

[28] Financial Services Competitiveness Act of 1995, 104 H.R. 1062 (Version 1), Sec. 109.

[29] *Id.* In the 1995 versions of the House bill, these WFI holding companies were referred to as "Investment Bank Holding Companies." *Compare* 104 H.R. 1062 (Version 1), Sec. 109 *with* 105 H.R. 10 (version 3), Sec. 131.

[30] This is how an American Bankers Association report described the 1997 proposal:

> To allow for two-way affiliations between banks and securities firms, a new type of holding company would be permitted. This would be the investment bank holding company. These companies would have still wider powers than the new bank holding company format would bring, but the separation between banking and commerce would still be retained. These special holding companies could own wholesale financial institutions (WFIs, also known as "woofies") which would be uninsured but also not subject to standard bank holding company firewalls.

Steve Cocheo, *Outlook Brightens for New Banking Laws,* ABA BANKING JOURNAL, Feb. 27, 1997, at 10.

[31] Goldman lobbied for specific inclusion of the commodity grandfathering clause in the "woofie" provisions of the House bill because of its existing investment in J. Aron, a commodity trading company. In fact, at the time, the commodity grandfathering provision was "widely viewed as the "Goldman" exception." Martin E. Lybecker, *Financial Holding Companies and New Financial Activities Provisions of the Gramm-Leach-Bliley Act,* in BACK TO THE FUNDAMENTALS: INSURANCE REGULATION, BROKER-DEALER REGULATION, AND IN-

Curiously, both Goldman and J.P. Morgan were among the big banks and securities firms that strongly pushed for the passage of the "woofie" charter. The proposal, however, became a subject of intense political contention in Congress. In contrast to the House bill, the Senate version of the reform legislation did not contain "woofie" provisions.[32] In April 1999, however, Senator Phil Gramm introduced an amendment that effectively replicated the commodity grandfathering provision for "woofies" in the House bill—but *without* any reference to "woofies."[33] In the Conference, the entire subtitle of the House bill dealing with "woofies" was dropped. The Senate's broader version of the commodity grandfathering clause, however, remained in the text of the GLBA and became the current Section 4(o) of the BHCA. Thus, an initially limited concession to financial institutions that were explicitly denied access to Federal deposit insurance became an open-ended exemption available to all newly registered FHCs fully backed by the Federal Government guarantees.

To sum up, the GLBA created significant opportunities for U.S. banking organizations to play a much more direct and active role in purely commercial sectors of the economy. In the years following the passage of the GLBA, large U.S. FHCs have used these statutory provisions to enter and grow operations in physical commodity and energy markets.

II. From the GLBA to the Global Financial Crisis: Physical Commodity Trading as "Complementary" to FHCs' Financial Activities

Even before the enactment of the GLBA, U.S. commercial banks and their affiliates had become actively involved in trading and dealing in financial derivatives—publicly traded futures and various over-the-counter contracts—linked to the prices of commodities. Since the mid-1980s, the OCC has been aggressively interpreting the bank powers clause of the National Bank Act to include derivatives trading and dealing as part of the "business of banking."[34] Similarly, under the BHCA, trading in commodity derivatives is generally treated as a financial activity that raises no controversial legal issues. Handling *physical* commodities, however, was a much different matter. Even physical settlement of permissible commodity derivatives—which necessitated taking ownership, transporting, and storing actual crude oil or iron ore—presented a problem in light of the general principle of separating banking from commerce. FHCs seeking to engage in physical trades had to find a specific legal authority to do so.

In the early 2000s, global commodities markets began experiencing an unprecedented price boom, which coincided with the increased push by large U.S. financial institutions to establish large-scale physical commodity trading operations. Between 2003 and 2008, several large U.S. FHCs and foreign banks successfully obtained Board orders allowing them to trade physical commodities as an activity "complementary" to the financial activity of trading and dealing in commodity derivatives.

In 2003, Citigroup became the first to receive Board approval of its physical commodities trading as a "complementary" activity.[35] Under the Board's order, Citigroup was allowed to purchase and sell oil, natural gas, agricultural products, and other nonfinancial commodities in the spot market and to take and make physical delivery of commodities to settle permissible commodity derivative transactions. The Board based its determination on four main considerations. First, the Board found that the proposed activities "flowed" from FHCs' legitimate financial activities, essentially providing them with an alternative method of fulfilling their obligations under otherwise permissible derivatives transactions. Second, permitting these activities would make FHCs more competitive *vis-a-vis* other financial firms not subject to regulatory restrictions on physically settled derivatives transactions. Third, the proposed activities would enable FHCs to offer a full range of commodity-related services to their clients in a more efficient manner. Finally, conducting physical commodity activities would enhance FHCs' understanding of the commodity derivatives market.

To minimize the safety and soundness risks that this type of commercial activity may pose, the Board imposed a number of conditions on Citigroup's commodity-trading business. First, the market value of any commodities owned by Citigroup may

---

VESTMENT ADVISER REGULATION (ABA CENTER FOR CLE NAT'L INSTITUTE, NOV. 8–10, 2001), fn. 11.

[32] S. 900, 106th Cong. (as placed on the Senate calendar, Apr. 28, 1999).

[33] S. Rep. 106–44 (Apr. 28, 1999), at 3.

[34] Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking,"* 63 U. MIAMI L. REV. 1041 (2009).

[35] Citigroup, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 89 Fed. Res. Bull. 508 (2003) [Citigroup Order].

not exceed 5 percent of its consolidated Tier 1 capital.[36] This market value limitation is generally meant to ensure that physical commodity trading does not grow too big, at least in relative terms. Second, Citigroup may take or make delivery only of those commodities for which derivatives contracts have been approved for trading on U.S. futures exchanges by the Commodity Futures Trading Commission ("CFTC"), unless the Board specifically allows otherwise. This requirement was designed to prevent Citigroup from dealing in finished goods and other items, such as real estate, which lack the fungibility and liquidity of exchange-traded commodities. Third, the Board made clear that Citigroup must conduct its physical commodity trading business in compliance with the applicable securities, commodities, and energy laws.

Finally, the 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. The expectation was that Citigroup would use storage and transportation facilities owned and operated by unrelated third parties. The purpose of this important limitation is to minimize nonfinancial risks inherent in physical commodity trading: storage risk, transportation risk, and potentially serious environmental and legal risks associated with these activities. The Board relied on specific representations from Citigroup to the effect that it would exercise heightened care in avoiding these nonfinancial risks. Thus, Citigroup represented that it would require the owner of any vessel carrying oil on behalf of Citigroup to carry the maximum insurance for oil pollution available from a protection and indemnity club and to obtain a substantial amount of additional pollution insurance. Similarly, it promised to require all third-party storage facilities to carry a significant amount of oil pollution insurance from a creditworthy insurance company. Citigroup would also place age limitations on vessels and develop a comprehensive backup plan in the event any owner of a vessel or storage facility fails to respond adequately to an oil spill.

In subsequent years, the Board granted similar orders authorizing physical commodity trading activities on the part of FHCs and foreign banks treated as FHCs for purposes of the BHCA. These grants of complementary powers allowed large non-U.S. banks—such as UBS, Barclays, Deutsche Bank, and Societe Generale—to expand their worldwide physical commodities businesses by adding U.S. operations, albeit on a limited scale. In 2005, JPMC also obtained an order permitting the FHC to engage in physical commodity trading activities as complementary to its booming financial derivatives business.[37] In all of these cases, the Board imposed the same standard set of conditions and limitations originally articulated in the Citigroup Order.

In 2008, The Royal Bank of Scotland ("RBS"), then the U.K.'s largest banking group, received the Board's order authorizing a wide range of physical commodities and energy trading activities as complementary to RBS's financial derivatives activities.[38] RBS sought these expanded powers in connection with its acquisition of a 51 percent equity stake in a joint venture with Sempra Energy, a U.S. utility group. The joint venture, RBS Sempra Commodities ("RBS Sempra"), was set up to conduct a worldwide business of trading in various physical commodities—including oil, natural gas, coal, and nonprecious metals—and be an active player in power markets in Europe and North America.

In the RBS Order, the Board significantly relaxed the standard limitations and expanded the scope of permissible trading in physical commodities. Thus, the Board allowed RBS to take and make physical deliveries of nickel, even though nickel futures were not approved for trading on U.S. futures exchanges by the CFTC. The Board reasoned that contracts for nickel were actively traded on the London Metals Exchange ("LME"), a major non-U.S. exchange subject to regulation comparable to the regulation of the U.S. futures exchanges. The Board also authorized physical trading in a long list of physical commodities—including natural gasoline, asphalt, kerosene, and other oil products and petrochemicals—despite the fact that contracts for these commodities have not been approved for trading on any major exchange. In authorizing physical trading in these commodities, the Board relied on the fact that these commodities were fungible and that contracts for them were traded in

[36] In 2003, Citigroup reported its total consolidated Tier 1 capital of nearly $66.9 billion. *See* Citigroup Inc., Form 10–K, Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, for the fiscal year ending on December 31, 2003, at 56. This puts the numerical limit for the market value of the physical commodities held by Citigroup for 2003 at slightly above $3.1 billion.

[37] JPMorgan Chase & Co., 92 Fed. Res. Bull. C57 (2006). Bank of America and Wachovia received Board approvals to conduct physical commodities trading in 2006–07.

[38] The Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60 (2008) [RBS Order].

sufficiently liquid over-the-counter markets (through individual brokers and on alternative trading platforms).

The Board authorized RBS to hire third parties to refine, blend, or otherwise alter the commodities. In effect, this removed the ambiguity in previous orders by explicitly allowing RBS, for example, to sell crude oil to an oil refinery and then buy back the refined oil product. The Board determined that this activity essentially posed the same risks as hiring a third party to operate a storage or transportation facility, as permitted under previous orders. In addition, RBS made a specific commitment that it would not have exclusive rights to use the alteration facility.

The Board also permitted RBS to enter into long-term electricity supply contracts with large industrial and commercial customers. The Board noted that, while most commodities traded by FHCs were limited to wholesale markets, electric power could much more easily reach small retail customers. To ensure that RBS remained a wholesale electric power intermediary dealing only with sophisticated customers, the RBS Order specified the minimum consumption levels for customers to whom RBS was allowed to sell electricity on a long-term basis.

Finally, in the RBS Order and in two separate orders issued to a Belgian-Dutch bank, Fortis, the Board specifically approved so-called energy management and energy tolling services these institutions sought to perform in the United States.[39] RBS and Fortis were authorized to provide certain energy management services—consisting of transactional and advisory services—to owners of power generation facilities under Energy Management Agreements ("EMA"). FHC-permissible energy management services generally entail acting as an intermediary for a power plant owner to facilitate purchases of fuel and sales of power by the plant, as well as advising the owner on risk-management strategies. Thus, the energy manager—Fortis or RBS—would buy fuel for the plant from third parties and sell it to the plant in a mirror transaction. It would then purchase the power generated by the plant and resell it in the market. In effect, the energy manager would provide credit and liquidity support for the plant owner, including the posting of any required collateral for transactions. In addition, the manager also would assume responsibility for administrative tasks in connection with, and the hedging of exposure under, fuel and power transactions.[40]

These FHC-permissible energy management services, however, were subject to several conditions designed to limit the safety and soundness risks of such activities. Thus, the Board required that the revenues attributable to the FHC's energy management services not exceed 5 percent of its total consolidated operating revenues. The Board also required that all EMAs, pursuant to which the FHC engages in these activities, include certain mandatory provisions. For example, the EMA must mandate that the plant owner approve all contracts for purchases of fuel and sales of electricity, although the owner may be allowed to grant a standing authorization to the manager to enter into contracts that meet certain owner-specified criteria. The owner must retain responsibility for the day-to-day maintenance and management of the power generation facility, including hiring employees to operate it. The owner must also retain the right to (i) market and sell power directly to third parties, although the manager may have the right of first refusal; and (ii) determine the facility's power output level at any given time. In addition, the FHC is prohibited, directly or through its subsidiaries, from guaranteeing the financial performance of the power plant and from bearing any risk of loss if the plant is not profitable.

Energy tolling is generally similar to energy management. Under these arrangements, an FHC (the "toller") makes fixed periodic (usually, monthly) "capacity payments" to the power plant owner, to compensate the owner for its fixed costs, in exchange for the right to all or part of the plant's power output. The plant owner retains control over the day-to-day operation of the power plant. The toller pays for the fuel needed to produce the power it directs the owner to produce. The owner receives a marginal payment for each megawatt hour produced by the plant, as compensation for its variable costs plus a profit margin.

The Board approved energy tolling as a complementary activity because it found it to be an "outgrowth" of the relevant FHC's permissible commodity derivatives activities. The Board reasoned, in a familiar fashion, that permitting energy tolling would provide the FHC with valuable information on the energy markets, which

[39] Fortis S.A./N.V., 94 Fed. Res. Bull. C20 (2008) [Fortis Order]; the RBS Order; Board Letter Regarding Fortis S.A/N.V. (May 21, 2008) [2008 Fortis Order].

[40] The administrative tasks include, among other things, arranging for third parties to provide fuel transportation or power transmission services, coordinating fuel purchases and power sales, negotiating and monitoring contracts with the plant owner's counterparties.

would help it to manage its own commodity risk, and allow the FHC to compete more effectively with other financial firms not subject to the BHCA.

These competitors, of course, were Goldman and Morgan Stanley, at the time independent investment banks. The recent financial crisis, however, brought both of these firms under the direct jurisdiction of the Board as new FHCs—and raised the potential salience of U.S. banking institutions' commodity trading activities to a whole new level.

III. The "Game-Changing" Impact of the Crisis: Morgan Stanley, Goldman Sachs, and JPMC

One of the most profound and least appreciated consequences of the recent financial crisis is the emergence of a powerful trio of large FHCs with extensive physical commodities business operations: Morgan Stanley, Goldman, and JPMC. Two extraordinary crisis-driven phenomena led to this result: the emergency conversion of Morgan Stanley and Goldman into BHCs and the once-in-a-lifetime acquisition by JPMC of the commodity assets of two failing institutions, Bear Stearns and RBS.

On September 21, 2008, Morgan Stanley and Goldman received approval to register as BHCs subject to the Board's regulation and supervision, in a desperate effort to bolster investor confidence and avoid potential creditor runs on their assets. In the midst of the unfolding crisis, the Board approved these firms' applications to become BHCs almost literally overnight, without putting them through its normal, lengthy and detailed review process. It is highly unlikely that, at the time of the conversion, the Board focused on these firms' extensive physical commodities assets and activities—or gave full consideration to the question of how to deal with such activities in the long run.

JPMC followed a different route to the top of the Wall Street commodities game. In 2008, the firm acquired the physical commodity trading assets of failing Bear Stearns. In 2009–2010, JPMC bought the global commodities business of nationalized RBS. In a few short years, the firm's aggressive growth strategy transformed it into one of the three biggest U.S. banking organizations dominating global commodity markets.[41]

Thus, in the wake of the financial crisis, the Board finds itself facing a qualitatively different commodities business conducted by three of the largest U.S. banking organizations. Under the BHCA, a newly registered BHC has up to 5 years from the registration date either to divest its impermissible nonbanking activities or to bring such activities into compliance with BHCA requirements.[42] The statutory 5-year grace period for the nonconforming commodity activities of Goldman and Morgan Stanley ends in the fall of 2013, at which point the Board must make a potentially fateful decision whether these firms will be able to continue—and further expand—their commodity and energy merchant businesses. This decision requires a thorough understanding of the nature and scope of these institutions' actual involvement in physical commodities and energy markets.

A. The Informational Gap

Crucially, however, there is no meaningful public disclosure of banking organizations' assets and activities related to physical commodities and energy. Hence, it is important to preface discussion of what is at stake in the Board's coming decision with a note on the scarcity of information available to those who might wish to weigh in, including Congress.

Three difficulties explain why the American public does not yet have a full picture of what is happening in this space. The first difficulty is that publicly traded financial institutions—including all of the largest FHCs—typically report their assets, revenues, profits, and other financial information for the entire business segment, of which commodities trading is only a part. For instance, Goldman includes commodities in its Fixed Income, Currencies and Commodities division, which is included in the firm's Institutional Client Services business segment.[43] The same is

---

[41] *Morgan Stanley May Sell Part of Commods Unit: CNBC,* REUTERS, June 6, 2012, Among non-U.S. financial institutions, only UK's Barclays and Germany's Deutsche Bank currently compete with Morgan Stanley, Goldman and JPMC in global commodity markets.

[42] 12 U.S.C. § 1843(a)(2).

[43] The Goldman Sachs Group, Inc., 2011 Form 10–K, at 1–4. The firm's Institutional Client Services activities are organized by asset class and include both "cash" and "derivative" instruments. Cash instruments refer to trading in the assets underlying derivative contracts, such as "a stock, bond or a barrel of oil." *Id.* at 3. The firm's annual report does not provide details on their physical commodity operations and simply lists commodity products FICC trades: "Oil and natural gas, base, precious and other metals, electricity, coal, agricultural and other commodity products." The report states that FICC generally facilitates client transactions and makes markets in commodities. *Id.* at 115.

true of Morgan Stanley, which includes commodities operations in its Fixed Income and Commodities division within the Institutional Securities business segment.[44] Neither firm provides full financial information attributable specifically to its commodities divisions.

The second difficulty is that, to the extent FHCs include in their regulatory filings financial information specific to their commodities operations, such information usually pertains to both commodity-linked derivatives operations and trading in physical commodities. As a result, most financial information reported under the "commodities" rubric relates to the derivatives business, leaving one to guess what is going on in the firms' physical commodities businesses. Because of this reporting pattern, industry analysts' estimates of the revenues or profits generated by large FHCs' commodities trading desks often include the estimated revenues and profits from purely financial transactions in commodity derivatives. More broadly, this disclosure format tends to de-emphasize—and thus make even less visible—the fact that financial institutions often act not only as dealers in purely financial risk but also as traditional commodity merchants.

Currently, large FHCs are required to report to the Board, on a quarterly basis, only one financial metric directly related to their physical commodities operations: the gross market value of physical commodities in their trading inventory.[45] These mandatorily reported data provide a hint of the potential scale of these activities. For instance, a look at this line item in JPMC's filings reveals a significant growth in the market value of physical commodities the company holds for trading purposes. Thus, as of March 31, 2009, JPMC reported the gross fair value of physical commodities in its inventory as a relatively modest $3.7 billion.[46] By September 30, 2009, the amount had doubled to $7.9 billion.[47] By the end of 2009, the number had further increased to slightly over $10 billion.[48] At the end of 2010, the reported amount reached above $21 billion.[49] As of December 31, 2011, JPMC reported the gross fair value of physical commodities in its inventory at approximately $26 billion.[50] As of March 31, 2012, the gross fair value of physical commodities in JPMC's inventory had slightly decreased to $17.2 billion.[51] At the end of 2012, that number was $16.2 billion.[52]

Morgan Stanley's regulatory filings show that, as of March 31, 2009, the gross fair value of physical commodities it held in inventory was slightly below $2.5 billion.[53] The reported value of this line item in Morgan Stanley's reports rapidly increased to $10.3 billion as of September 30, 2011,[54] before going slightly down to approximately $9.6 billion as of March 31, 2012.[55] At the end of 2012, the gross fair value of physical commodities in Morgan Stanley's inventory was about $7.3 billion.[56]

Goldman's filings show more fluctuations in the gross fair value of physical commodities in the firm's inventory during the same 3-year period. Thus, as of March 31, 2009, Goldman reported $1.2 billion in this line item.[57] At the end of the next quarter, the number fell to $682 million.[58] It peaked at the end of 2010 at over $13

---

[44] Morgan Stanley, 2011 Form 10–K, at 2–3. According to the company's description of its activities, The Company invests and makes markets in the spot, forward, physical derivatives and futures markets in several commodities, including metals (base and precious), agricultural products, crude oil, oil products, natural gas, electric power, emission credits, coal, freight, liquefied natural gas and related products and indices. The Company is a market-maker in exchange-traded options and futures and OTC options and swaps on commodities, and offers counterparties hedging programs relating to production, consumption, reserve/inventory management and structured transactions, including energy-contract securitizations and monetization. The Company is an electricity power marketer in the United States and owns electricity-generating facilities in the United States and Europe.

[45] *See* "Consolidated Financial Statements for Bank Holding Companies—FR Y–9C," Schedule HC–D ("Trading Assets and Liabilities"), Item M.9.a.(2) (the "Gross Fair Value of Physical Commodities held in Inventory"). Form FR Y–9C is a quarterly report filed with the Board by BHCs with total consolidated assets of $500 million or more. 12 U.S.C. § 1844; 12 C.F.R. § 225.5(b).

[46] JPMC, FR Y–9C, March 31, 2009, Schedule HC–D, Item M.9.a.(2).

[47] JPMC, FR Y–9C, September 30, 2009, Schedule HC–D, Item M.9.a.(2).

[48] JPMC, FR Y–9C, December 31, 2009, Schedule HC–D, Item M.9.a.(2).

[49] JPMC, FR Y–9C, December 31, 2010, Schedule HC–D, Item M.9.a.(2).

[50] JPMC, FR Y–9C, December 31, 2011, Schedule HC–D, Item M.9.a.(2).

[51] JPMC, FR Y–9C, March 31, 2012, Schedule HC–D, Item M.9.a.(2).

[52] JPMC, FR Y–9C, December 31, 2012, Schedule HC–D, Item M.9.a.(2).

[53] Morgan Stanley, FR Y–9C, March 31, 2009, Schedule HC–D, Item M.9.a.(2).

[54] Morgan Stanley, FR Y–9C, September 30, 2011, Schedule HC–D, Item M.9.a.(2).

[55] Morgan Stanley, FR Y–9C, March 31, 2012, Schedule HC–D, Item M.9.a.(2).

[56] Morgan Stanley, FR Y–9C, December 31, 2012, Schedule HC–D, Item M.9.a.(2).

[57] Goldman Sachs Group, FR Y–9C, March 31, 2009, Schedule HC–D, Item M.9.a.(2).

[58] Goldman Sachs Group, FR Y–9C, June 30, 2009, Schedule HC–D, Item M.9.a.(2).

billion.[59] As of March 31, 2012, Goldman reported the gross fair value of its physical commodities inventory at $9.5 billion.[60] At the end of 2012, Goldman's number rose to $11.7 billion.[61]

As issuers of publicly traded securities, FHCs include the same data in their quarterly reports filed with the SEC. The gross market value of FHCs' physical commodity trading inventory, however, measures solely their current exposure to commodity price risk.[62] It does not provide a full picture of these organizations' actual involvement in the business of producing, extracting, processing, transporting, or storing physical commodities. To a great extent, this nearly exclusive regulatory focus on commodity price risk reflects the underlying assumption that U.S. banking organizations do not conduct any commodity-related activities that could potentially pose any additional risks to their safety and soundness or create systemic vulnerabilities. If one assumes that banking organizations act only as arms' length buyers and sellers of physical commodities, strictly for the purpose of providing *financial* risk management services to their clients, then it is logical to conclude that sudden price fluctuations in commodity markets are the main source of potential risk from such activities. In the absence of detailed information on U.S. banking organizations' actual commodities assets and operations, however, this assumption becomes dangerously unreliable.[63]

Gaps in the current system of public disclosure and regulatory reporting explain the near-absence of reliable, detailed data on the precise nature and full scope of U.S. banking organizations' physical commodity operations. The traditional lack of transparency in global commodity markets and the inherently secretive nature of the commodity trading industry create a third source of difficulties for understanding what exactly U.S. FHCs do, and how significant their role is, in these markets. A handful of large, mostly Switzerland-based commodities trading houses—including Glencore, Vitol, Trafigura, Mercuria, and Gunvor—dominate the global trade in oil and gas, petroleum products, coal, metals, and other products. Nearly all of these publicity-shy commodities trading firms are privately owned. They do not publicly report results of their financial operations and generally refrain from disclosing information about the structure or performance of their investments. Secrecy has always been an important attribute of the traditional commodities trading business, in which access to information is vital to commercial success and having informational advantage often translates into windfall profits. Given this lack of transparency and secretive nature of the commodities trading business, it is nearly impossible for an industry outsider—and even for most insiders—to gauge accurately the relative size and importance of U.S. FHCs as traders and dealers in the global markets for physical commodities.[64]

---

[59] Goldman Sachs Group, FR Y–9C, December 31, 2010, Schedule HC–D, Item M.9.a.(2).

[60] Goldman Sachs Group, FR Y–9C, March 31, 2012, Schedule HC–D, Item M.9.a.(2).

[61] Goldman Sachs Group, FR Y–9C, December 31, 2012, Schedule HC–D, Item M.9.a.(2).

[62] Similarly, the VaR data included in FHCs' SEC filings provide a measure of their exposure to commodity price risk.

[63] There may be ways to collect some information on FHCs' physical commodities activities from a wide variety of diverse sources, including statistical records maintained by the Department of Energy ("DOE"), FERC, or other nonfinancial regulators. However, theoretical availability of these disparate data does not cure the fundamental informational deficiency in this area. Even if it can be located, with significant effort, such amalgamation of data is not likely to create a complete and reliable picture of large FHCs' commodity operations and assets.

[64] This is especially true of oil and gas markets. Currently, the markets for trading crude oil and oil products are dominated by three groups of players: major oil companies (Royal Dutch Shell, Total, and British Petroleum), independent commodity trading houses (Vitol, Gunvor, Glencore, Trafigura, and Mercuria), and financial institutions (Morgan Stanley, Goldman). *See,* LITASCO SA, International Oil Markets Market and Oil Trading (Sept. 19, 2008), *http://www.litasco.com/_library/pdf/social_acts/international_oil_market_and_oil_trading.pdf.* Although these three types of oil traders have significantly different business structures and profiles, they have been converging in some important respects. Thus, the trading arms of oil majors and commodity trading houses have been developing active financial derivatives trading and dealing capabilities to supplement their traditional operations in physical markets. Recent media reports indicate that independent commodity trading companies have also been acquiring both upstream (oil production) assets and downstream (refining and processing) assets. Javier Blas, *Trading houses: Veil slowly lifts on a secretive profession,* FIN. TIMES, May 23, 2011; Javier Blas, *Commodities traders face growing pains,* FIN. TIMES, Apr. 26, 2012. It is nearly impossible, however, to ascertain how big or important financial institutions' physical oil and gas trading operations are *vis-a-vis* the other two groups, in large part because that would require access to potentially sensitive nonpublic information on the oil companies' and trading houses' operations and activities. In an informal interview with the author, a professional oil industry consultant who wished to remain anonymous claimed that even a rough estimate would require a lot of sophisticated and prohibitively expensive investigative work not dissimilar to industrial espionage.

With these information-related caveats in mind, it is nevertheless possible to piece together enough data to get a sense of the *potential* significance of Goldman's, Morgan Stanley's, and JPMC's physical commodities businesses.

B. Morgan Stanley: Oil, Tankers, and Pipelines

During the years preceding the latest financial crisis, Morgan Stanley built a significant business trading in oil, gas, electric power, metals, and other commodity products. According to industry estimates, Morgan Stanley's commodities unit generated $17 billion in revenue over the past decade, trading both financial contracts and physical commodities.[65] Unlike Goldman, Morgan Stanley "has remained resolutely a merchant-trader, focusing on the business of storing or transporting raw materials."[66] According to a 2008 research report, traditional client "flow" business—market-making, selling indices to investors, and commodity risk hedging—constituted only about 10–15 percent of the firm's commodities activities.[67] About half of Morgan Stanley's commodities business is reportedly in crude oil and oil products, while about 40 percent is in power and gas.

Morgan Stanley has been using physical assets in trading energy and commodities since the mid-1980s. In the early 1990s, Morgan Stanley's oil trader, Olav Refvik, struck deals to buy and deliver oil and oil products to large commercial users around the globe and earned the nickname "King of New York Harbor" for accumulating a record number of leases on storage tanks at the key import hub, which gave the firm a great market advantage. During the same period, Morgan Stanley constructed power plants in Georgia, Alabama and Nevada, which allowed it to become a major electricity seller.

In the mid-2000s, Morgan Stanley began aggressively expanding its energy infrastructure investments, especially in oil and gas transportation and logistics. In 2006, Morgan Stanley acquired full ownership of Heidmar Inc., a Connecticut-based global operator of commercial oil tankers. Although Morgan Stanley sold 51 percent of equity in 2008, it still retained a 49 percent stake. Heidmar operates a fleet of more than 100 double-hull vessels and provides transportation and logistics services to major oil companies around the world.[68]

In September 2006, Morgan Stanley acquired, in a leveraged buyout, the full ownership of TransMontaigne Inc., a Denver-based oil-products transportation and distribution company. TransMontaigne markets "unbranded gasoline, diesel fuel, heating oil, marine fuels, jet fuels, crude oil, residual fuel oils, asphalt, chemicals and fertilizers."[69] The company is affiliated with a fuel terminal facility operator, TransMontaigne Partners L.P., which operates oil terminals in several U.S. States and Canada.[70] In 2005, the last year TransMontaigne was a publicly listed company, it reported revenues of about $8.6 billion and assets of slightly less than $1.2 billion.[71] Forbes estimated the company's 2011 revenues at $12 billion.[72]

Both Heidmar and TransMontaigne are subsidiaries of Morgan Stanley Capital Group Inc. ("MS Capital Group"), Morgan Stanley's commodities and energy trading arm through which it holds equity stakes in multiple commodity businesses. According to Morgan Stanley's own description of its physical commodities business activities in its SEC filings:

> In connection with the commodities activities in our Institutional Securities business segment, we engage in the production, storage, transportation, marketing and trading of several commodities, including metals (base and precious), agricultural products, crude oil, oil products, natural gas, electric power, emission credits, coal, freight, liquefied natural gas and related products and indices. In addition, we are an electricity power marketer in the United States and own electricity generating facilities in the United States and Europe; we own TransMontaigne Inc. and its subsidiaries, a group of companies operating in the refined petroleum products marketing and distribution business; and we own a minority interest in Heidmar

---

[65] *Morgan Stanley May Sell Part of Commods Unit: CNBC,* REUTERS, June 6, 2012.

[66] Matthew Robinson & Scott DiSavino, *Deal or no deal,Morgan Stanley commodity trade shrinks,* REUTERS, Jun. 7. 2012.

[67] *Id.*

[68] *http://www.heidmar.com/what-we-do/.*

[69] *http://www.transmontaigne.com/about-tmg/.*

[70] *http://www.transmontaigne.com/about-tmg/.* TransMontaigne is the general partner of TransMontaigne Partners L.P., a publicly traded Delaware limited partnership.

[71] CNN Money, Fortune 500 Rankings 2006, *http://money.cnn.com/magazines/fortune/fortune500/snapshots/1452.html.*

[72] *http://www.forbes.com/lists/2011/21/private-companies-11_TransMontaigne_7I0O.html.* The estimate excludes the revenues generated by the company's publicly traded subsidiaries.

> Holdings LLC, which owns a group of companies that provide international marine transportation and U.S. marine logistics services.[73]

The SEC filings of TransMontaigne Partners, the only publicly traded subsidiary of MS Capital Group and TransMontaigne, provide a fascinatingly detailed picture of one significant facet of Morgan Stanley's physical commodities business: "oil terminaling and transportation."[74] TransMontaigne Partners owns and operates a vast infrastructure, including numerous crude oil and refined products pipelines and terminals along the Gulf Coast, in the Midwest, in Texas, along the Mississippi and Ohio Rivers, and in the Southeast. The company receives refined oil products and liquefied natural gas from customers via marine vessels, ground transportation, or pipelines; stores customers' products in its tanks located at the terminals; monitors the volume of stored products in its tanks; provides product heating and mixing services; and transports the refined products out of its terminals for further distribution.

In 2011, TransMontaigne Partners earned over $152 million in revenues, of which almost $107 million came from its affiliates.[75] The company's primary customers are its indirect parent-entities, MS Capital Group and TransMontaigne. This is how the company described the business activities of MS Capital Group:

> Morgan Stanley Capital Group is a leading global commodity trader involved in proprietary and counterparty-driven trading in numerous commodities markets including crude oil and refined products, natural gas and natural gas liquids, coal, electric power, base and precious metals and others. Morgan Stanley Capital Group has been actively trading crude oil and refined products for over 20 years and on a daily basis trades millions of barrels of physical crude oil and refined products and exchange-traded and over-the-counter crude oil and refined product derivative instruments. Morgan Stanley Capital Group also invests as principal in acquisitions that complement Morgan Stanley's commodity trading activities. Morgan Stanley Capital Group has substantial strategic long-term storage capacity located on all three coasts of the United States, in Northwest Europe and Asia.[76]

TransMontaigne Partners' SEC filings offer a rare glimpse into Morgan Stanley's sprawling network of assets and activities in the energy sector. Ownership of critical infrastructure assets—including terminals, pipelines, and marine vessels—greatly facilitates Morgan Stanley's trading of energy and commodities, in both physical and derivatives markets. At the same time, such a direct and active involvement in the business of oil and gas processing, storage, and transportation creates significant risks for Morgan Stanley. Global energy prices are notoriously volatile and depend on a complex interplay of various factors, including geopolitical ones. More importantly, however, these activities expose the firm to potential legal liability, financial loss, and reputational damage in the event of industrial accidents, oil spills, explosions, terrorist acts, or other catastrophic events that cause serious environmental harms.[77] It is difficult to quantify the extent of this risk, especially in the case of potential large-scale environmental disaster, but it is not difficult to imagine that it may be potentially fatal even for a large company with a formidable balance sheet. For a financial institution whose main business depends greatly on its reputation and market perceptions of the quality of its credit, even a remote risk of such an event may be too much to live with.

---

[73] Morgan Stanley, Form 10–K, Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, for the fiscal year ending on December 31, 2011, at 27.

[74] TransMontaigne Partners L.P., Form 10–K, Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, for the fiscal year ending on December 31, 2011.

[75] *http://sec.gov/Archives/edgar/data/1319229/000104746912005319/a2208753z10-ka.htm#aa3,* at 73.

[76] *Id.*

[77] According to Morgan Stanley's own description of the risk factors specific to its physical commodities business in its annual report:

> As a result of these activities, we are subject to extensive and evolving energy, commodities, environmental, health and safety and other governmental laws and regulations. In addition, liability may be incurred without regard to fault under certain environmental laws and regulations for the remediation of contaminated areas. Further, through these activities we are exposed to regulatory, physical and certain indirect risks associated with climate change. Our commodities business also exposes us to the risk of unforeseen and catastrophic events, including natural disasters, leaks, spills, explosions, release of toxic substances, fires, accidents on land and at sea, wars, and terrorist attacks that could result in personal injuries, loss of life, property damage, and suspension of operations.

Morgan Stanley, Form 10–K, December 31, 2011, at 27.

C. Goldman Sachs: Metals, Warehouses, and Other Things

Wall Street's biggest commodities dealer by revenues, Goldman is "credited with attracting the investors to the asset class with the creation of the Goldman Commodity Index in 1991."[78] According to industry estimates, the firm's commodities business—including derivatives and physical trading—generated annual revenues of $3–4 billion between 2006 and 2008.[79]

Goldman's commodities trading business goes back at least to 1981, when the firm bought its principal commodities trading subsidiary, J. Aron & Co., which at the time specialized mostly in trading futures and options on precious metals and coffee.[80] In the 1980s–90s, Goldman focused primarily on client-driven financial transactions in commodities and built a dominant position in the energy futures and OTC derivatives markets. In the first decade of this century, however, Goldman has also been expanding into physical commodities, with ventures into coal and shipping trading. For example, in early 2005, the press reported that Goldman had bought 30 electricity-generating plants.[81] At least in part, this may have been a reference to Goldman's 2003 acquisition of Cogentrix Energy LLC, a major power producer based in Charlotte, North Carolina. At the time, Cogentrix owned and operated 26 coal- and natural gas-fired power plants.[82]

During the same period, Goldman reportedly made significant acquisitions in the oil and gas sector, including a significant stake in Kinder Morgan, Inc. ("KMI"), a major oil transportation and terminaling company that controls approximately 37,000 miles of pipelines and 180 terminals handling crude oil, natural gas, and refined petroleum products.[83] According to KMI's SEC filings, at the end of 2011, Goldman owned (through several controlled funds) 19.1 percent of the company's common stock.[84] In addition, the report listed each of the two managing directors of Goldman who also served on KMI's board of directors as holders of 19.1 percent of the company's common stock.[85] It appears that Goldman has similarly structured private equity investments in other energy companies, including Cobalt International Energy Inc. ("CIE"), a Houston-based deep-water oil exploration and production company.[86]

Even after becoming an FHC subject to the activities restrictions of the BHCA and the consolidated supervision by the Board, Goldman continued to acquire significant hard assets in the commodities sector. For instance, in May 2012, the Financial Times reported that Goldman made a $407 million deal with Brazil's Vale, to acquire full ownership of Vale's Colombian coal assets, including the El Hatillo coal mine, Cerro Largo coal deposit, and a coal port facility on Colombia's Atlantic coast. The deal also included an 8.43 percent equity stake in the railway connecting the mines to the port.[87]

Goldman's subsidiary, GS Power Holdings LLC, holds another prized asset in Goldman's commodities empire: Metro International Trade Services LLC ("Metro"). Metro is a metals warehousing company that owns and operates nineteen warehouses in the Detroit metropolitan area, as well as warehousing facilities in Europe

---

[78] Jack Farchy, *Goldman and Clive Capital to launch commods index,* FIN. TIMES, June 12, 2011.

[79] Javier Blas, *Commodities Trading Loses its Goldman Queen,* FIN. TIMES, Jan. 12, 2012.

[80] *J. Aron & Co. Reduces Staff,* N.Y. TIMES, Aug. 19, 1983.

[81] Ann Davis, *Morgan Stanley Trades Energy Old-Fashioned Way: In Barrels,* WALL ST. J., Mar. 2, 2005.

[82] Ryan Dezember, *Carlyle to Acquire Cogentrix from Goldman,* WALL ST. J., Sept. 7, 2012. According to media, "Goldman sold off most of those plants—and built and sold others—during the last decade as Cogentrix transformed into more of a developer of power plants." *Id.* In September 2012, Goldman reportedly agreed to sell Cogentrix to a private equity firm, Carlyle Group L.P., on undisclosed terms.

[83] Kinder Morgan, Inc., 2011 Form 10–K, at 5. In investing in KMI, Goldman teamed up with two private equity partners, The Carlyle Group ("Carlyle") and Riverstone Holdings LLC ("Riverstone"). *Id.*

[84] *Id.,* at 121–22.

[85] It is difficult to ascertain whether and to what extent this ownership structure and board membership give Goldman effective control over KMI's management and operations. It appears that, for regulatory purposes, Goldman treats its investment in KMI as a merchant banking investment permissible to FHCs under the BHCA. In the context of Goldman's overall commodities trading business, however, one may legitimately question whether Goldman's stake in KMI is truly a passive, purely financial investment made solely for the purpose of reselling it at a profit.

[86] According to the 2011 SEC filings, Goldman held a common equity stake in CIE through several controlled funds, and two of its managing directors in the merchant banking division served on CIE's board. The firm originally invested in CIE in partnership with Carlyle and Riverstone. Cobalt International Energy Inc., 2011 Form 10–K, at 5; Cobalt International Energy Inc., Schedule 14A, Proxy Statement (filed on Mar. 22, 2012), at 10–17.

[87] Joe Leahy, *Goldman in Deal to Buy Vale's Coal Assets,* FIN. TIMES, May 28, 2012.

and Asia. By acquiring Metro in February 2010, Goldman gained control of one of the largest metals warehouses in the global network of storage facilities approved by the LME. This acquisition strategically positioned the firm in the middle of the global metals trading chain. Storing large quantities of metal generates lucrative rental income for warehousing companies like Metro. The warehousing business is particularly profitable during economic downturns when slackening demand forces producers to hold more of their commodity inventories in storage. Not surprisingly, Goldman was not the only commodity trader that rushed to acquire large LME-approved warehouses in the wake of the global financial crisis.[88] The recent entry of financial institutions effectively turned this traditionally low-profile industry run by dispersed independent operators into yet "another arm of Wall Street."[89]

This transformation has caused serious turbulence in the global market for aluminum, the second most widely used metal in the world after steel.[90] Aluminum producers store their metal in LME-approved warehouses and then sell their metal to industrial users. The buyers claim their purchased quantities of aluminum from the warehouse, which must deliver it to the specific buyer.[91] Ownership of the key LME warehouses by large commodity traders with integrated financial and physical metals operations allows them to control the supply of aluminum to commercial users and, as a result, to control prices.[92] This led other market participants to worry about unfair advantage for such firms, as they now can use their knowledge of how much metal is stored, as well as their ability to control delivery of physical metal to consumers, to determine their own trading strategies.

Goldman and its subsidiary Metro became the key figures in a recent ugly battle over global aluminum prices. In mid-2011, Metro reportedly stored nearly half of the global inventories of the industrial aluminum.[93] Months-long delivery delays at the firm's storage facilities in Detroit caused much discontent among big commercial users of aluminum, such as the soft-drink giant Coca-Cola and the aluminum sheetmaker Novelis. In mid-2011, Coca-Cola filed a complaint with the LME alleging that Goldman intentionally limited the releases of aluminum from its Metro-operated warehouses in order to inflate the price of aluminum. In addition to potentially enabling Goldman to sell its own aluminum at artificially inflated prices, holding aluminum in the warehouse generates additional fees for Metro, as the buyers have to pay for each day their purchased metal stays in the warehouse.[94]

In response to these complaints, the LME doubled the minimum delivery rates for large warehouses, including Metro. Nevertheless, warehousing bottlenecks and record-high aluminum premiums continued to wreak havoc in global aluminum markets. By mid-2013, the reported waiting time for aluminum in Detroit was longer than 460 days.[95] In July 2013, the LME's new leadership proposed another

---

[88] Glencore, bought metals warehousing assets of Italy based Pacorini Group, while JPMC acquired the UK-based Henry Bath as part of its purchase of RBS Sempra's assets. See Tatyana Shumski & Andrea Hotter, *Wall Street Gets Eyed in Metal Squeeze,* WALL ST. J., June 17, 2011.

[89] *Id.*

[90] Jack Farchy, *Banks force aluminium market shake-up,* FIN. TIMES, Sept. 12, 2012 ("The arrival of investment banks in the aluminum market has triggered a shake-up in the $100bn industry that is forcing producers from Alcoa to Rusal and consumers such as BMW and Coca-Cola to change the way they do business. The increasingly dominant role of banks including Goldman, JPMorgan and Deutsche Bank—as well as traders such as Glencore—has prompted a surge to record levels in the premium consumers pay for metal over the benchmark price set at the London Metal Exchange.").

[91] The LME rules set the minimum delivery rates for its warehouses. If the demand for delivery of aluminum out of a particular warehouse significantly exceeds the rate at which the warehousing company actually releases it, the resulting bottleneck prevents the industrial users of aluminum from getting their purchased metal.

[92] Financial institutions like Goldman Sachs can also use their warehouses to store vast quantities of physical metals in so-called "financing" deals. This strategy allows financial institutions to secure a guaranteed return. Removing a large portion of physical metal from the market, however, creates artificial shortages of aluminum for commercial purchase and inflates its market price.

[93] Pratima Desai, Clare Baldwin, *Goldman's New Money Machine: Warehouses,reuters.com,* Jul. 29, 2011 (stating that, in the first 6 months of 2011, "Metro warehouses in Detroit took in 364,175 tonnes of aluminum and delivered out 171,350 tonnes," which "represented 42 percent of inventory arrivals globally and 26 percent of the metal delivered out.").

[94] Trefis Team, *Metals Warehousing Pays Off for Goldman Sachs,* FORBES, July 8, 2011 ("Goldman charges 42 cents to store a metric ton of aluminum in its facilities for a day, which translates into $150 in annual revenues for every metric ton it stores. With millions of tons in storage, the industry is expected to rake in $1 billion in storage revenues each year. Goldman Sachs which is estimated to hold 900,000 tons in its facilities can make $138 million in revenues from its storage business alone.").

[95] Laura Clarke & Matt Day, *New Stab at Metals Gridlock,* WALL ST. J., July 2, 2013, C1.

change to its rules to require warehouses experiencing logjams to deliver out more metal than they take in.[96] The new rule, however, is expected to become effective only starting in April 2014.

D. JPMC: The New "Whale?"

Unlike Morgan Stanley and Goldman, JPMC has always been a regulated BHC subject to activity restrictions. As discussed above, in 2005, JPMC received the Board's approval to trade physical commodities as an activity "complementary" to its commodity derivatives business. Under the terms of the Board's approval, however, JPMC did not have legal authority to own, operate, or invest in any physical assets and facilities for the extraction, transportation, processing, storage, or distribution of commodities.

The financial crisis became the key turning point for JPMC, which emerged from it significantly larger and even more systemically important than before the crisis. In 2008, JPMC bought the key assets of Bear Stearns, an independent investment bank on the verge of failure. As part of the deal, JPMC acquired commodity trading assets and operations, including a significant network of electric power generating facilities owned by Arroyo Energy Investors L.P., a commodities subsidiary of Bear Stearns.

After acquiring Bear's energy assets, JPMC's CEO Jamie Dimon and the head of commodities operations Blythe Masters began aggressively expanding the firm's physical commodities business. In 2008, the firm started trading physical oil and looking at "more ways to boost its presence in energy markets."[97] In addition to hiring more people in its commodities and energy trading and investment team, JPMC started drawing plans for strategically expanding its metals and energy operations in Asia.

JPMC's once-in-a-lifetime chance to become a major player in commodities came in late 2009, when the European Commission ordered nationalized RBS to divest its riskier assets, including its 51 percent stake in RBS Sempra, a large U.S. commodities and energy trading company. In July 2010, JPMC bought RBS Sempra's global oil, global metals and European power and gas businesses. In addition to bringing in approximately $1.7 billion of net assets, the $1.6 billion acquisition nearly doubled the number of clients of JPMC's commodities business and enabled the firm "to offer clients more products in more regions of the world."[98]

In November 2010, JPMC also bought RBS Sempra's North American power and gas business, which added further strength to the operations the firm inherited from Bear Stearns. This purchase propelled JPMC into the top tier of natural gas and power marketers in North America.[99] Several months after closing the deal, the firm boasted having control of "a diverse network of physical assets, including 70 billion cubic feet per day of storage capacity—an increase of almost 100 percent since the purchase—and almost double the transport capacity it had had previously."[100]

By late 2010, JPMC had emerged as a formidable contender for the title of the dominant Wall Street energy and commodities trading house, previously shared by Morgan Stanley and Goldman. JPMC's official Web site describes the firm as one of the leading energy market-makers in the world:

> We are active in both the physical and financial markets worldwide for crude oil and oil-refined products, coal, power and gas, and have extensive capabilities in the voluntary and mandatory emissions markets. [. . .]. Our geographically diverse physical asset portfolio includes more than 40 North American locations. In addition, we are one of the largest natural gas traders in the U.K. and European markets, with daily volumes of approximately 100 million therms.[101]

---

[96] Jack Farchy, *LME takes aim at warehousing queues,* FIN. TIMES, July 1, 2013.

[97] Sambit Mohanty, *JPMorgan to Start Physical Oil Trade; Eyes $200 Oil,* REUTERS, May 15, 2008.

[98] JPMorgan Chase & Co., 2011 Form 10–K, at 184.

[99] Gregory Meyer, *JPMorgan buys RBS Sempra Commodities' trading book,* FIN. TIMES, Oct. 7, 2010 ("In the second quarter [of 2010], RBS Sempra ranked the fifth-largest North American gas marketer by volume, after BP, Royal Dutch Shell, Conoco-Phillips and Macquarie, According to Platt's. JPMorgan was 12th.").

[100] J.P.Morgan, *Energy Risk Names J.P.Morgan "Oil &Products House of the Year"* (Jul. 1, 2011), *available at http://www.jpmorgan.com/cm/cs?pagename=JPM__redesign/JPM__Content__C/Generic__Detail__Page__Template&cid=1309472621690&c=JPM__Content__C.*

[101] *http://www.jpmorgan.com/pages/jpmorgan/investbk/solutions/commodities/energy.*

In addition to oil, gas, and electric power assets, JPMC's crisis-driven acquisitions allowed the firm to become a significant force in global markets for metals. In late 2011, JPMC bought a stake in LME from the bankrupt futures firm, MF Global, and became the exchange's largest shareholder. 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 LME-approved global metal storage networks. According to the company's own description:

> Today, Henry Bath, a subsidiary of JPMorgan, engages in the storage and shipping of exchange traded metals and soft commodities. It offers warehousing, shipping transportation and customs clearance services. The company stores and issues exchange traded warrants for commodities, including aluminum, copper zinc, lead, nickel, tin, steel billets, cocoa, coffee and plastics.[102]

Media reports indicate that JPMC has been building up its metals warehousing business in order to strengthen the competitive position of Henry Bath *vis-a-vis* Glencore's Pacorini and Goldman's Metro. The reports of JPMC moving large amounts of metal from other warehouses into its own suggest that the firm may be rebuilding its stocks and consolidating its warehousing business in key European locations. This is likely to exacerbate the conflict within the aluminum industry over the unprecedented degree of power that the largest warehousing companies like Henry Bath and Metro exercise over global aluminum prices.

JPMC may be in a particularly sensitive situation because of its controversial move to market the first exchange-traded fund ("ETF") backed by physical copper.[103] JPMC has been reportedly buying up copper since 2010, in anticipation of its ETF launch.[104] The firm's ability to remove from the market and store in its own warehouses vast quantities of this critically important metal potentially lends more credibility to the fears of market cornering expressed by the opponents of JPMC's ETF plan. It makes it difficult for JPMC to argue that trading copper-backed ETF shares would not artificially inflate global copper prices.

JPMC's newly acquired physical commodity and energy assets and operations, however, raise a more fundamental legal question as to whether the firm has the statutory authority to own such assets and to conduct such operations in the first place. The Board's original order authorizing JPMC's physical commodity trading does not allow JPMC to own or operate any assets involved in generating, storing, transporting, or processing commodities. In fact, even energy tolling and energy management were outside of the scope of that original authorization. Presumably, as part of its Sempra acquisition, JPMC had to obtain the Board's approval to continue the commodities activities permissible under the RBS Order. Unfortunately, it is difficult to locate any public records showing how and when the Board amended its original authorization, to allow JPMC to conduct "complementary" commodities activities of RBS, including energy tolling and energy management.

It appears that JPMC generally conducts its physical commodity operations subject to Board-imposed limitations. According to the firm's SEC filings, it entered into operating leases for "premises and equipment" used for "energy-related tolling service agreements."[105] JPMC also enters into various forms of "supply and off-take" contracts with producers and processors of commodities, such as oil refineries. These contracts are functionally similar to energy management arrangements JPMC and other FHCs have with electric power plants under the "complementary" authority grants. Thus, in April 2012, business media reported that Delta Airlines was planning to purchase Conoco's idle Trainer oil refinery, in order to lower its jet fuel costs, and that JPMC agreed to finance the entire production process through a supply and off-take agreement. Under the arrangement, JPMC would purchase and pay

---

[102] Mike Jackson, *Henry Bath & Son: A Company and family History* (2010), *available at http://www.henrybath.com/assets/__files/documents/jun__11/HENRYBATH__1308588481__Complete__Henry__Bath__History.pdf.*

[103] Jack Farchy, *Copper ETF would "wreak havoc,"* FIN. TIMES, May 23, 2012. The SEC approved JPMC's plan to market its copper-backed ETF in December 2012. *See http://www.sec.gov/rules/sro/nysearca/2012/34-68440.pdf.*

[104] Louise Armitstead & Rowena Mason, *JPMorgan as mystery trader that bought £1-bn-worth of copper on LME,* TELEGRAPH, Dec. 4, 2010. In April 2012, JPMC reportedly held 30–40 percent of total copper positions on the LME. *CESCO week: Glencore, JPMorgan hold dominant copper position as back flares—sources,* METALBULLETIN.COM, Apr. 18, 2012.

[105] JPMC, 2011 10–K, Note 30, at 289. This probably reflects the general practice among FHCs engaged in physical commodity trading under the Board's "complementary" orders. To avoid legally owning or operating any physical assets involved in the marketing chain, JPMC probably enters into some form of a sale-and-lease-back contract, whereby an unaffiliated third party is the legal owner of the physical facilities and operates those facilities under a lease agreement with JPMC.

for delivery of the crude for the refinery's operation, sell the jet fuel to Delta at a wholesale price, and then sell other refined products on the open market. In July 2012, JPMC entered into a similar supply and off-take arrangement with the largest oil refinery on the East Coast, owned and operated by Sunoco and Carlyle. These transactions significantly reduce refineries' working capital needs and offload the risk on JPMC, which has far greater balance-sheet capacity.[106] In effect, JPMC contractually replicates owning oil refineries without violating the letter of the law.

Nevertheless, some of JPMC's recently acquired physical commodity operations appear to exceed the boundaries of the Board's "complementary" power grants. In April 2012, JPMC sold its metals-concentrate trading unit to Connecticut-based Freepoint. The sale was reportedly part of the mandatory divestment by JPMC of RBS Sempra's commercial assets and activities impermissible for FHCs under the BHCA.[107] The firm's ownership and operation of Henry Bath, however, continue to present a potential problem in this regard.

JPMC's speedy rise to the top of the Wall Street commodity-trading circle has created new legal and reputational risks for the firm. In the summer of 2012, the FERC launched an investigation into JPMC's electric power trading practices. The agency began its probe in response to complaints from electric power grid operators in California and the Midwest in 2011, alleging that JPMC's power traders had intentionally bid up wholesale electricity prices by more than $73 million. Artificial inflation of wholesale prices benefits power generators (which is functionally JPMC's role) but translates into higher power prices for households and other endusers. As recent FERC enforcement actions demonstrate, the focus of today's fraud prevention in power markets is on more subtle trading strategies that seek to manipulate the price of physical power in order to increase the value of the manipulator's financial bets. JPMC's role as the leading global energy derivatives dealer potentially exacerbates concern over the firm's traders engaging in this type of Enron-reminiscent market manipulation.[108]

Even in the absence of conclusive evidence of any wrongdoing on the part of JPMC, however, the very fact of FERC's investigation—and potentially severe regulatory sanctions—raises uncomfortable questions about the potential impact of the firm's newly expanded energy operations on its overall institutional culture and reputation. These concerns become particularly acute in the context of the infamous "London Whale" scandal that exposed deep problems with JPMC's risk management practices. Both cases demonstrate the inherent difficulty of drawing regulatory distinctions among various transactions based on the firm's intentions and proclaimed business purposes. Just like a legitimate hedge can become a lucrative bet under favorable market conditions, so can financing-and-risk-management arrangements with oil refineries and power generators become a profitable proprietary business of energy merchanting.

How the law should deal with this complex reality is one of the key questions in today's financial services regulation reform.

IV. Potential Legal and Policy Implications of Allowing This Trend to Continue

Even a cursory overview of publicly available information shows that the current commodity operations of Morgan Stanley, Goldman, and JPMC defy carefully drawn pre-crisis regulatory boundaries of FHC-permissible physical commodities activities—and, if permitted to continue, effectively nullify the principle of separating banking from commerce. Broadly, there are two potential ways to resolve this doctrinal tension: either FHCs' commercial activities must be curtailed, or the law should be changed to reflect FHCs' newly acceptable role as global commodity merchants.

Unfortunately, the BHCA does not provide a clear and effective *legal* framework for making a fundamental policy decision on the socially efficient degree of mixing

---

[106] According to Blythe Masters, the head of JPMC's commodities unit, it is this "risk and balance sheet capacity" that puts big banks in the unique position to do these supply and off-take deals. Nonbank commodity trading houses typically use about 75–80 percent of their credit lines, which leaves them little room for taking on new deals, while maintaining a comfortable cushion against sudden price rises. *See* Gregory Meyer, *Wall Street banks step up oil trade role,* FIN. TIMES, July 15, 2012.

[107] Because metal concentrate futures were not traded on major organized commodity exchanges, the Board excluded metal concentrates from the scope of its original order approving RBS's "complementary" activities.

[108] On September 20, 2012, the FERC initiated official proceeding accusing J.P. Morgan Ventures Energy Corporation, JPMC's commodity trading arm, in intentionally providing misleading information to the regulator. FERC, News Release (Sept. 20, 2012), *available at http://www.ferc.gov/media/news-releases/2012/2012-3/09-20-12-E-24.asp.*

banking and commercial commodities activities. There are, however, important *policy* reasons to suggest that such mixing, at least to the degree it is done today, may be socially undesirable and inefficient. Some of these policy concerns grow out of the traditional rationales for the separation of banking and commerce, while others reflect broader regulatory principles and normative commitments.

A. The Indeterminacy of the Current Statutory Framework

Under the BHCA, as amended by the GLBA, it is likely that all (or nearly all) of the existing physical commodity assets and activities of Goldman, Morgan Stanley, and JPMC can be permitted to continue as compliant with the formal requirements of the statute. However, while technically plausible, such an interpretation brings to the surface a deep tension within the existing legal regime between the *letter* and the *spirit* of the law.

The commodity grandfathering provision of Section 4(o) of the BHCA potentially provides the greatest latitude for Morgan Stanley and Goldman, as two FHCs qualifying for this exemption, to continue owning and operating their extensive commodity assets "and underlying physical properties." On its face, Section 4(o) does not impose any qualitative limits on grandfathered activities: the language of the provision is broad and open to expansive interpretation. Yet, as discussed above, the legislative history of this grandfathering provision, originally conceived as a special concession to "woofies"—financial institutions without access to FDIC-insured retail deposit-taking—indicates that it was not conceived to operate as a completely open-ended commodity-business license for banking organizations. It is doubtful that, at the time the GLBA was passed, Congress actually envisioned the current extent and depth of these firms' physical commodities operations.

In the alternative, Morgan Stanley, Goldman, and JPMC can seek the Board's approval of their existing commodities activities as complementary to FHC-permissible financial activities, such as commodity derivatives. As discussed above, the BHCA does not define what "complementary" means and leaves it largely to the Board's discretion to determine whether any particular activity fits that description. An examination of published Board orders shows the regulator's general reluctance to allow FHCs to incur nonfinancial risks associated with owning and operating oil rigs, coal mines, refineries, storage tanks, pipelines, and tankers. As is the case with any agency policy, however, the Board's position may change in response to various internal and external factors. Moreover, even if the Board insists on its pre-crisis determination that "complementary" commodity trading activities exclude direct ownership and operation of physical assets, the practical impact of that seemingly bright-line border may be rather limited. FHCs can (and do) use various forms of "sale and lease-back" or "supply and off-take" arrangements to replicate the effects of owning and operating individual key links in the commodity supply chain.[109]

Finally, FHCs can use merchant banking authority to keep, and even expand, their current physical commodity assets. Merchant banking is a potentially tempting choice, because it can be used without the Board's pre-approval: the FHC can make the determination that it holds certain investments under that statutory authority. As discussed above, FHC-permissible merchant banking investments must meet certain statutory requirements intended to prevent FHCs from actively running the commercial businesses of their portfolio companies. The holding period limitations and the prohibition on FHCs' involvement in "routinely managing" portfolio companies' businesses seem tough in principle but are not necessarily "deal-killers." It is not difficult to structure specific investments to meet the formal statutory criteria without giving up real control. It is difficult to ascertain, however, whether these investments are, in fact, truly passive private equity interests acquired purely for the purposes of profitable resale. In practice, FHCs can—and most likely do—exercise informal influence on portfolio companies' business decisions, which may be just as effective as a formal management role.

It may be tempting to assume that the post-crisis regulatory reforms mandated by the Dodd-Frank Act—such as, *e.g.,* the Volcker Rule—impose (at least, prospectively) effective limits on FHCs' commercial activities. Yet, there is little basis for any such assumption at this point. Although the Dodd-Frank Act reiterated Congress's general commitment to the principle of separation of banking and commerce, the new law does not directly address the issue of the proper scope of FHC-permissible nonfinancial activities. It is not clear whether and how the regulatory

[109] While these arrangements may potentially reduce direct risks to individual FHCs' safety and soundness, their proliferation implicates other policy concerns the Board must consider in granting "complementary" powers to FHCs: excessive concentration of market power, conflicts of interest, and increased systemic risk.

implementation of the Act will ultimately affect large FHC's physical commodities operations.

B. Potential Policy Concerns and Implications

Even though, as a technical matter of law, the U.S. FHCs' current physical commodity-trading and related activities may be fully permissible under the BHCA, there are several compelling policy reasons to resolve the resulting doctrinal tension in favor of explicitly curtailing such activities. In the absence of comprehensive and detailed information on the precise nature and scale of individual FHCs' physical commodity interests and activities, it is difficult to arrive at a definitive conclusion in this regard. Nevertheless, the potential gravity of these policy concerns demands their prompt and thorough investigation.

1. Safety and Soundness; Systemic Risk

From the perspective of safety and soundness of individual banking organizations, there is at least one straightforward, plausible argument for allowing FHCs to conduct physical commodities trading as a diversification strategy. Diversifying their business activities by investing in oil pipelines and metals warehouses should make FHCs less vulnerable to periodic crises in financial markets. Trading, transporting, storing, and processing physical commodities are volatile businesses, and that volatility is expected to continue for the foreseeable future. It is a reliably profitable business, as global commodity prices have been rising since the early 2000s and, despite sudden ups and downs, are generally expected to continue rising in response to increasing global demand. Intermediating physical commodities trading is the surest way to profit from these trends.

As professional intermediaries, financial institutions appear to be perfectly positioned to assume that lucrative role. Large FHCs have huge balance sheets, access to cheaper financing, superior access to information and in-house research capacity, and sophisticated financial derivatives trading capabilities. To the extent that utilizing these unique advantages allows FHCs to be more efficient, low-cost suppliers of physical commodities and related logistics services, allowing them to perform that function should produce economic benefits for the FHCs and their customers.[110]

This traditional economic efficiency-based argument, however, misses or ignores a crucial fact—namely, that running a physical commodities business also diversifies the sources and spectrum of risk to which FHCs become exposed as a result. Let us imagine, for example, that an accident or explosion on board an oil tanker owned and operated by one of Morgan Stanley's subsidiaries causes a large oil spill in an environmentally fragile area of the ocean. As the shocking news of the disaster spreads, it may lead Morgan Stanley's counterparties in the financial markets to worry about the firm's financial strength and creditworthiness. Because the full extent of Morgan Stanley's clean-up costs and legal liabilities would be difficult to estimate upfront, it would be reasonable for the firm's counterparties to seek to reduce their financial exposure to it. In effect, it could trigger a run on the firm's assets and bring Morgan Stanley to the verge of liquidity crisis or collapse.

But there is more. What would make this hypothetical oil spill particularly salient is a shocking revelation that the ultimate owner of the disaster-causing oil tanker was not Exxon-Mobil or Chevron but Morgan Stanley, a major U.S. banking organization not commonly associated with the oil business. That revelation, in and of itself, could create a far broader controversy that would inevitably invite additional public scrutiny of the commodity dealings of Goldman, JPMC, and other Wall Street firms. Thus, in effect, an industrial accident could potentially cause a major systemic disturbance in the financial markets. These hidden contagion channels make our current notion of interconnectedness in financial markets seem rather quaint by comparison. FHCs' expansion into the oil, gas, and other physical commodity businesses introduces a whole new level of interconnections and vulnerabilities into the already fragile financial system.

The basic economic efficiency-based argument may also be overstating the claim that forcing U.S. FHCs out of the physical commodity and energy business would leave consumers' needs in those markets unmet. Traditional commodity trading companies will almost certainly step in to fill any such gap. These nonbank commodity traders may not be able to offer the same "fully integrated risk management" services to industrial clients by assuming nearly all financial risk (and

[110] By assuming this role of a "super-intermediary," financial institutions effectively—and far more successfully—adopted the business model pioneered by Enron. See William W. Bratton & Adam Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs* (Aug. 13, 2012), available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2126778.*

logistical headaches) inherent in such clients' commodity-driven businesses. That possibility lends some support to the argument for letting banks act as super-intermediaries, or commodity traders *plus*.

At the same time, however, it begs the real question as to *why* banks are able to out-compete other commodity traders in this realm, or where that all-important *plus* comes from. Huge balance sheets, high credit ratings, and access to plentiful and relatively cheap financing—these factors enable large banking organizations to absorb their clients' commodity-related risks at a lower cost than anyone else could. These unique advantages ultimately stem from the fact that, by taking deposits and serving as the main channel for the flow of payments and credit throughout the economy, banks perform a "special" public service and, therefore, enjoy a special public subsidy through access to Federal deposit insurance, special liquidity facilities, and other forms of implicit Government guarantees. In this context, the discussion should focus not on a factual question whether banks are in the best position to offer these services more efficiently but on a normative question: should banks be offering them at all?

If banks' superior ability to provide commodity-related services is rooted in the Federal subsidy, the answer to that question is not as simple as the efficiency argument assumes.[111] If taxpayers are the party ultimately conferring this precious economic benefit on banks, taxpayers also have the right to stop banks from abusing that benefit by engaging in risky commercial activities unrelated to their "special" functions. The choice of moving into the physical commodities business does not belong solely to bank executives—the choice ultimately belongs to the taxpaying, bank-subsidizing public. If JPMC's management wants to be free to make profits by drilling for and shipping crude oil, it should be able to do so without the estimated $14 billion in annual Federal subsidy it receives as a "special" banking institution.[112]

2. Conflicts of Interest, Market Manipulation, and Consumer Protection

Banks' extensive involvement in physical commodity activities also raises significant concerns with respect to potential conflicts of interest and market integrity. One of the key policy reasons for separating banking from commerce is the fear of banks unfairly restricting their commercial-market competitors' access to credit, the lifeblood of the economy. Without reliable empirical data, it is difficult to assess the extent to which this obvious form of conflict of interest currently presents a problem in the commodities sector. Yet, there is a heightened danger that banks may use their financial market power to gain an unfair advantage in commodities markets, and vice versa.

Goldman's role in the ongoing aluminum warehousing crisis provides an instructive example. As discussed above, Coca-Cola complained that Goldman intentionally created a bottleneck at its Metro warehouses in order to drive up market prices for aluminum and sell their own metal stock at the inflated price. It is curious, however, that more industrial endusers did not publicly complain, a lot sooner and louder, about this potential conflict-of-interest situation. It is very likely that commercial companies deliberately avoided an open confrontation with Goldman because it was a Wall Street powerhouse with which they had—or hoped to establish—important credit and financial-advisory relationships. If they were facing Metro as an independent warehousing operator, they might have felt less pressure to keep quiet—and to continue paying high aluminum premia. This form of subtle counterparty coercion may be difficult to detect and police but it raises a legitimate question for further inquiry.

---

[111] In June 2012, when Moody's downgraded JPMC's credit rating by three levels, the rating agency was quoted as saying that:

> JPMC benefited from the assumption that there's a "very high likelihood" the U.S. Government would back the bank's bondholders and creditors if it defaulted on debt. Without the implied Federal backing, JPMorgan's long-term deposit rating would have been three levels lower and its senior debt would have dropped two more steps.

Dawn Kopecki, *JPMorgan Trading Loss Drove Three-Level Standalone Cut,* BLOOMBERG.COM, June 21, 2012.

[112] *See* Editorial, *Dear Mr. Dimon, Is Your Bank Getting Corporate Welfare?* BLOOMBERG.COM, June 18, 2012. Section 23A of the Federal Reserve Act, which imposes quantitative and qualitative limitations on transactions between federally insured depository institutions and their affiliates, should theoretically prevent the leakage of this public subsidy from banks to their commodity-trading nonbank affiliates. 12 U.S.C. § 371c. As the recent crisis demonstrated, however, the practical effectiveness of this statutory firewall is subject to considerable doubt. *See* Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: the Unfulfilled Promise of Section 23A of the Federal Reserve Act,* 89N.C.L. Rev.1683 (2011).

Moreover, metal warehousing operations are only one element in a large financial conglomerate's complex business strategy involving trading in metals and related financial contracts. Goldman is one of the largest traders of derivatives in the metals markets. Unlike an independent warehouse operator, Goldman can potentially use its storage capabilities not only to generate rental income but also to move commodity prices in a way that would benefit its derivatives positions. This directly implicates serious issues of market integrity. As one of the world's biggest dealers in commodity derivatives, Goldman can devise and execute highly sophisticated trading strategies across multiple markets. The ability to influence prices of physical assets underlying derivatives, in effect, completes the circle. It makes Goldman's derivatives profits not so much a function of its traders' superior skills or executives' talents, but primarily a function of the firm's *structural market power.*

It should be noted here that one of the fundamental drivers of the value of any derivative is the degree of volatility of the value of the underlying asset. If the value of the underlying asset is predictably stable, neither hedgers nor speculators would have any reason to enter into derivative contracts tied to that value. Conversely, the higher the volatility, the higher the demand for derivatives instruments allowing transfer of the underlying risk. This basic fact reveals the fundamental incentive for a derivatives dealer with sufficient market power in the underlying physical commodity markets to maintain price volatility in such markets, regardless of the fundamentals of supply and demand, as the necessary condition of continuing viability and profitability of its commodity derivatives business.

Market manipulation in commodities markets has long been a hot button issue. In contrast to securities market, commodities markets are particularly vulnerable to so-called market power-based manipulation that may not involve fraud or deceptive conduct.[113] A large trader can significantly move prices of futures and underlying physical commodities not only by "cornering" the market in a particular product but also by placing very large sell/buy orders in excess of available liquidity. This salience of market power in commodities market manipulation underscores the potential dangers of allowing large financial institutions to dominate both commodity derivatives markets and the related cash commodity markets.

Finally, artificially high premia for industrial aluminum translate into higher consumer prices for a wide range of products, from soft drinks to automobiles. Similarly, if JPMC's commodity traders did, in fact, inflate wholesale power prices in California, their manipulative conduct accounts for retail consumers' higher electricity bills. Generally, commodity price inflation is a major component of consumer price inflation. To the extent that banks' direct involvement in physical commodity markets distorts traditional supply and-demand dynamics and contributes to commodity price volatility, it becomes an important matter of consumer protection.

An unsustainable rise in consumer prices, driven by the rising prices of basic commodities, has significant macroeconomic consequences. The recent spikes in nationwide gasoline and heating oil prices illustrate these systemic effects. Despite the general prevalence of traditional supply and-demand theories, there is also a legitimate argument that a significant factor explaining these prices is purely financial speculation in oil.[114] Large financial intermediaries enable and amplify such speculation by creating, marketing, and dealing in commodity-linked financial products. Indirectly, these intermediaries' physical commodities operations contribute to speculative bubbles in key commodities, which ultimately increase the cost of living for the ordinary Americans. Because rises in the costs of basic goods tend to disproportionally affect the poor, this artificially created price volatility can widen socioeconomic disparities that have tangible and potentially grave consequences for social cohesion and civil unity. From this perspective, large FHCs' physical commodities businesses raise potential concerns not only as a matter of consumer protection but also as a matter of macroprudential regulation and even political stability.

3. Concentration of Economic and Political Power

Concerns with potential conflicts of interest, market manipulation, and consumer protection are closely connected to the broader policy concern with excessive concentration of economic power. That concern looms especially large in the context of FHCs' physical commodity trading.

It is difficult to overestimate the importance of this issue for the long-term health and vitality of the U.S. economy and of American democracy. Writing almost a cen-

---

[113] Craig Pirrong, *Energy Market Manipulation: Definition, Diagnosis, and Deterrence,* 31 ENERGY L.J. 1, 2 (2010).

[114] *See, e.g.,* Robert Lenzner, *Speculation in Crude Oil Adds $23.39 To The Price Per Barrel,* FORBES, Feb 27, 2012; Joseph P. Kennedy II, *The High Cost of Gambling on Oil,* N.Y. TIMES, Apr. 10, 2012.

tury ago, Justice Brandeis famously warned against the dangers of combination—or "concentration intensive and comprehensive"—that gave financial institutions direct control over industrial enterprises.[115] Brandeis saw the "subtle and often long-concealed concentration of distinct functions, which are beneficial when separately administered, and dangerous only when combined in the same persons" as a great threat to economic and political liberties.[116]

The global financial crisis of 2008–2009 demonstrated the continuing salience of Brandeis's concerns. The taxpayer-funded bailout of large financial conglomerates whose risky activities had contributed to—and, indeed, largely created—the crisis reignited the century-old debate on the role of "financial oligarchy" in American politics.[117] Not surprisingly, one of the central themes in post-crisis regulatory reform is the prevention of future bailouts of "too big to fail" financial institutions. The ongoing transformation of large U.S. financial institutions into leading global merchants of physical commodities and energy, however, significantly complicates the reformers' task. By giving banks that are already "too big to fail" an additional source of leverage over the economy—and, consequently, the polity—it elevates the dangers inherent in cross-sector concentration of economic power to a qualitatively new level. When large financial conglomerates that control access to money and credit also control access to such universal production inputs as raw materials and energy, their already outsized influence on the entire economic—and, by extension, political—system may reach alarming proportions.

For these reasons, in rethinking the foundational principle of separating banking and commerce, especially in the context of energy and commodity activities, it is critically important to remember Brandeis's warnings. Reassessing and reasserting the original antitrust spirit of U.S. bank holding company regulation may be the necessary first step in the right direction.

4. Institutional Governability and Regulatory Capacity

An examination of FHCs' physical commodity activities also highlights potential problems such activities pose from the perspective of regulatory design, regulatory process, and firm governability.

Understanding what exactly large U.S. FHCs own and do in global commodity markets is the critical first step toward developing an informed regulatory approach to this issue. Under the current regulatory disclosure system, there is no reliable way to gather and evaluate this information. Existing public disclosure is woefully inadequate to understand and evaluate the nature and scope of U.S. banking organizations' physical commodities trading assets and activities. It may not be feasible or desirable to mandate detailed disclosure of every commercial activity of a large FHC, but when it comes to energy and other key commodities, what is hidden from the public view may be highly consequential.[118] It is imperative, therefore, to mandate *full public disclosure* of financial institutions' direct and indirect activities and investments in physical commodities and energy.

Simply mandating more disclosure, however, will not be enough. The recent crisis has demonstrated the limits of disclosure as a regulatory tool, especially in the context of complex markets, institutions, and instruments. Complexity is one of the fundamental drivers of systemic risk, and managing complexity is one of the key challenges in today's financial services sector. Large U.S. financial conglomerates are already complex, in terms of their corporate structure, risk management, and the breadth and depth of financial services and products they offer. Allowing these firms to run extensive commercial operations that require specialized technical and managerial expertise adds to their internal complexity. Firm-wide coordination and monitoring of operations, finances, risks, and legal and regulatory compliance become all the more difficult in that context. This is particularly true of capital-intensive, operationally complex, and potentially high-risk physical commodity activities. An effec-

---

[115] Louis D. Brandeis, OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT (1933), at 3.

[116] *Id.* at 4.

[117] *See, e.g.,* Simon Johnson & James Kwak, THIRTEEN BANKERS (2010); Matt Taibbi, *Why Isn't Wall Street In Jail?* ROLLING STONE, Feb. 16, 2011.

[118] The Dodd-Frank Act requires SIFIs to submit to federal regulators enterprise-wide recovery and resolution plans, or "living wills," to help their orderly resolutions in the event of failure. Dodd-Frank Act 165(d). Goldman, Morgan Stanley, JPMC, and other large FHCs have already submitted their living wills to the Board in July 2012. These documents should provide an exhaustive description of each institution's corporate structure and core business activities. They could give regulators the necessary information on these firms' physical commodity assets and operations. It is not clear, however, whether this is actually the case, as the bulk of the information in these resolution plans is confidential. None of the publicly available portions of the living wills filed to date contain any relevant information on this issue. *See, http://www.federalreserve.gov/bankinforeg/resolution-plans.htm.*

tive integration of these operations may be further complicated by potential shifts in corporate culture. Thus, the traditionally aggressive risk-taking culture of commodity traders (think Enron) may push the already questionable ethics of bankers beyond the limits of prudency and legality. All of these factors present serious challenges for large *financial firms' internal governance and governability.*

More importantly, mixing banking with physical commodity trading creates potentially insurmountable challenges from the perspective of *regulatory efficiency and capacity.* Direct linkages, through the common key dealer-banks, between the vitally important and volatile financial market with the vitally important and volatile commodity and energy market may amplify the inherent fragility of both markets, as well as the entire economy. Who can effectively regulate and supervise this new super-market? And how should it be done?

The U.S. system of financial services regulation is already highly fragmented and ill-suited to detecting and reducing systemic risk across different financial markets and products. The expansion of FHCs' activities into yet more new areas subject to extensive regulation under very different regulatory schemes—environmental regulation, workplace safety regulation, utility regulation—lays the foundation for jurisdictional conflicts on an unprecedented scale. In addition to the several Federal bank regulators, the SEC and CFTC, banking organizations become subject to regulation by the DOE, the FERC, the Environmental Protection Agency, the Federal Trade Commission, and possibly other Federal and State agencies. Yet, none of these many overseers are likely to see the whole picture, leaving potentially dangerous gaps in the regulation and supervision of these systemically important super-intermediaries. An additional complicating factor is the high strategic and geopolitical significance of energy trading. The flow of oil and gas in global markets is as much a matter of foreign policy and national security as it is a matter of business. Accordingly, the State Department could also be expected to insist on a say in the affairs of large U.S. FHCs that import and export oil, gas, and other strategically important commodities.

In terms of substantive regulatory oversight, the situation is equally discouraging. In addition to being the umbrella regulator for BHCs, the Board is now primarily responsible for prudential regulation and supervision of all SIFIs. As discussed above, physical commodities activities expose financial institutions to qualitatively different, and potentially catastrophic, risks. In addition, commodities operations create potential new channels of contagion and systemic risk transmission. Yet the Board is not equipped to regulate and supervise companies that own and operate extensive commodity trading assets: oil pipelines, marine vessels, or metal warehouses.

It is not enough to pay lip service to these concerns by simply requiring FHCs to conduct their commercial activities in compliance with the applicable securities, commodities, energy, and other laws and regulations. Those regulatory schemes are not designed with SIFIs in mind and, therefore, do not address the unique risks—enterprise-wide and systemic—posed by their activities. Realistically, however, the Board has little choice but rely on FHCs' promises to comply with such parallel regulatory regimes. Without the necessary expertise and a clear legal mandate, neither the Board nor any other financial regulator can be expected to exercise meaningful oversight of large financial institutions' commodity businesses and the risks they generate. This natural limit on regulatory capacity is an important reason for serious reconsideration of FHCs' role in physical commodities markets.

V. Conclusion

This testimony has described the legal, regulatory, and policy aspects of an ongoing transformation of large U.S. FHCs into global merchants of physical commodities and energy. In the absence of detailed and reliable information, it is difficult to draw definitive conclusions as to the social efficiency and desirability of allowing this transformation to continue. What we can already ascertain about U.S. financial institutions' physical commodity assets and activities, however, raises potentially serious public policy concerns that must be addressed through fully informed public deliberation. Even if big U.S. FHCs were, in fact, to scale down their physical commodity operations either in response to current regulatory developments or as a temporary market adjustment, it would not obviate the need for such deliberation. Addressing these policy concerns in a timely, open, and publicly minded manner remains a task of the utmost importance, both as an economic matter and as a matter of democratic governance.

PREPARED STATEMENT OF RANDALL D. GUYNN

PARTNER AND HEAD OF THE FINANCIAL INSTITUTIONS GROUP
DAVIS POLK & WARDWELL LLP

JULY 23, 2013

Introduction

Chairman Brown, Ranking Member Toomey, Members of the Subcommittee: My name is Randall Guynn, and I am a partner and head of the Financial Institutions Group of Davis Polk & Wardwell LLP.[1] Thank you for your invitation to testify at this important hearing.

My testimony will describe the laws and regulations that currently permit insured banks, bank holding companies, financial holding companies and their nonbank affiliates to engage as principal in futures, forwards and other commodities contracts and in owning or controlling physical or intangible commodities or related facilities, including electric power plants, commodities warehouses and oil refineries. These financial institutions are permitted to engage in commodities activities to meet the needs of customers, increase customer choice, increase competition, act as more effective intermediaries between producers and endusers, provide increased liquidity to the markets and lower prices to consumers, and increase the diversification of the revenue streams and exposures of these financial institutions. All things being equal, increased diversification of activities reduces risk, preserves capital and should help an institution improve its financial condition over time.

As you will see, insured banks are the most limited in what they are permitted to do, are not permitted to take delivery of physical commodities and generally are not permitted to control related facilities such as power plants, commodities warehouses or oil refineries. Only separately incorporated, capitalized and insulated nonbank affiliates are permitted to exercise broader powers, and even they are subject to significant limits in doing so. These nonbank affiliates are granted broader powers because they are not eligible for Federal deposit insurance and do not have access to the Federal Reserve's discount window.[2] In addition, other Federal laws, including Sections 23A and 23B of the Federal Reserve Act,[3] prevent insured banks from passing on the funding advantages of deposit insurance or giving their nonbank affiliates access to the discount window. These other laws also insulate insured banks against the risks of a nonbank affiliate's commodities and other nonbanking activities.

Even the powers of these nonbank affiliates, however, are subject to significant limits. Bank holding companies that do not qualify as financial holding companies, and their nonbank affiliates, are subject to the most severe limits. Subject to certain very narrow exceptions, they are not permitted to buy, sell or make or take delivery of physical or intangible commodities or control related facilities.

Moreover, even financial holding companies and their nonbank affiliates must generally show that physical commodities activities are complementary to permissible financial activities, such as entering into futures, forwards or other commodities contracts, before being permitted to engage in such physical commodities activities. They must also show that their exercise of these powers does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. They are prohibited from trading in physical commodities unless a derivative contract has been authorized for trading on a futures exchange by the Commodity Futures Trading Commission or they otherwise demonstrate that the particular commodity is sufficiently fungible and liquid. They are generally prohibited from owning or controlling the day-today operations of processing, storage, transportation or other physical or intangible commodities facilities, including electric power plants, commodities warehouses and oil refineries. They may, however, temporarily own or control companies that operate such facilities pursuant to the merchant banking power, the temporary exception for acquiring companies substantially engaged in financial activities or the exception for acquisitions in satisfaction of a debt previously contracted in good faith. Finally, their physical commodities activities are subject to a variety of conditions and limitations. These include appro-

[1] My practice focuses on providing bank regulatory advice and advising on M&A and capital markets transactions when the target or issuer is a banking organization or other financial institution. My clients include many of the largest U.S. and non-U.S. banks, a number of regional, mid-size and community banks, and certain financial industry trade associations.

[2] Deposit insurance and access to the Federal Reserve's discount window are often referred to as the Federal safety net.

[3] 12 U.S.C. § 371c.

priate risk management requirements, oversight by the Federal Reserve and other regulators, and volume limitations.

Financial holding companies whose commodities activities are grandfathered under Section 4(o) of the Bank Holding Company Act are generally permitted to engage in trading, sale or investment in physical commodities activities and related facilities, but only subject to certain conditions and limitations. These conditions and limitations include appropriate risk management requirements, oversight by the Federal Reserve and other regulators, and volume limitations.

All of these financial holding companies and their bank and nonbank affiliates are subject to generally applicable laws and regulations that govern these activities. For example, they must conduct their commodities activities in compliance with all applicable antitrust, securities, futures and energy laws. These include the orders, rules and regulations of the Government agencies, exchanges and self-regulatory organizations responsible for implementing and enforcing those laws, including the U.S. Department of Justice, the Federal Trade Commission, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Energy Regulatory Commission, the National Futures Association, the CME Group, Intercontinental Exchange and the London Metal Exchange.

My testimony will also describe the extent to which banks, bank holding companies, their nonbank affiliates and other nonbank financial institutions were permitted to act as principal—and were major players—in the commodities markets before the Gramm Leach Bliley Act of 1999, the Glass-Steagall Act of 1933 or even the National Bank Act of 1863. In fact, there has been a close relationship between banking and commodities since ancient times as well as in this country for most of the past 200 years shows that both the grandfathering provision in Section 4(o) of the Bank Holding Company Act and the complementary powers orders that permit certain nongrandfathered financial holding companies to engage in trading physical and energy commodities were only incremental expansions of traditional banking powers, not the sort of radical departure some of argued.

I will then discuss whether commodities activities, as currently permitted by the law, are inconsistent with the principle of keeping banking and commerce separate. Finally, I will address whether insured banks or their nonbanking affiliates, including financial holding companies, should be prohibited from engaging in commodities activities or at least from controlling related facilities.

II. Current State of the Law

The National Bank Act expressly permits national banks to engage in the "business of banking," as well as all activities that are "incidental" to that business.[4] Although the National Bank Act does not define the business of banking, it provides a list of activities that are included within that term, including "buying and selling exchange, coin, and bullion"[5]—that is, trading in precious metals and other commodities that function as money or monetary substitutes. In *NationsBank v. VALIC,* the Supreme Court held that the business of banking is not limited to the list of activities in the National Bank Act:

> We expressly hold that the 'business of banking' is not limited to the enumerated powers in § 24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated. The exercise of the Comptroller's discretion, however, must be kept within reasonable bounds. Ventures distant from dealing in financial investment instruments—for example, operating a general travel agency—may exceed those bounds."[6]

In a series of orders and interpretive letters issued over time, the Office of the Comptroller of the Currency ("OCC") has defined the range of activities that fall within the business of banking or that are incidental to it. Among the activities that the OCC has defined as bank-permissible are acting as principal or agent in connection with a wide range of derivative contracts, including commodities contracts, as long as certain risk management and other conditions are satisfied.[7] National banks are generally not permitted to take delivery of any underlying physical or intangible commodities and generally are not permitted to control related facilities such as power plants, commodities warehouses or oil refineries. They may, however, acquire

[4] 12 U.S.C. §24 (Seventh).
[5] *Id.*
[6] 513 U.S. 251, 258–259 note 2 (1995).
[7] *See* Comptroller of the Currency, Administrator of National Banks, *Activities Permissible for a National Bank,* Cumulative, at 57–64 (2011 Annual Edition, Apr. 2012).

temporary ownership or control of companies that operate such facilities in satisfaction of a debt previously contracted in good faith for a maximum of 10 years.[8]

Section 4(c)(8) of the Bank Holding Company Act of 1956 ("BHC Act") similarly authorizes bank holding companies and their nonbank affiliates to engage in activities that are determined by the Board of Governors of the Federal Reserve System ("Federal Reserve Board" or "Board") "to be so closely related to banking as to be a proper incident thereto."[9] In a series of orders eventually codified in Section 225.28(b)(8) of the Board's Regulation Y, the Federal Reserve Board has determined that engaging as principal in a wide range of derivative contracts, including commodities contracts, is "closely related to banking" as long as certain risk-management and other conditions are satisfied.[10] Subject to certain very narrow exceptions, Regulation Y does not permit bank holding companies or their nonbank affiliates to take or make delivery of physical or intangible commodities as a closely related-to-banking activity.[11] Nor are bank holding companies permitted to acquire control of related facilities, except temporarily in satisfaction of a debt previously contracted in good faith for a maximum of 10 years.[12]

Section 4(k)(1) of the BHC Act, which was added in 1999 by the Gramm Leach Bliley Act ("GLB Act"), expressly permits bank holding companies that qualify as financial holding companies, as well as their nonbank affiliates, to engage in activities that are "financial in nature," "incidental" to a financial activity or "complementary" to a financial activity if certain conditions are satisfied.[13] Among the conditions that apply to engaging in a complementary activity is that such activity can be and is conducted in a manner that does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.[14]

Section 4(k)(4)(F) expressly defines financial activities for this purpose as including all of the closely related-to-banking activities in Section 225.28 of Regulation Y, including the commodities activities described above.[15] Thus, Section 4(k)(4)(F) codified the Federal Reserve Board's regulation as a matter of binding statutory law.

In a series of orders issued to specific institutions after passage of the GLB Act, the Federal Reserve Board determined that purchasing or selling a wide range of physical or intangible commodities, including oil, natural gas, electric power, emissions allowances, agricultural products, metals and certain other nonfinancial commodities in the spot markets or to take or make delivery of such physical or intangible commodities pursuant to commodities contracts, is "complementary" to the financial activity of acting as principal with respect to commodity contracts, subject to certain conditions.[16] Among the conditions applicable to this authority is that the commodities activities be limited to commodities that are sufficiently fungible and liquid.[17] To ensure that they are, the Board has generally required financial holding companies requesting these expanded powers to limit their physical commodities activities to commodities for which a derivative contract has been authorized for trading on a futures exchange by the CFTC or which the Board has specifically determined to be sufficiently fungible and liquid.[18]

Complementary authority does not provide a basis for financial holding companies to own or control the day-to-day operations of processing, storage, transportation or other physical or intangible commodities facilities, including electric power plants, commodities warehouses and oil refineries. They may, however, temporarily own or control companies that operate such facilities pursuant to the merchant banking power, the temporary exception for acquiring companies engaged in nonfinancial ac-

---

[8] *See* 12 U.S.C. 24 (Seventh) (incidental powers clause); OCC Interpretive Letter No. 643, reprinted in Fed. Banking L. Rep. (CCH) ¶ 83,551 (July 1, 1992); OCC Interpretive Letter No. 511, reprinted in [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,213 (June 20, 1990); OCC Interpretive Letter No. 1007 (September 7, 2004); See also *Activities Permissible for a National Bank,* supra note 7, at 86.

[9] 12 U.S.C. § 1843(c)(8).

[10] 12 C.F.R. § 225.28(b)(8). See also Randall D. Guynn, Luigi L. De Ghenghi & Margaret E. Tahyar, *Foreign Banks as U.S. Financial Holding Companies,* in REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES, § 10:4[9][a] (6th ed. 2012); Melanie L. Fein, FEDERAL BANK HOLDING COMPANY LAW § 18.07 (3rd ed. 2011).

[11] *See* 12 C.F.R. § 225.28(b)(8).

[12] 12 U.S.C. § 1843(c)(2); C.F.R. § 225.22(d)(1).

[13] 12 U.S.C. § 1843(k)(1).

[14] *Id.* § 1843(k)(1)(B).

[15] *Id.* § 1843(k)(4)(F).

[16] *See, e.g., Citigroup,* 89 Fed. Res. Bull. 508 (2003); *JPMorgan Chase & Co.,* 92 Fed. Res. Bull. C57 (2006); Royal Bank of Scotland Group, 94 Fed. Res. Bul. C60 (2008). *See also* Guynn, De Ghenghi & Tahyar, *supra* note 10, § 10:4[9][a].

[17] *See, e.g., Royal Bank of Scotland Group,* supra note 16.

[18] *See, e.g., id.*

tivities, or in satisfaction of a debt previously contracted in good faith, which are discussed more fully below.

In approving the applications of certain financial holding companies to engage in physical commodities activities, the Board also determined that the activities would satisfy the requirement that they be conducted in a manner that does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally if they were conducted subject to certain conditions. These conditions include appropriate risk management requirements, oversight by the Federal Reserve and other regulators, and a volume limit on the extent to which balance sheet resources may be dedicated to these activities.[19]

Finally, the Board found that permitting physical commodities activities would likely produce public benefits in the form of increasing customer choice, competition and market efficiency.[20] These activities almost certainly also produce public benefits in the form of providing increased liquidity to the markets and lower prices to consumers, and increasing the diversification of the revenue streams and exposures of these financial institutions. All things being equal, increased diversification of activities reduces risk, preserves capital and should help an institution improve its financial condition over time. Another important benefit of allowing financial holding companies to own inventory in physical commodities is that this permits them to finance the inventory for customers, such as airlines and refiners.

The merchant banking power is contained in Section 4(k)(4)(H) of the BHC Act.[21] It permits all financial holding companies and their nonbank affiliates to make temporary investments in any company that is engaged in nonfinancial activities or mixed financial and nonfinancial activities, subject to certain conditions.[22] Such nonbanking activities would include investing in physical commodities or related facilities. The most important conditions on the merchant banking power are that such investments in nonfinancial companies must be made as part of a bona fide underwriting or merchant or investment banking purpose and generally must be divested within 10 years, and the financial holding company must not be involved in the routine management of the portfolio company, except temporarily if necessary to preserve the value of the investment.[23]

Financial holding companies are also permitted, under a separate authority, to acquire temporary control of any company that is engaged in both financial and nonfinancial activities, provided that the company is "substantially engaged" in financial activities and the company conforms, terminates or divests any nonfinancial activities within 2 years.[24] A company is deemed to be "substantially engaged" in financial activities if at least 85 percent of its revenues and 85 percent of its assets are attributable to financial activities.[25] Like other bank holding companies, financial holding companies and their nonbank affiliates are also permitted to acquire temporary control of a company that controls physical commodities or related facilities in satisfaction of a debt previously contracted in good faith for a maximum of 10 years.[26]

Finally, Section 4(o) of the BHC Act, which was also added in 1999 by the GLB Act, contains a permanent grandfathering provision for institutions that were engaged in any commodities activities as of September 30, 1997, were not bank holding companies when the GLB Act was signed into law, but subsequently become bank and financial holding companies.[27] Section 4(o) expressly permits any qualifying financial holding company to "*continue* to engage in, or directly or indirectly own or control shares of a company engaged in, activities related to the trading, sale, or investment in commodities and underlying physical properties,"[28] provided that not more than 5 percent of the qualifying company's consolidated assets are attributable to such commodities or underlying physical properties.[29] Unlike other grandfathering provisions such as Section 4(n) of the BHC Act,[30] Section 4(o) does not have a time limit. Thus, it is a permanent exemption from the general requirement for a new bank holding company to conform its activities to the restrictions

---

[19] *See, e.g.,* Citigroup, supra note 16; *JPMorgan Chase & Co.,* supra note 16; *Royal Bank of Scotland Group,* supra note 16.

[20] *See, e.g., id.*

[21] 12 U.S.C. 1843(k)(4)(H).

[22] *See id.*

[23] See 12 U.S.C. § 1843(k)(4)(H); 12 C.F.R. §§ 225.171, 225.172.

[24] 12 C.F.R. § 225.85(a)(3).

[25] *Id.* § 225.85(a)(3)(ii).

[26] 12 C.F.R. § 225.22(d)(1).

[27] 12 U.S.C. § 1843(o).

[28] *Id.* (emphasis added).

[29] *Id.*

[30] *Id.* § 1843(n).

on nonbanking activities otherwise contained in Section 4 of the BHC Act within 5 years of becoming a bank holding company.[31]

Section 4(o) was one of several provisions in the GLB Act that were designed to ensure that the GLB Act would be a "two-way street" for commercial banks and investment banks, making it just as easy for an investment bank with a major commodities business to affiliate with an insured bank as it is for an insured bank to affiliate with a securities underwriting and dealing firm.[32] The legislative history stated that the activities described in Section 4(o) should be construed broadly and to include at a minimum the ownership and operation of properties and facilities required to extract, process, store and transport commodities.[33] It also explained that the purpose of Section 4(o) was to ensure that:

> a securities firm currently engaged in a broad range of commodities activities as part of its traditional investment banking activities, is not required to divest certain aspects of its business in order to participate in the new authorities granted under the [GLB Act]."[34]

All of these financial holding companies and their bank and nonbank affiliates are subject to generally applicable laws and regulations that govern these activities. For example, they must conduct their commodities activities in compliance with all applicable antitrust, securities, futures and energy laws. These include the orders, rules and regulations of the Government agencies, exchanges and self-regulatory organizations responsible for implementing and enforcing those laws, including the U.S. Department of Justice, the Federal Trade Commission, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Energy Regulatory Commission, the National Futures Association, the CME Group, Intercontinental Exchange and the London Metal Exchange.

III. Commodities Activities Before the GLB Act

Two of the most vocal critics of allowing financial holding companies and their bank and nonbank affiliates to continue to buy and sell physical and energy commodities are Professor Saule Omarova of the University of North Carolina Law School and Mr. Joshua Rosner, managing director of Graham Fisher & Co. In a widely circulated draft article, Professor Omarova has asserted that U.S. financial holding companies somehow waged a "quiet transformation" to become "global merchants of physical commodities" during that period.[35] To Professor Omarova, this mixing of banking and commodities activities is a radical departure from the past and not an incremental expansion of traditional banking and nonbanking powers. She characterizes it as a serious breach of the "legal wall designed to keep them out of any nonfinancial business"[36] and "effectively nullifies the foundational principle of separation of banking from commerce."[37] She argues that these physical and energy commodities activities "threaten to undermine the fundamental policy objectives . . . [of] ensuring the safety and soundness of the U.S. banking system, maintaining a fair and efficient flow of credit in the economy, protecting market integrity, and preventing excessive concentration of economic power."[38] According to Professor Omarova, unless these activities are prohibited or severely curbed, financial holding companies will be exposed to a variety of new and excessive risks, engage in anticompetitive behavior and even threaten "American democracy."[39] She sums up the implication of her argument as follows: "If there are good reasons to believe that extreme power breeds extreme abuses, the ongoing expansion of large FHCs into physical commodities and energy business warrants serious concern."[40]

---

[31] *See id.* § 1843(a)(2) (providing a transition period of 2–5 years for new bank holding companies to conform their activities to the nonbanking activities restrictions in the BHC Act).

[32] *See, e.g.,* Cong. Rec. H3141 (daily ed. May 13, 1998) (statement of Rep. Dingell) ("H.R. 10 . . . does nothing to hurt the banks. It expands the range of allowable banking activities . . . It creates, insofar as humanly possible, a fair two-way street for all players.").

[33] *See, e.g.,* H.R. Rep. No. 104–127, pt. 1, at 97 (May 18, 1995) ("The Committee intends that activities relating to the trading, sale or investment in commodities and underlying physical properties *shall be construed broadly* and shall include owning and operating properties and facilities required to extract, process, store and transport commodities.") (Emphasis added.)

[34] Amendment No. 9 by Senator Gramm (Mar. 4, 1999), available at *http://banking.senate.gov/docs/reports/fsmod99/gramm9.htm.*

[35] *See, e.g.,* Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities,* at 4 (draft of Nov. 24, 2012), available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.* at 5.

[40] *Id.*

Mr. Rosner has expressed similar views. As reported in the *Huffington Post,* Mr. Rosner has stated that "[i]f banks own storage, distribution, transmission or generating assets, they have the ability to manipulate prices for the benefit of their own balance sheet, to the disadvantage of the public interest, which is why they were prohibited from such activities after the Great Depression to the passage of Gramm-Leach-Bliley in 1999."[41] Professor Omarova and Mr. Rosner also reportedly told the *Huffington Post* that traders at banks that own physical commodities business have a natural incentive to use inside knowledge gleaned from their co-workers to reap profits from trades of derivatives tied to the underlying commodities.[42]

Not only does Professor Omarova's law review article reflect a deep distrust of the motives and behavior of financial holding companies and their employees, but she has also reportedly been severely critical about the Federal Reserve Board's lack of transparency about the commodities activities of these firms. According to the *Huffington Post,* Professor Omarova has said that "[t]he Fed has absolutely not been transparent" and that "[t]he Fed is like the Kremlin: They do their magic and then tell people like me to go away."[43]

Before addressing whether today's commodities activities are inconsistent with the principle of keeping banking separate from commerce and whether there is sufficient evidence to justify prohibiting or severely curbing these powers, let me first straighten out a few historical facts about the relationship between banking and physical commodities activities. First, there has been a close relationship between banking and physical commodities since the dawn of history. The essence of banking is the creation of money through the maturity transformation process. By funding themselves with demand or other short-term deposits or other liabilities (including the issuance of paper currency) and then making medium- to long-term loans, commercial banks participate in the money and credit creation processes.

Physical commodities such as grain, salt, shells and pieces of wood were among the first forms of money in ancient Mesopotamia, Egypt, China, Korea, Japan, North America, Ethiopia, and Oceana, and some of these commodities continued to be used as money until quite recently in certain places.[44] While not as durable as gold or silver, or as reliable and easy to move as coins, paper or electronic money issued by commercial banks, these physical commodities nevertheless had the essential characteristics that made them an efficient medium of exchange and store of value (*i.e.,* money)—fungibility, divisibility and relative liquidity. These ancient forms of money made trading much more efficient than in a barter economy where nonfungible and nondivisible goods and services are exchanged.

Second, the modern history of banking (and money) began with grain merchants in Lombardy creating markets in grain and other commodities, financing crops, holding gold (another commodity) of others for settlement of their grain transactions and trading in gold while it was on deposit.[45]

Third, U.S. banks and other financial institutions were major players in the commodities markets during the 19th century. National banks were expressly permitted to trade in gold, silver and other precious metals commodities. Many of the major U.S. merchant banks of the 19th century started as dry goods and commodity traders, which expanded into banking in somewhat similar ways and for somewhat similar reasons as their Lombard predecessors from centuries earlier.[46] These commodity traders turned bankers include Lazard Brothers and Brown Brothers.[47] The private banking partnership of J. Pierpont Morgan, Sr. engaged in wholesale or merchant banking, which included the buying and selling of physical commodities and related facilities. To take just one famous example, a trust controlled by J.P. Morgan purchased Andrew Carnegie's steel company in 1901 and combined it with

---

[41] Shahien Nasiripourshahien & Zach Carterzach, *Beer Brewers Blast Wall Street Banks over Aluminum Business Amid Congressional Scrutiny,* HUFFINGTON POST (July 16, 2013).

[42] *Id.*

[43] *Id.*

[44] *See, e.g.,* Catherin Eagleton & Jonathan Williams, MONEY: A HISTORY at 18, 22, 135, 155–156, 196–197, 200 (The British Museum Press 2006) (grain used as money in ancient Mesopotamia and Egypt, as well as China, Korea and Japan; salt used as money in Ethiopia and China; shells and pieces of wood used in China, North America and Oceana). According to Milton Friedman, cigarettes were used as money in Germany after World War II. Milton Friedman, MONEY MISCHIEF at 14 (1992).

[45] *See, e.g.,* Charles P. Kindleberger, A FINANCIAL HISTORY OF WESTERN EUROPE (1984).

[46] *See, e.g.,* Vincent P. Carosso, INVESTMENT BANKING IN AMERICA: A HISTORY (1970); BRAY HAMMOND, BANKS AND POLITICS IN AMERICA: FROM THE REVOLUTION TO THE CIVIL WAR (1957).

[47] *See id.*

other steel companies to form U.S. Steel.[48] Pig iron and steel were the most important commodities of the day, just as important then as energy is today.[49] In short, U.S. banks and other financial institutions were actively involved in the commodities markets before the Glass-Steagall Act of 1933 or even the National Bank Act of 1863.

Fourth, the Glass-Steagall Act did not prohibit or otherwise limit banks from engaging in commodities activities or affiliating with commodities firms. It only prohibited banks from dealing in securities or having affiliates that were principally engaged in underwriting or dealing of corporate debt and equity securities.[50]

Fifth, while the BHC Act limited the authority of bank holding companies and their nonbank affiliates to engage in commodities activities or to own or control commodities firms, U.S. banks, bank holding companies and investment banks were not entirely locked out of the physical or energy commodities markets before the GLB Act in 1999. The National Bank Act continued to permit national banks to buy and sell gold, silver and other precious metals. More importantly, Goldman Sachs, Morgan Stanley and various other investment banks emerged as major players in the physical commodities in the 1980s,[51] nearly 20 years before passage of the GLB Act and nearly 30 years before Goldman Sachs and Morgan Stanley became bank holding companies.

Since then, financial institutions have assumed key roles in satisfying customer needs, offering services that enable more cost-effective commodity price hedging and secured financing for a broad range of participants in the commodities sector. In fact, reducing financial institution participation in the commodities sector would likely reduce liquidity on exchanges and in over-the-counter markets, and even the availability of some commodities hedging, financing and other intermediation services. A retrenchment could lead to increased prices and greater price volatility, among other consequences.[52]

Moreover, these investment banks had a strong track record of conducting these commodities activities in an efficient, profitable, fair, responsible, and safe and sound manner, without any material violations of applicable laws or regulations or losses as a result of natural catastrophes. I am not aware of any evidence that their activities undermined the safety or soundness of the U.S. financial system, resulted in an unfair or inefficient flow of credit, involved any material anticompetitive behavior or insider trading, or otherwise resulted in other harmful effects on the financial system or the wider economy, much less threatened the end of American democracy.

Indeed, their significant involvement and strong risk-management record in conducting commodities activities was almost certainly one of the reasons why Section 4(o) was considered to be such an acceptable and important way to ensure that the GLB Act would provide a "two-way" street of opportunities to investment banks as well as commercial banks. It also was almost certainly one of the reasons why the Federal Reserve Board determined that physical and energy commodities could be traded by nongrandfathered financial holding companies as a complement to their existing financial activities, that such activities would produce public benefits that outweighed their potential adverse effects and that they could otherwise be conducted in a manner that would not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.[53]

In short, the close relationship between banking and commodities activities since ancient times as well as in this country for most of the past 200 years shows that

---

[48] *See* Ron Chernow, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 82–24 (1990).

[49] *See, e.g.,* Milton Friedman and Anna Jacobson Schwartz, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960 (1963) (using statistics of pig iron to estimate the growth or contraction of the economy during the Great Depression).

[50] *See* Banking Act of 1933, §§ 16, 20.

[51] For example, Goldman Sachs acquired commodities trading firm J. Aron & Co. in 1981, and that same year, the commodities trading firm Phibro Corporation acquired Salomon Brothers to form Phibro-Salomon Inc. In 1984, Morgan Stanley formed the Natural Gas Clearinghouse with law firm Akin Gump and Transco Energy, and in 1985, Morgan Stanley expanded commodities coverage from metals options to oil markets. *Changing Landscape: Energyrisk.com,* July 2009 (at 26). Prior to the financial institutions' arrival, the commodities markets were best described, according to Henrik Wareborn, head of commodities trading at Natixis, as a shadowy place dominated by physical merchants and cartels, which was opened up and transformed thanks to the entry of European banks and U.S. investment banks. *Insight: Banks struggle to adapt or survive in commodities:* Reuters, November 5, 2012.

[52] *Comments on Volcker Rule Regulations Regarding Energy Commodities,* submitted by IHS Inc., February 2012, at 7–9.

[53] *See, e.g.,* Citigroup, supra note 16, JPMorgan Chase & Co., supra note 16; Royal Bank of Scotland, supra note 16.

both Section 4(o) of the BHC Act and the complementary powers orders that permit certain nongrandfathered financial holding companies to engage in trading physical and energy commodities were only incremental expansions of traditional banking powers rather than a radical departure as Professor Omarova has argued. While electricity and oil are modern commodities, they are not fundamentally different from the traditional bank-eligible commodities such as gold and silver in the sense that they are fungible, divisible and relatively liquid.

IV. The Principle of Keeping Banking and Commerce Separate

The principle of keeping banking separate from commerce can be a useful way to simplify the otherwise complex U.S. banking laws. Certainly, the basic structure of the National Bank Act and the BHC Act reflects this general principle. But this general principle is not a binding legal rule and does not create an impermeable wall, and reasonable people can disagree as to where the line is and should be drawn.

For example, Professor Omarova argues that the current commodities powers of the grandfathered and nongrandfathered financial holding companies are radically inconsistent with this principle.[54] Yet former Representative James Leach, who has long been one of the most vociferous and consistent champions of the separation between banking and commerce,[55] does not believe that the merchant banking power or the physical commodities power under either the complementary power orders or Section 4(o) of the BHC Act are inconsistent with this principle.[56] Thus, he defended the general principle in words that are strikingly similar to those used by Professor Omarova in her forthcoming article:

> [T]here are few broad principles that could hurriedly be legislated, which could in shorter order change the fabric of American democracy as well as the economy, than adoption of a new radical approach to this issue [*i.e.,* mixing commerce and banking].[57]

Yet, he said this about its application to the GLB Act:

> Fortunately, despite the active advocacy of many in Congress and early on support of the Treasury and partial support in the Fed (both later reconsidered), the commerce and banking breach did not occur.[58]

I agree with former Congressman Leach that the merchant banking power and the physical commodities powers under either the complementary powers orders or Section 4(o) of the BHC Act are fully consistent with the historic principle of keeping banking separate from commerce. The merchant banking power permits nonbank affiliates of insured banks to engage in the traditional financial activity of providing capital to small and medium-sized companies, without becoming involved in the routine day-to-day management of these companies and with a clear fixed time horizon. The physical commodities power is only an incremental expansion of the physical commodities powers that banks or their nonbank affiliates have exercised in this country for more than 200 years. If the authority to buy and sell electricity or oil is relatively new, it is probably because they are relatively modern commodities. In addition, it was only relatively recently that that futures contracts in these commodities have been authorized for trading on a futures exchange by the CFTC or otherwise become sufficiently fungible and liquid. Once they satisfied these criteria, however, it was natural that the Federal Reserve would permit trading in them as a complement to the financial activity of trading in their related derivative contracts.

V. Should Existing Commodities Powers be Repealed or Scaled Back?

Professor Omarova has argued that the existing commodities powers of financial holding companies should be repealed or severely scaled back to be consistent with her concept of the "foundational principle" of the separation of banking from commerce. She has said that "[t]here is a particular urgency to focusing" on whether financial holding companies should be allowed to continue engaging in physical and energy commodities activities since Goldman Sachs and Morgan Stanley are "approaching the end of their 5-year grace period during which they must either divest

---

[54] *See* Omarova, supra note 35, at 4.

[55] *See, e.g.,* James A. Leach, *The Mixing of Banking and Commerce,* in Proceedings of the 43rd Annual Conference on Banking Structure and Competition, Federal Reserve Bank of Chicago (May 2007).

[56] *See, e.g.,* James Leach, *Regulatory Reform: Did Gramm-Leach-Bliley contribute to the crisis?,* Northwestern Financial Review (Oct.15, 2008).

[57] *See* supra note 55.

[58] *See* supra note 56.

their impermissible commercial businesses or find legal authority under the [BHC Act] for keeping them. In the fall of 2013, the Board will have to determine whether these firms may continue their existing commodities operations and, if so, under what conditions."[59]

Before addressing this argument on the merits, let me explain why there is no urgency at all to this issue, at least not for the reason Professor Omarova gives. Goldman Sachs and Morgan Stanley are indeed approaching the end of the 5-year transition period for conforming their activities to the activities restrictions in the BHC Act. But that deadline is irrelevant to the grandfathered commodities activities of Goldman Sachs and Morgan Stanley because the grandfathering provisions of Section 4(o) of the BHC Act have no time limit and do not provide the Federal Reserve Board with the discretion to limit their effect.

Professor Omarova's argument that the existing commodities powers of the financial holding companies should be repealed or scaled back is based on seven basic predictions:

- Otherwise, financial holding companies will continue to face a variety of new and excessive risks that will threaten the safety and soundness of the U.S. financial system.
- The fair and efficient flow of credit in the economy will be threatened.
- Market integrity will be at risk.
- Financial holding companies have or will continue to gain and may abuse market power.
- Traders at financial holding companies will use inside information to engage in illegal insider trading.
- American democracy will be at risk.

The Congress that included Section 4(o) in the GLB Act clearly had a different view of the benefits and risks of commodities activities than Professor Omarova. That Congress said that the grandfathered activities "shall" be broadly construed,[60] and that the purpose of the permanent grandfathering provision was to allow qualifying financial holding companies to continue engaging in commodities activities as long as certain conditions were satisfied.[61] The Federal Reserve that issued the complementary powers orders also had a very different view of the benefits and risks of permitting financial holding companies and their nonbank affiliates to buy and sell physical and energy commodities. The Federal Reserve Board, applying the standard in the BHC Act, found that the public benefits from those activities in terms of increased customer choice and increased competition outweighed their risks, provided they were conducted in accordance with certain limitations and conditions discussed in Section II of this testimony.

This Subcommittee should not take action to repeal or curb the existing commodities powers of financial holding companies, including any temporary or permanent authority to own companies that control electric power plants, commodities warehouses or oil refineries, unless and until critics provide substantial evidence that such powers cannot be exercised without creating a substantial risk to the safety or soundness of depository institutions or the financial system generally. It should not be enough for critics to merely provide speculative assertions of potential adverse consequences. Nor should this Subcommittee take action to repeal or cut back on those powers solely because certain financial institutions or their employees may from time to time violate any generally applicable laws or regulations that govern commodities activities, such as applicable antitrust, securities, futures or energy laws. There is currently no reason to believe that such laws and regulations, and the vigilant actions of the Government agencies, exchanges and self-regulatory organizations responsible for implementing and enforcing those laws, would not be sufficient to deter or remedy any such compliance issues. Nor is there reason to believe that such issues would never occur if these types of assets were owned only by entities not subject to comprehensive Federal regulation, as all bank holding companies are.

VI. Conclusion

In conclusion, insured banks, bank holding companies, financial holding companies and their nonbank affiliates are currently permitted to engage as principal in futures, forwards and other commodities contracts and, in some cases, owning or controlling physical or intangible commodities or related facilities, including electric

[59] *See* Omarova, supra note 35, at 7.
[60] *See* supra note 33.
[61] *See* supra note 34.

power plants, commodities warehouses and oil refineries, subject to certain conditions. Both Congress and the Federal Reserve have previously found that the public benefits of these activities outweigh their potential adverse effects. This Subcommittee should not take action to repeal or curb those powers unless and until critics provide substantial evidence that such powers cannot be exercised without creating a substantial risk to the safety or soundness of depository institutions or the financial system generally.

PREPARED STATEMENT OF JOSHUA ROSNER

MANAGING DIRECTOR, GRAHAM FISHER & CO.

JULY 23, 2013

Banking and Commerce:

Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee, thank you for inviting me to testify today on this important subject.

We stand on the other side of the largest financial crisis since the Great Depression, a crisis that occurred less than a decade after the repeal and erosion of long standing separations of commercial and investment banking and of banking and nonfinancial business.

Since 2003, our Government and central bank have allowed an unprecedented mixing of banking and commerce. So far, that grand experiment has gone better for the banks than it has for consumers. Electricity users appear to pay more because of Wall Street involvement, aluminum for airplanes and soda cans costs more, and some say gasoline at the pump costs more—without any measurable benefit to anyone but the banks. This is partially the result of unilateral decisionmaking by the Federal Reserve, which Congress empowers to use its judgment to grant exemptions to a half-century-old law. Our largest bank holding companies now seek further control over other nonfinancial infrastructure assets through the long-term leasing and control over America's patrimony, in return for short-term influxes of cash. We're on the threshold of a new Gilded Age, where the fruits of all are enjoyed by a few.

Only Congress can prevent this unfortunate consolidation of American business. The Federal Reserve Board should not allow banks to be in businesses that don't directly support the resilience of the payments system or the stability of FDIC insured deposits. "Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen; it would be bad for banking, bad for business, and bad for borrowers and consumers."[1]

President Richard M. Nixon said that in 1969. At the time, a generation had enjoyed relative tranquility in the banking system. That was because in 1935, Congress recognized risks associated with the combination of commercial banking and investment banking. And in 1956, recognizing failures to protect the public interest from the competitive and systemic risks arising from bank's control of nonfinancial businesses, Congress then passed legislation to prevent bank holding companies from exercising such control. Nixon's remarks came as Congress debated closing a loophole in the 1956 Act, and in 1970, Congress did just that.

The line did not hold.

In 1987, as rumors began to circulate that the White House was considering supporting the creation of "financial leviathans" or "Super banks",[2] Federal Reserve Chairman Volcker echoed Nixon's warning of two decades earlier: "Widespread affiliations of commercial firms and banks [carry] the ultimate risk of concentrating banking resources into a very few hands, with decisions affecting these resources influenced by the commercial ownership links, resulting in inevitable conflicts of interest and impairment of impartial lending judgment."

At the time, large U.S. banks claimed prohibitions against the combination of commercial and investment banks and commercial banks and nonfinancial businesses were putting the United States' economy at a competitive disadvantage to the Japanese banks—then the largest and most concentrated in the world and also

---

[1] (DOC 02–1–71) The 1970 Amendments to the Bank Holding Company Act: Opportunities to Diversify By ALFRED HAYES President, Federal Reserve Bank of New York, speech before the New York Scale Bankers Association in New York City on January 25. 1971, MONTHLY REVIEW. FEBRUARY 1971 available at: *http://www.newyorkfed.org/research/monthly_review/1971_pdf/02_1_71.pdf.*

[2] "BUSINESS FORUM: DOES THE U.S. NEED SUPERBANKS? Why Bigger Isn't Better in Banking", Thomas Olson, The New York Times, June 28,1987 available at: *http://www.nytimes.com/1987/06/28/business/business-forum-does-the-us-need-superbanks-why-bigger-isn-t-better-in-banking.html.*

at disadvantage to the German banks which had no such structural restrictions. Volcker's response was clear: "I have not heard any concern over the years that American banks are not active competitors internationally. They have been at the cutting edge of international banking competition and we have very active international competitors among the American banks". But the United States' "money center" banks were not ready to give up.

On April 7, 1998, in defiance of Glass-Steagall, Citibank announced a merger with Travelers Group, creating the world's largest financial services company.[3] In 1999, with the passage of Gramm-Leach-Bliley, banks were given the ability to combine commercial and investment banking and, as a result, were able to expand more deeply into nonfinancial businesses. At the November 12, 1999 signing ceremony, President Clinton offered the promise that "this historic legislation will modernize our financial services laws, stimulating greater innovation and competition in the financial services industry" and "Removal of barriers to competition will enhance the stability of our financial services system".[4]

Unfortunately, less than a decade after those words were uttered, our financial services industry was more concentrated, more cartel-like and less stable. The result was the biggest financial calamity since the Great Depression. While the actions of many parties, from policymakers and banks, investors and consumers all led us to crisis the fact remains that structured products innovated and sold as a result of the combination of commercial and investment banking, devastated Main Street USA and ravaged consumers and businesses alike. Banks, which had previously been prevented from investment banking activities, had stimulated demand for faulty mortgage products. When the house of cards collapsed, the Federal Reserve and FDIC were called on to support activities that are clearly outside of their legal purpose.

In 2003, with the stroke of a pen, the Federal Reserve razed the walls between deposits and commerce with its approval of Citi's ownership of Phibro, a nonfinancial business. It did so again, in 2005, when it approved JPM's entry into the physical commodities business. This kind of unilateral extra-legal decisionmaking by an entity not directly accountable to voters or Congress or even the executive branch has proven perilous to the public and anti-democratic. Lawmakers ought to remove the Federal Reserve's right to rewrite securities laws.

Today, regulators remain unprepared for the future demands that will be put on them and have failed to even manage those early forays that are primary to the discussion today. With "systemically important financial institutions"(SIFIs) involvement in global and regulated nonfinancial assets there are now too many regulators across too many jurisdictions for the public to hope for any regulatory effectiveness. While the Federal Reserve remains the primary regulator of our federally chartered bank holding companies, today these banks operate businesses overseen by the Federal Energy Regulatory Commission, State utility regulators, the Commodity Futures Trading Commission, the Securities and Exchange Commission, commodity exchanges and their international counterparts.

In 2005, the Federal Reserve decided that JPMorgan's ownership of commodities would be ancillary to their financial business. They determined that: "Based on JPM Chase's policies and procedures for monitoring and controlling the risks of Commodity Trading Activities, the Board concludes that consummation of the proposal does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally and can reasonably be expected to produce benefits to the public that outweigh any potential adverse effects.

In issuing their approval, they took pains to make it clear that: "To minimize the exposure of JPM Chase to additional risks, including storage risk, transportation risk, and legal and environmental risks, JPM Chase would not be authorized (i) to own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities; or (ii) to process, refine, or otherwise alter commodities."

Yet that is precisely what JPM proceeded to do.

In 2008, RBS sought Federal Reserve Board approval proposed to enter into physical commodity trading including in certain commodities not approved by the CFTC for trading on a futures exchange, long-term energy supply contracts, energy tolling and energy management services. The Federal Reserve ruled[5] that each of these ac-

---

[3] "Citicorp and Travelers Plan to Merge in Record $70 Billion Deal: A New No. 1: Financial Giants Unite", The New York Times, Mitchell Martin, April 7, 1998, available at: *http://www.nytimes.com/1998/04/07/news/07iht-citi.t.html.*

[4] *http://www.presidency.ucsb.edu/ws/index.php?pid=56922#axzz1aV0pqgub.*

[5] Federal Reserve Bulletin, Volume 94, First Quarter 2008, "The Royal Bank of Scotland Group plc Edinburgh, Scotland, "Order Approving Notice to Engage in Activities Complementary

tivities would be ancillary to their financial services businesses assuming certain safety and oversight regimes, including the ability to ensure proper position limits, were in place.[6]

Between 2008 and 2010, through its purchase of Bear Stearns and parts of RBS Sempra, JPMorgan acquired a number of power plants, electricity tolling agreements, and the metals concentrates and warehouses of Henry Bath.

By 2011, warnings were being sounded before the United Kingdom's House of Commons: "I believe there is a lot we can do just by enforcing correct commercial law. For example, on the London Metal Exchange there are four very large companies that own the very warehouses that people deliver metal into. J.P. Morgan[2] is one of them. They own a company called Henry Bath. They are, therefore, a ring-dealing member of the exchange and they also own the warehouse. That is restrictive. They were also reported, at one point, to have had 50 percent of the stock of the metal on the London Metal Exchange. That is manipulative. These are things that we can do something about here. That would mean the copper price probably would not be $10,000 a tonne, which is higher than for some forms of titanium. That price is not down to the fact that the metal is not being mined, it is because of such actions."[7]

Limits on Nonfinancial Assets:

Among the key legal requirements that the Federal Reserve must address when considering Gramm-Leach-Bliley Act's allowance of 'nonfinancial activities' is: "the attributed aggregate consolidated assets of the company held by the holding company pursuant to this subsection, and not otherwise permitted to be held by a financial holding company, are equal to not more than 5 percent of the total consolidated assets of the bank holding company, except that the Board may increase that percentage by such amounts and under such circumstances as the Board considers appropriate, consistent with the purposes of this Act".[8]

When Banks are as large as they are able to lever as much as they do, perhaps we should consider whether 5 percent is still an appropriate threshold. When one company can have its hands on 50 percent of all metals on LME and still be less than 5 percent of total assets, the question becomes one of competition rather than arbitrary thresholds.

Moreover, given the various forms of "control", one should ask how much can that threshold can be gamed and what the banks are counting as being in their control? As we have now seen, the banks may abide by the letter of the regulation but not its spirit, finding various loopholes to exploit as they conduct their business.

Such is the approach of Goldman when it states that their warehouse unit, Metro, never *owns* the metal in its sheds, rather it merely stores it. After all, it is prohibited from owning metal it stores. Similarly, JPMorgan's "tolling agreements" with electricity generators are a means for them to buy and sell power without having to *own* it. Five-percent appears to be an arbitrary number and easily manipulated as a liar loan.

Even if the Federal Reserve was serious about its efforts to limit nonfinancial activities, the task may be too large because of all of the legal loopholes available to banks, witnessed by the proliferation of shell companies, differing ownership structures and subsidiaries. According to research from the Federal Reserve Bank of New

---

to a Financial Activity", available at: *http://www.federalreserve.gov/pubs/bulletin/2008/legal/q108/order7.htm.*

[6] Note: UNITED STATES OF AMERICA Before the COMMODITY FUTURES TRADING COMMISSION, CFTC Docket No. 12–37, "ORDER INSTITUTING PROCEEDINGS PURSUANT TO." Last modified 2012, available at: *http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfJPMorganorder092712.pdf* (On September 27, 2012, the CFTC issued an Order against JPMorgan for violations of Section 4a(b)(2) of the Commodity Exchange Act: "deficiency in its newly created automated position limit monitoring system for the commodity business . . . *used by commodity traders to track their current positions in particular futures contracts* . . . after learning of this deficiency, JPMCB utilized a manual position limit monitoring procedure pending correction of the automated monitoring system. Despite adoption of this manual position limit monitoring procedure, JPMCB violated its short-side speculative position limit on several occasions.").

[7] House of Commons of the United Kingdom, Select Committee on Science and Technology, "Strategically important metals—Science and Technology Committee", "Examination of Witnesses (Question Numbers 70–107)", February 16, 2011, available at: *http://www.publications.parliament.uk/pa/cm201012/cmselect/cmsctech/726/11021602.htm.*

[8] GRAMM–LEACH–BLILEY ACT, PUBLIC LAW 106–102—NOV. 12, 1999, available at: *http://www.gpo.gov/fdsys/pkg/PLAW-106publ102/pdf/PLAW-106publ102.pdf.*

York, the four biggest bank holding companies had, combined, about 3,000 subsidiaries in 1990. By 2011, the top four had more than 11,000.[9]

The Risks are Real:

As we have witnessed during and since the financial crisis, when business-line profitability declines or regulatory or reputational risks rise banks tend to exit markets.

In the world of narrow banking this behavior would pose little risk to our system of financial intermediation. Unfortunately, in the various businesses within investment banking, and in critical nonfinancial businesses, withdrawals of liquidity that are manageable during normal periods create dislocations during crisis. Contagion and the failure of firms within an industry are acceptable realities within a competitive economy. However, we must guard against the risk that such dislocations lead to contagion within our banking sector, where the explicit guarantees of depositors and direct access to the Federal Reserve's discount window engender systemic risks to the public.

Conflict between the private motives of managements, with their primary obligation to shareholders, and the public interest are not rare. They exist and are the fundamental reason for regulation within industries. Where these conflicts lead to abuses that circumvent regulation they often can lead to failure, as was the case with Enron. Unfortunately, where Enron could be shut down easily, the reality is that our systemically important financial institutions are more complex. Unlike a bank, Enron did not have ability to drive capital away from competitors and this reduces the development of natural competitors and possible successor firms. Enron did not have the explicit guarantee that backs the deposits of our banks or the implied guarantees still conferred by the market, even in the wake of the Dodd-Frank Act. While banks have four types of risk, only the failure of reputational risk management drives necessary collapse. Enron's reputational risk posed no systemic risk.

While operational, liquidity and credit risks can cause the downfall of a firm the value of the core assets can typically be transferred, even at a loss, to other industry participants. Unfortunately, reputational risk within a systemically important financial institution can result in requirements that the firm backstop assets, even those that were legally isolated. In 2008 Citi was obligated to guarantee and then repurchase $17.4 billion of structured investment vehicles (SIVs).[10] As a result, the failure of the Federal Government to backstop a firm's reputation against such losses during a time of crisis could exacerbate panics and lead to contagion and the creation of larger systemic problems.

While there is no suggestion that the current reputational problems in banks' nonfinancial businesses are of a scale that could create a systemic crisis, the possibility of such failures occurring in the future must still be considered by prudential regulators and policymakers.

This past weekend the New York Times demonstrated how Goldman Sachs became a key middleman in the aluminum industry, possibly adding cost to consumers without any real benefit . The warehouse business worked[11] fine without them; now, with their presence in the market, it can be argued that it is neither better nor more efficient, only more expensive.

Similarly, in January 2013, the FERC took action against the JPMorgan for its attempts at preventing the implementation of State-requested changes to two Huntington Beach, California, power plants owned by AES Corporation.[12] The State deemed the work necessary in order to replace lost power capacity that resulted from the shutdown of the San Onofre nuclear plant.[13] JPM sought to prevent the changes and claimed its marketing contract with AES gave them the right to veto the work. While the bank's motives were not stated it is reasonable to consider that the firm sought to profit from the higher peak energy prices that would have re-

---

[9] "Fed Reviews Rule on Big Banks' Commodity Trades After Complaints", Bloomberg, Bob Ivry, July 20, 2013 available at: *http://www.bloomberg.com/news/2013-07-20/fed-reviews-rule-on-big-banks-commodity-trades-after-complaints.html.*

[10] "Citi Finalizes SIV Wind-down by Agreeing to Purchase All Remaining Assets", Citigroup, Press Release, November 19, 2008, available at: *http://www.citigroup.com/citi/press/2008/081119a.htm.*

[11] "A Shuffle of Aluminum, but to Banks, Pure Gold", The New York Times, David Kocieniewski, July 20, 2013, available at: *https://www.nytimes.com/2013/07/21/business/a-shuffle-of-aluminum-but-to-banks-pure-gold.html?ref=todayspaper&__r=0.*

[12] "JPMorgan Unit Can't Block Calif. Power Project, FERC Says", Law 360, Daniel Wilson, January 07, 2013, available at: *http://www.law360.com/articles/405284/JPMorgan-unit-can-t-block-calif-power-project-ferc-says.*

[13] "Feds rule JPMorgan can't block California power plant changes." The Sacramento Bee, Mary Lynne Vellinga, January 5, 2013, available at: *http://www.sacbee.com/2013/01/05/5093370/feds-rule-JPMorgan-cant-block.html#mi__rss=Capitol%20and%20California.*

sulted from its actions to prevent new capacity from coming on line. While the Federal Reserve, as the primary regulator of the holding company, had authorities over the bank's activities it appears not to have asserted any authority.

The Goal is Control Rather than Consolidating Ownership:

Today, there are few financial assets classes left to support growth of the size necessary to generate returns proportional to our largest banks' needs. Seeking new returns, our largest and most systemically interconnected banking firms, under the guise of infrastructure development, are turning their focus to an expansion of their control of nonfinancial assets. Bank ownership and control of physical commodities and the warehouses that store those commodities is the subject that brings us here today, but they are only a small part of the larger systemic risks being created by those excursions across the commercial divide.

Our largest bank holding companies now seek to "control" other nonfinancial infrastructure assets and will again wrap their intentions in the flag of this great Nation—arguing that "public private partnerships" are the key to redevelopment of our infrastructure. This is the same strategy employed, through the largest public-private partnership in our history, the National Partners in Homeownership, which was supposed to be the key to a stable future for homeowners.[14]

The benefits and risks of public investment in essential infrastructure, as well as the privatization of nonessential and nonutility infrastructure, can be debated. The control of assets in which the public has funded and invested, often for generations, by our largest financial firms should give elected officials and regulators pause.

Today, the Asset Management units of several of these firms are seeking "controlling interests" nonfinancial assets without ownership [15] of those assets.

To effect these goals the firms are pitching pension and other investors on investments in the leasing, operation and control of infrastructure assets. To date, these firms have attained "controlling interests"[16] and have "active control strategies"[17]—in the United States and abroad. They currently control ports, airports, electric utilities, water utilities, sewer utilities, wind power farms, parking meters, solar power generation, parking garages, rail leasing, charter schools and other assets.

According to the firms' own marketing materials, these assets are attractive, because of the "monopolistic" and "quasi-monopolistic" nature of the assets. They can "support more debt/leverage without incurring more risk than real estate" and have

---

[14] Rosner, Joshua, Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt, June 29, 2001, p.5. Available at SSRN: *http://ssrn.com/abstract=1162456* or *http://dx.doi.org/10.2139/ssrn.1162456* (See: "In an effort to restore the promises of the "American dream", the Clinton Administration embarked on a major initiative to increase homeownership. In 1993, the Census Bureau recommended ways to do so. Lowering down payment requirements and increasing available down payment subsidies were suggested. In early 1994, HUD Secretary Henry Cisneros met with leaders of major national organizations from the housing industry. By early fall, the Clinton Administration, along with over 50 public and private organizations agreed on 'working groups', a basic framework and the core objectives of what they named the "National Homeownership Strategy". The creators of the strategy of the National Partners in Homeownership ('NPH') include, among others: HUD, Federal Deposit Insurance Company, Fannie Mae, Freddie Mac, the Mortgage Bankers Association, the American Institute of Architects, America's Community Bankers, the U.S. Dept. of Treasury and the National Association of Realtors. Their primary goal was "reaching all-time high national homeownership levels by the end of the century". This was to be achieved by "making homeownership more affordable, expanding creative financing, simplifying the home buying process, reducing transaction costs, changing conventional methods of design and building less expensive houses, among other means".4 It was almost unprecedented for regulators to partner this closely with those that they have been charged to regulate.")

[15] Citi Capital Advisors, Overview, last accessed July 22, 2013, available at: *https://www.citicapitaladvisors.com/ciiOverview.do* (See: "Citi Infrastructure Investors (CII) manages Citi Infrastructure Partners (CIP), a multi-billion infrastructure fund that has controlling interests in mature transportation and utility infrastructure assets. CIP's portfolio includes: Kelda, owner of Yorkshire Water, a regulated UK water and sewer company; Itinere Infraestructuras S.A., a Spanish toll road concessionaire; DP World Australia, a container terminal business in Australia; and Vantage Airport Group, an airport investment and management company with airports in Canada and the UK.")

[16] See, as example, *https://www.citicapitaladvisors.com/ciiOverview.do* and *https://www.JPMorgan.com/cm/ContentServer?pagename=Chase/Href&urlname=JPMorgan/am/ia/investment_strategies/investmentsGroupLHK* and *http://www.morganstanley.com/infrastructure/portfolio.html* and *http://www.goldmansachs.com/what-we-do/investing-and-lending/direct-private-investing/equity-folder/gs-infrastructure-partners.html.*

[17] JPMorgan IIF Acquisitions LLC Maher Terminals, LLC, Letter to: Mr. Ryan Pedraza Program Manager, Virginia Office of Transportation Public-Private Partnerships, last accessed July 22, 2013, available at: *http://www.vappta.org/resources/RREEF%20and%20JPMorgan_Detailed%20Proposal.pdf.*

"attractive inflation protection characteristics".[18] Though the firms have control over these assets and are responsible for the management and operations of the assets, investors in the funds in fact, own the assets. Through their control, these firms can target majority and control positions to enable the implementation of their business plans and other strategic initiatives via a disciplined "active asset management approach."[19]

There are Substantial Public Policy Issues to be Considered:

Besides the reputational risks of the projects failing,[20] leaving investors with losses and municipalities with long-term leases and the possibility of limited refinancing opportunities, there are other risks to the bank operators that should be of concern.

Conflicts of Interest

While, as example, JPMorgan claims to be "a long-term infrastructure owner who understands its responsibilities to all stakeholders"[21] the reality is, that as a fiduciary, there are internal conflicts in these transactions. The firms have a fiduciary obligation that may be unmanageable to pension and other investors—as they did during the expansion of the Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligation (CDO) markets. Even if these investments are legally isolated, as we witnessed with Citi's SIVs, the firm may be pressed or required to reconsolidate. Moreover, contractual obligations to the lessor, operating and contracted partners (that may also be investment-banking clients[22]) and obligations to customers of the operating entity all pose risks that become difficult for a bank holding company to manage.

Furthermore, in a concentrated financial industry, the presence of a bank affiliate as an operator of nonfinancial businesses poses significant risks to competition. These risks include:

- Informational advantage that can result from ineffective controls and therefore allow a firm's trading desk to gain market information about underlying financial contracts or securities that can be used to benefit the firm or its customers or disadvantage customers and competitors.
- The risk that a firm that controls an electric utility and also, through a separate affiliate, has tolling agreements, can manipulate the availability of energy for advantage.
- The risk that a bank may choose to deny lending or underwriting to a competitor of their commercial affiliate.
- The risk that a bank may choose to lend, at preferential rates, to a commercial affiliate.
- The risk that a bank may, legally or illegally, tie loans to the purchase of a commercial affiliate's products.

Concentration of Economic Power Within Banking

When Glass-Steagall was enacted, recent history served as a reminder of the risks that existed with the combination of banking and commerce and with the concentration of power within a small number of financial companies. The need to protect against these dual risks remains as much of an imperative today as it did then.

---

[18] CIPFA Scotland Asset Management Workshop, "Investing in Infrastructure", JPMorgan, Larry Kohn, Managing Director, March 1, 2007, last accessed July 22, 2013, available at: *http://www.slideshare.net/Jacknickelson/cipfa-scotland-asset-management-workshop-investing-in.*

[19] JPMorgan IIF Acquisitions LLC Maher Terminals, LLC, Letter to: Mr. Ryan Pedraza Program Manager, Virginia Office of Transportation Public-Private Partnerships, last accessed July 22, 2013, available at: *http://www.vappta.org/resources/RREEF%20and%20JPMorgan__Detailed%20Proposal.pdf.*

[20] PPP Failures, Scribd, last accessed July 22, 2013, available at: *http://www.scribd.com/doc/155206053/PPP-Failures.*

[21] JPMorgan IIF Acquisitions LLC Maher Terminals, LLC, Letter to: Mr. Ryan Pedraza Program Manager, Virginia Office of Transportation Public-Private Partnerships, last accessed July 22, 2013, available at: *http://www.vappta.org/resources/RREEF%20and%20JPMorgan__Detailed%20Proposal.pdf.*

[22] FDIC Banking Review, "The Future of Banking in America The Mixing of Banking and Commerce", Current Policy Issues, Christine E. Blair, last updated February 11, 2005, last accessed July 22, 2013, available at: *http://www.fdic.gov/bank/analytical/banking/2005jan/article3.html#30* (See: "Several banks have recently faced losses from lines of credit that were extended to corporate customers in return for receiving that corporation's underwriting business. In this sense, legal tying or cross-selling can lead to losses that could threaten the bank's safety and soundness.")

Only a generation before the Great Depression, J.P. Morgan began to amass his power over both banking and, with the powers of the purse, commerce. The over-indebted railroad industry, plagued by falling rates provided Morgan with an opportunity and by 1900 he had consolidated the industry and controlled one-sixth of the Nation's rail network.

Soon, he turned his attention to the control of the electricity and steel industries. "As a result of this extreme consolidation, most of which occurred under Morgan's watch, businesses depended on Wall Street and Morgan's money. Because most had no choice but to give up managerial control, it was the bankers who approved mergers, handled legal matters, underwrote securities, appointed managers and framed policies. Even more importantly, the bankers set initial stock values for companies and marketed them on an international level. Therefore, if a company did not get Morgan's approval, it did not make it to market; it was doomed."[23]

In the aftermath of the crisis, with our largest financial institutions having become ever larger and more concentrated, there is an opportunity for those firms designated as SIFIs to use their market power to subvert and distort competition and development in the real economy. Moreover, if they are allowed to control vast networks of nonfinancial assets, either as principal or agent, they will have the power to pick winners and losers in the commercial world, not based on the productivity or competitive advantages of those firm's operations but as a result of their own profit motives.

As Cam Fine of the ICBA warned in 2007: "Over time, the individual, the small business owner, small towns, and rural countryside will suffer economically. More power will devolve to fewer and fewer hands, and economic diversity will whither, and with it, choices. While population centers may flourish, the decline of rural and small town America will accelerate . . . The less advantaged of our society will become even more disadvantaged."[24]

Others have argued that the strong regulatory oversight by U.S. regulators and the clear separation of banking and affiliates ameliorate these risks but their arguments were largely disproved during the crisis as bank holding companies demonstrated that their first the impulse was to use bank resources in support of failing commercial affiliates, potentially jeopardizing the bank's safety and soundness. Such an effort was followed by a focused effort to move affiliate obligations into the banks to be supported by the FDIC and the Federal Reserve.

Catastrophic Risk

By allowing bank holding companies to "control" these assets and accept the operating risks of those assets, regulators are supporting the accumulation of potentially catastrophic and systemic risks associated with the underlying operations . Imagine if a systemically important financial institution[25] was in the business of transporting oil and was unfortunate enough to own the Exxon Valdez? The systemic implications to the financial system and un-priced risks to counterparties could result in the risk of a series of systemically significant failures.

Conclusion

While our banks claim they provide efficiencies and that they must be able to compete with the largest global banks it must be pointed out that many of these efficiencies were merely an arbitrage with the benefits accruing to executives and losses apportioned to investors and the public.

European governments have, through actions and deeds in Greece, Ireland, Cyprus, Italy and elsewhere, explicitly accepted their banks as sovereign obligations. In the United States both parties have stated their intent, whether or not we have yet become successful in our efforts, that never again will our banks receive any im-

---

[23] J.P. Morgan: a Biography, Liz Bowen, Fordham University, last accessed July 22, 2013, available at: *http://www.fordham.edu/academics/colleges_graduate_s/undergraduate_college/fordham_college_at_l/special_programs/honors_program/hudsonfulton_celebra/homepage/biographies/jp_morgan_322212.asp.*

[24] Chicago Fed Letter, "The Mixing of Banking and Commerce: A conference summary", Nisreen H. Darwish, Douglas D. Evanoff, Essays on Issues, The Federal Reserve Bank of Chicago, Number 244a, November 2007, last accessed July 22, 2013, available at: *http://qa.chicagofed.org/digital_assets/publications/chicago_fed_letter/2007/cflnovember2007_244a.pdf.*

[25] CIPFA Scotland Asset Management Workshop, "Investing in Infrastructure", JPMorgan, Larry Kohn, Managing Director, March 1, 2007, last accessed July 22, 2013, available at: *http://www.slideshare.net/Jacknickelson/cipfa-scotland-asset-management-workshop-investing-in* p.4 (See: Debt represents 84 percent of Skyway's $1.83 billion concession price. Under a concession structure, the private sector concessionaire captures projected revenue growth in exchange for assuming operating risk).

plied or explicit Government support for activities outside of the narrow banking function of deposit insurance.

With that goal clearly stated we must recognize the most troubling issue here before us today is that dominance of global banks in our country has set us down a slippery slope where those firms can justify, and convince captured regulators, that whatever they do is in the national interest. And in a way, they are right about that because, should they fail, the entire country will pay the price for it. Make no mistake about that—there is no other way to deal with such a calamity.

The growth of big banks is a case of too much of a good thing metastasizing into a bad thing. What started out with a limited safety net designed to protect the payments system and to provide a safe place for small, unsophisticated depositors to place their savings has morphed into an anticompetitive system where Government-subsidized banks can use unfair advantage to enter and dominate any market or business, financial or nonfinancial, that they choose. This is inconsistent with those concepts of competition and creative destruction that have done so well for our country.

Let me make it clear, the people running these banks are smart, smarter than many of us. The problem isn't that they are dumb, malevolent, unpatriotic or dishonest. The real problem has three components:

- First, they are human, which means they are fallible and they will fail, repeatedly, just like the rest of us;
- Second, they are motivated by corporate values, which don't allow them to sacrifice or compromise to protect public interests, even if they would personally be inclined to;
- Third, they are huge and of such size because they enjoy public safety net benefits that foster unlimited growth, which includes the sort of inappropriate growth in nonbanking businesses discussed here today.

There is much for people across the political spectrum to dislike about this. SIFI activity in the energy markets and other commercial markets paints a clear picture of what we should not allow banks to do. Government-subsidized businesses should be boring, low profit, and limited by original purpose.

Reflecting on the Federal Reserve Board's 2005 letter allowing JPMorgan to hold physical commodities while prohibiting them from storing those commodities should lead legislators to reconsider the authorities they have vested in the Fed regarding these activities. One has to look with concern at the poor job of the Fed in policing the limitations of their order allowing banks to enter commodity businesses. Still, let us move past that and on to the real issue. The Federal Reserve Board should not be allowing banks to be in businesses that don't directly support the resilience of the payments system or the stability of FDIC insured deposits.

There is a lot of undoing to be done in banking. The public good and the benefits to Main Street and free enterprise, rather than enrichment of SIFI executives, must be our primary focus.

PREPARED STATEMENT OF TIMOTHY WEINER

GLOBAL RISK MANAGER, COMMODITIES AND METALS

MILLERCOORS LLC

JULY 23, 2013

Good morning Mr. Chairman and Members of the Committee. My name is Tim Weiner. I am the Global Risk Manager of Commodities and Metals for MillerCoors, a U.S. brewing company headquartered in Chicago, IL.

MillerCoors employs 8,800 people here in the United States, working in eight breweries in Irwindale, CA, Trenton, OH, Eden, NC, Fort Worth, TX, Albany, GA, Elkton, VA, Golden, CO, and Milwaukee, WI. We also operate the Leinenkugel's craft brewery in Chippewa Falls, WI, and the Blue Moon Brewing Company in Denver, CO. We sell our products in all 50 States and we contract brew for export through associates. MillerCoors insists on building its brands the right way: through brewing quality, responsible marketing, sales, environmental and community impact.

This year, MillerCoors will brew and ship in excess of 60 million barrels of beer within the United States. Our company will package about 60 percent of that beer in aluminum cans and aluminum bottles. That's the equivalent of about 4,000 747 jumbo jets worth of aluminum each year. Beer in aluminum containers has a long history within our company. In fact, Bill Coors invented the seamless two-piece alu-

minum container in 1958 and started the first aluminum can recycling program 55 years ago.

To make our cans, we need aluminum—a lot of aluminum. In the extensive portfolio of commodities that we manage, aluminum is our single largest price risk. That risk, and the importance of aluminum to our business, is why I am here today. As a representative of MillerCoors, I will share with you my company's concerns about the warehousing practices conducted by members of the London Metal Exchange (LME). I will explain how the LME's rules allow those unfair practices to impact U.S. manufacturing. I will explain why U.S. legislators and regulators, including the Federal Reserve, should strengthen their oversight of bank holding company activities, which are creating an economic anomaly in the aluminum and other base metal markets.

Mr. Chairman, my statement is neither an indictment of free market principles nor the existing exchange traded futures system here in the United States, which we use regularly to hedge our commodity price risks and volatility. In fact, our hope is the LME system could one day function as transparently and efficiently as the exchanges here in the United States.

Before I begin, my concerns are not unique to MillerCoors or even the beer industry. MillerCoors is just one of a number of companies that purchase aluminum for the production of a number of everyday products used by Americans, from beer and soda cans to automobiles and airplanes. MillerCoors is joined in airing its concerns about the LME by a range of companies from a variety of business sectors, including The Coca-Cola Company, Novelis, Ball Corp., Rexam, Dr. Pepper Snapple Group, D.G. Yuengling Brewing Company, North America Breweries, Rogue Brewery and Reynolds Consumer Products to name just a few.

The risk management team at MillerCoors also manages the risk for the other commodities we use to brew beer and the energy to power our eight breweries. Those include barley, corn, natural gas, electricity to fuel our breweries and diesel fuel for our trucking operations. We spend billions of dollars annually on these commodities, and must manage the risk of price fluctuations to be an efficient brewer. In order to properly manage this risk, we created strict governance in the form of a commodity risk policy that clearly forbids speculation in our hedging program, as we are not a trading operation.

Historically, consumers and suppliers purchased aluminum directly from aluminum producers. The LME was always a market of last resort—where aluminum producers would go to sell their stock in times of oversupply and where aluminum users would go to buy metal in times of extreme shortage. This is a key function of all exchanges. However, Mr. Chairman, over the past few years, the market for aluminum and other base metals has drastically changed. My company and other manufacturers can no longer plan to buy the aluminum we need directly from aluminum producers.

I am not an expert in the Bank Holding Company Act, but I understand under that statute, the Federal Reserve has the authority to decide whether commercial and physical commodity activities like the LME warehouses are appropriate lines of businesses. Under this Federal Reserve exemption, U.S. bank holding companies have effective control of the LME, and they have created a bottleneck which limits the supply of aluminum. Aluminum prices in general and for can sheet in particular have remained inflated relative to the massive oversupply and record production. What's supposed to happen under these economic conditions? When supplies rise while demand is flat to down, prices should fall.

Instead, what's happening is that the aluminum we are purchasing is being held up in warehouses controlled and owned by U.S. bank holding companies, who are members of the LME, and set the rules for their own warehouses. These bank holding companies are slowing the load-out of physical aluminum from these warehouses to ensure that they receive increased rent for an extended period time. Aluminum users like MillerCoors are being forced to wait in some cases over 18 months to take physical delivery due to the LME warehouse practices or pay the high physical premium to get aluminum today. This does not happen with any of the other commodities we purchase. When we buy barley we receive prompt delivery, the same with corn, natural gas and other commodities. It is only with aluminum purchased through the LME that our property is held for an extraordinary period of time, with the penalty of paying additional rent and premiums to the warehouse owners, until we get access to the metal we have purchased.

What's most concerning is that all the key elements of the LME (ownership/warehousing/policy control) for aluminum and other base metals worldwide, are controlled by the same entities—bank holding companies.

The practical effect of these LME warehouse rules is to essentially create a funnel, with a wide end at entry and a very narrow end exiting out. At the wide end,

there is a massive supply of metal going into these warehouses, at the rate of tens of thousands of metric tons per day. At the narrow end, the LME warehouses, such as those in Detroit, use minimum load-out rates as maximums, releasing no more than 3,000 MT/day. Just imagine a warehouse with a big garage door marked "in" and the small front door of your house marked "out." A lot more metal goes into the warehouse than comes out. U.S. manufacturers want to take possession of their metal, but cannot because the LME rules allow the warehouses to collect rent for every day, month and year that the aluminum sits in these LME warehouses. The current system does not work. It has cost MillerCoors tens of millions of dollars in excess premiums over the last several years with no end in sight. My company and others estimate that last year alone, the LME warehouse rules have imposed an additional $3 billion expense on companies that purchase aluminum.

As I stated earlier, my job is to reduce commercial risk associated with our business. We are challenged in managing our aluminum costs due to these LME warehouse practices. Aluminum prices have become inflated and this flows directly through to the price of can sheet. Let me restate one very important point. Although the LME has ordered strict minimum release requirements for warehouses controlled by LME members, those minimums are being treated as maximums and continue to restrict the flow of metal out to the market. No matter what the markets demand, the approved LME warehouses only release the minimum required amount of metal each day, which is public record. This only increases the length of the queues waiting for delivery. The warehouses are not responding to ordinary supply/demand market conditions in part because of two things.

1. The fact that the bank holding companies that are members of the LME also comprise the LME Warehouse Rules and Regulations committee and also own a number of LME-certified warehouses. This structure is unprecedented in other global futures exchanges. Specifically, the largest LME principal through December 2012 was Goldman Sachs, which through its ownership of Metro International Trade Services owns one of the largest warehouse complexes in the LME system. They control 29 of the 37 warehouse locations at the LME approved warehouse site in Detroit. This site houses approximately one quarter of the aluminum stored in LME facilities globally and over 70 percent of the available aluminum in North America. Henry Bath (100 percent owned by JPMorgan), Glencore and other trading companies also own LME warehouses.
2. There is no clear "regulator" or oversight of the London Metal Exchange warehouses, the LME itself is a self-regulated entity. In addition to direct talks with the LME, both formal and informal, we have urged regulators in the United States, the United Kingdom and the European Union to give thoughtful consideration to the effect of LME business practices on the industries that rely on a supply of aluminum priced by reasonable market conditions. Specifically, we have asked the UK Financial Services Authority (recently reorganized as the Financial Control Authority) and the CFTC to regulate the LME system as it pertains to the commodity metals market. Both agencies have indicated they are uncertain whether they have the regulatory authority necessary.

On the commercial side, my company and other aluminum users have attempted over the last year to resolve our concerns directly with the LME. We offered up sensible and reasonable recommendations to expedite and improve the current LME business practices and mitigate their adverse impact on aluminum purchasers. We specifically asked the LME to amend their rules to allow:

- A daily rental to be charged for a limited period following cancellation of a warrant (*i.e.,* 30–45 days).
- A daily load out rate for each warehouse shed at each official site, rather than by company at an official site.
- A daily load-out rate by warehouse shed that would clear the queue within a reasonable period.
- A review and adjustment of load-out rates more frequently so that bottlenecks do not persist.

The LME dismissed our proposals. The changes they have made and recently proposed to increase the daily load-out rates are minimal and would seem to make no real impact, but we look forward to submitting comments on their proposed rule changes.

In closing, in the view of MillerCoors and other companies in similar situations, the LME's current practices must be changed. We simply ask for the same regulatory and legislative oversight of the LME that other U.S. futures exchanges receive in order to level the playing field and ensure a transparent balanced func-

tional market for buyers and sellers. This oversight will restore the free market functioning of the LME, which will regain our confidence in the institution and permit us to successfully brew, ship and sell our fine beers.

On behalf of MillerCoors and any other companies adversely impacted by the practices of the LME, I thank the Committee for allowing me to appear and testify today. I am happy to answer any questions that you have.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM SAULE T. OMAROVA

Q.1.a.–b. The "grandfathering" provision in the Bank Holding Company Act was clearly included in the Gramm-Leach-Bliley Act by interested parties who foresaw that investment banks would someday want access to the Federal Reserve's discount window and other facilities. Regulators point out that it is a statutory exemption, and argue that they cannot prevent eligible institutions from engaging in many nonfinancial activities. The language is arguably ambiguous and open to a narrow interpretation by the Federal Reserve, if it wanted to do so.

a. Should the Federal Reserve take a tougher line by narrowing the scope of nonfinancial activities that financial holding companies can engage in—both under section 4(k) and 4(o)?

b. As a policy matter, what value does the 4(o) provision add to enable regulatory safety, soundness and capacity?

A.1.a.–b. Did not respond by publication deadline.

Q.2. The Federal Reserve has other tools to address nonfinancial activities that it finds disconcerting or impermissible. For example, Section 5 of the Bank Holding Company Act authorizes the Fed to force a bank holding company to divest a nonbank subsidiary that "constitutes a serious risk to the financial safety, soundness or stability" of any bank subsidiary.

- Should the Federal Reserve use this section 5 authority to force financial holding companies to divest themselves of subsidiaries that expose it to risks—for example, an oil spill or an oil tank explosion—that are not the typical purview of banking regulators?

A.2. Did not respond by publication deadline.

Q.3.a.–c. The Federal Reserve order approving Goldman Sachs' formation into a bank holding company states " . . . Goldman expects promptly to file an election to become a financial holding company pursuant to sections 4(k) and (l) of the BHC Act and section 225.82 of the Board's Regulation Y. Section 4 of the BHC Act by its terms provides any company that becomes a bank holding company 2 years to conform its nonbanking investments and activities to the requirements of section 4 of the BHC Act, with the possibility of three 1-year extensions. Goldman must conform to the BHC Act any impermissible nonfinancial activities it may conduct within the time requirements of the Act."

a. To the best of your knowledge, has the Federal Reserve Board developed a list or given any written guidance of what constitutes as "impermissible nonfinancial activities" at any point during the 2-year conformance period?

b. Has the Federal Reserve Board determined any of the assets held by the two former investment banks, Goldman Sachs and Morgan Stanley, as "an impermissible nonbanking activity" after they were made into federally insured FHCs in 2008?

c. In essence, is it fair to say the Board legally transformed the two largest investment banks into financial holding companies in 2008, and then allowed them to continue to operate as investment banks by enabling them to hold and acquire traditionally impermissible nonbanking commercial and physical commodities assets?

A.3.a.–c. Did not respond by publication deadline.

Q.4.a.–b. You have stated, " . . . it is virtually impossible to glean even a broad overall picture of Goldman Sachs, Morgan Stanley and JPMorgan's physical commodities and energy activities from their public filings with the Securities and Exchange Commission and Federal bank regulators . . . [this] added complexity makes the financial system less stable and more difficult to supervise."

a. Please further describe the potential regulatory capacity challenges since you have stated regulators may be incapable of effectively monitoring and overseeing large financial conglomerates.

b. Please describe the operational and supervisory risks at the institutional level that may arise given the increased complexity from traditionally nonbank, physical commodity and energy holding.

A.4.a.–b. Did not respond by publication deadline.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM RANDALL D. GUYNN

Q.1. You state in your written testimony that " . . . financial institutions are permitted to engage in commodities activities to meet the needs of customers, increase customer competition, act as more effective intermediaries between producers and endusers, provide increased liquidity to the markets and lower prices to consumers, and increase the diversification of the revenue streams and exposures of the financial institutions."

What evidence exists to prove that this statement holds true in reality?

A.1. Since these questions and answers are for the record, let me first note some slight but material errors in the question regarding the actual words I used in my written testimony, as well as provide some context for the passage.

The actual statement in my written testimony read as follows:

> These financial institutions are permitted to engage in commodities activities to meet the needs of customers, increase customer choice, increase competition, act as more effective intermediaries between producers and end users, provide increased liquidity to the markets and lower prices to consumers, and increase the diversification of the revenue streams and exposures of these financial institutions.

As made clear by the totality of my written statement and the context of this passage, this passage was describing the findings made by the Office of the Comptroller of the Currency (the "OCC")

in its various orders determining that national banks are permitted to buy and sell futures, forwards and other commodities contracts as a component or incident of the business of banking, subject to certain risk-mitigating limitations and conditions. It was also describing the findings by the Board of Governors of the Federal Reserve (the "Federal Reserve Board") in its various orders as to why certain financial holding companies and their nonbank affiliates (but not their insured bank affiliates) are permitted to make or take delivery of, or otherwise own or control, certain physical or intangible commodities, and to have certain relationships with commodities storage, generation, refining, transportation or other related facilities, subject to certain risk-mitigating limitations and conditions, as a complement to the financial activity of buying and selling commodities contracts. Among the risk-mitigating conditions imposed by the Federal Reserve Board in its complementary powers orders is that the power to make or take delivery, or otherwise own or control, physical commodities is limited to commodities that are sufficiently fungible and liquid.

See, e.g., Randall D. Guynn, Luigi L. DeGhenghi & Margaret E. Tahyar, *Foreign Banks as U.S. Financial Holding Companies,* in REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES §§ 11:2[3], 11:4[9], pp. 957–960, 1025–1029 (Randall D. Guynn, Editor, 7th edition 2013); Gibson Dunn, *Federal Reserve to Re-evaluate the Permissibility of Physical Commodities Trading: The Rationale Historically and Today* (July 22, 2013).

As made clear later in my written testimony, these findings are the considered findings of the OCC and the Federal Reserve Board, and were balanced against their findings about the potential adverse effects of these activities and the ability of various risk-mitigating limitations and conditions to address those potential adverse effects. I do not know whether the OCC or the Federal Reserve Board conducted any empirical studies to test whether these findings held true in reality or whether the applicants for the particular orders provided any empirical evidence to support these findings in their application materials.

Most of these findings are obviously true, however, based on widely accepted, fundamental principles of basic economics. As a result, most people would find it unnecessary and even a waste of public and private resources to conduct or require costly empirical studies to support them.

Let me give a few examples. One set of findings is that allowing insured banks or their nonbank affiliates to enter into commodities contracts with customers, including allowing certain nonbank affiliates to make or take physical delivery or otherwise own or control physical commodities that are sufficiently fungible and liquid, will "meet the needs of customers, increase customer choice, increase competition, . . . provide increased liquidity to the markets and lower prices to consumers." These findings are obviously true under virtually all likely circumstances.

For example, if a customer like JetBlue has the option to hedge its exposure to the volatility of jet fuel prices or finance its inventory of jet fuel by entering into contracts with insured banks or their nonbank affiliates, its needs will be met better and it will

have more choice in counterparties and financial products than if banks and their nonbank affiliates are not permitted to enter or are forced to exit the commodities markets. Similarly, absent anticompetitive behavior that is adequately prohibited by our antitrust laws, the commodities markets will be more competitive, not less competitive, if banks and their nonbank affiliates are allowed to enter and remain in the commodities markets, and are not forced to exit them, compared to a world in which competitors in commodities markets are protected by regulatory barriers to entry that keep banks or their nonbank affiliates out of that market or regulatory mandates that force them to exit. *See, e.g.,* Gregory Meyer, *A ban on banks holding physical commodities could backfire,* FINANCIAL TIMES (July 26, 2013). Indeed, the very heart of our antitrust (pro-competition) laws is to break down barriers to entry or mandates to exit, prevent excessive concentrations of market share and otherwise foster free and robust competition from the greatest number of competitors. *See, e.g.,* Robert H. Bork, THE ANTITRUST PARADOX (1978).

A consequence of making commodities markets more competitive is that the prices to consumers (meaning endusers) will be lower than if the markets were less competitive as a result of regulatory barriers to entry or mandates to exit. It is well established that prices will be lower in a more competitive market compared to those in a less competitive market. *See, e.g.,* James R. Kearl, ECONOMICS AND PUBLIC POLICY: AN ANALYTICAL APPROACH, p. 225 (6th ed. 2011). Thus, one consequence of forcing banks and their nonbank affiliates to exit any of these markets will be to reduce the number of competitors and possibly competition in general, which would almost certainly result in higher commodities prices for end users than in a world in which banks and their nonbank affiliates are allowed to compete freely with everyone else. I am confident that empirical evidence exists to support the finding that prices are lower in competitive markets than in noncompetitive markets, but it seems unnecessary to require or spend any significant time searching for empirical evidence to support the basic proposition that prices are generally lower in competitive than in uncompetitive markets.

Another consequence of making commodities markets more competitive is that they will be more liquid and efficient. A more liquid commodities market means that the spread between bid and ask prices of a particular commodity will be lower, and that larger quantities of the commodity can be bought or sold without affecting the then current market price of the commodity. Markets are generally considered to be more efficient the more liquid they are. Indeed, in the most idealized and efficient market model—the perfectly competitive market model—perfect liquidity is simply assumed when the market is in long-term equilibrium—there is no spread between bid and ask prices and individuals can buy and sell virtually any quantity without moving market prices. All individual consumers and producers are assumed to be price takers in such an idealized market. *See, e.g.,* James R. Kearl, ECONOMICS AND PUBLIC POLICY: AN ANALYTICAL APPROACH, p. 157 (6th ed. 2011). Perhaps the actual market that is closest to the perfectly competitive model is the market for U.S. Treasury securities, which

is considered to be among the most liquid and efficient markets in the world.

Although the finding about increased liquidity almost certainly flows from the finding about increased competition in the commodities markets, it is my understanding that reliable empirical studies have been conducted to support the finding that allowing insured banks and their nonbank affiliates to participate in certain commodities markets will "provide increased liquidity to the markets." For example, IHS Inc. included such empirical data with respect to the liquidity of the markets for energy commodities in its comments on the proposed regulations implementing the Volcker Rule. *See IHS Inc., Comments on Volcker Rule Regulations Regarding Energy Commodities (Feb. 2012),* available at *http://www.Federalreserve.gov/SECRS/2012/March/20120321/R-1432/R-1432_021412_105313_542080912901_1.pdf.*

It is also a truism that allowing banks and their nonbank affiliates to compete in the commodities markets will "increase the diversification of the revenue streams and exposures of financial institutions," compared to the level of diversification of their revenue streams and exposures based on their other activities alone. Adding a revenue stream from and exposures to a new activity that is different from their existing activities necessarily increases the diversification of their revenue streams and exposures.

Finally, allowing certain nonbank affiliates (but not insured banks) to make or take physical delivery or otherwise own or control physical commodities will allow financial holding companies to "act as more effective intermediaries between producers and endusers." While the validity of this finding may not be as self-evident as some of the other findings without empirical proof, I understand that allowing nonbank affiliates to make or take physical delivery, or otherwise own or control physical commodities, in addition to trading in commodities derivative contracts, helps to improve the efficiency of both the derivatives markets and the cash markets, fostering a greater convergence between the prices in both markets. Like the convergence between bid and ask prices in any market, a convergence between prices in the derivatives and cash markets for a particular commodity generally makes both markets more efficient and beneficial for both producers such as small jet fuel refineries and end users such as JetBlue in my example above. Thus, allowing certain nonbank affiliates to make or take physical delivery or otherwise own or control physical commodities, in addition to buying and selling commodity derivative contracts, helps them to be more effective intermediaries between producers and endusers. If the Subcommittee desires more empirical evidence to support this finding about improved intermediation, it may be worthwhile to ask the Federal Reserve Board, the General Accounting Office or a financial industry trade organization to undertake an empirical study of the evidence supporting this finding.

Rather than focus on whether sufficient empirical evidence exists to support the considered findings of the OCC and the Federal Reserve Board, the Subcommittee might consider asking whether there is any empirical evidence to support any of the potential adverse effects that were alleged by some of the other witnesses at the hearing and whether a world in which banks and their

nonbank affiliates are forced to exit the commodities markets is better than a world in which they are permitted to compete, subject to appropriate risk-mitigating limitations and conditions. *See, e.g.,* Gregory Meyer, *A ban on banks holding physical commodities could backfire,* FINANCIAL TIMES (July 26, 2013).

For example, one of the witnesses criticized the U.S. financial holding companies ("FHCs") engaged in commodities activities for their alleged lack of transparency in disclosing material information about their commodities activities. Set aside the fact that she was not alleging that the disclosure was insufficient to satisfy the FHCs' disclosure obligations to investors as publicly traded companies under the U.S. securities laws or that her main frustration seemed to be that the disclosure was not sufficient to satisfy her curiosity as an academic about their activities. Rather than offer a surgical solution to this alleged problem, she offered a blunderbuss approach: just force them to exit the commodities markets altogether. But this blunderbuss approach would actually decrease rather than increase the transparency of the commodities markets if she is right about the players who otherwise dominate the global commodities markets. Why? Because she also said that the world's commodities markets, including the U.S. markets, are otherwise dominated by ultra-secretive, privately held foreign commodities firms that are even less transparent about their commodities activities than the publicly traded and highly regulated U.S. FHCs that were the main targets of her criticism. Here is what she said in her written testimony about those otherwise allegedly dominant players:

> A handful of large, mostly Switzerland-based commodities trading houses—including Glencore, Vitol, Trafigura, Mercuria, and Gunvor—dominate the global trade in oil and gas, petroleum products, coal, metals, and other products. Nearly all of these publicity-shy commodities trading firms are privately owned. They do not publicly report results of their financial operations and generally refrain from disclosing information about the structure or performance of their investments. Secrecy has always been an important attribute of the traditional commodities trading business, in which access to information is vital to commercial success and having informational advantage often translates into windfall profits.

Written Testimony of Saule T. Omarova, Associate Professor of Law, University of North Carolina at Chapel Hill, Before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions and Consumer Protection, p. 12 (July 23, 2013).

If this assertion is true that the world's commodities markets are otherwise dominated by these ultra-secretive, privately held commodities firms—and I am not sure it is—then there is no more sure-fire way to eliminate whatever transparency exists, and also decrease competition, reduce liquidity and increase prices in these markets, than by forcing the publicly traded and highly regulated U.S. FHCs to sell their commodities businesses, since these ultra-secretive, privately held foreign players may be the most likely buyers.

Q.2.a. You further state that " . . . all things being equal, increased diversification of activities reduces risk, preserves capital and *should help* an institution improve its financial condition over time." [Emphasis added]

Are there cases in which a financial holding companies physical commodity and energy assets could present a risk to the institutions safety and soundness?

A.2.a. As noted in my written testimony, the Federal Reserve Board issued a series of complementary powers orders allowing certain financial holding companies to make or take physical delivery of, and otherwise control, certain physical or intangible commodities, subject to certain risk-mitigating limitations and conditions including a requirement that the commodities involved are sufficiently fungible and liquid. While these complementary powers orders allowed them to enter into certain relationships with commodities storage, generation, refining, transportation or other related facilities, they did not permit these FHCs to own or otherwise control these facilities as a complement to their financial activities. All FHCs including these FHCs, however, are generally permitted by Section 4(k)(4)(H) of the Bank Holding Company Act of 1956 (the "BHC Act") to make temporary "merchant banking" investments in companies that own or control such facilities, provided they comply with the conditions and limitations applicable to such investments. These conditions and limitations generally include a 10-year maximum holding period and a prohibition on engaging in the routine management of these companies, subject to certain narrow exceptions. *See* Sections 225.171 and 225.172 of the Federal Reserve Board's Regulation Y, 12 C.F.R. §§ 225.172, 225.172. FHCs are also permitted to make temporary investments in companies that own or control such facilities, provided the companies are "substantially engaged" in activities that are financial in nature or incidental to a financial activity. *See* Section 225.85(a)(3) of the Federal Reserve Board's Regulation Y, 12 C.F.R. § 225.85(a)(3).

Congress also permanently grandfathered the commodities activities of certain companies that became financial holding companies after 1999, such as Goldman Sachs and Morgan Stanley. That grandfathering provision is contained in Section 4(o) of the BHC Act. The grandfathering provision applies to both owning and controlling physical and intangible commodities, as well as any commodities storage, generation, refining, transportation or other related facilities, subject to certain risk-mitigating limitations and conditions.

See, e.g., Randall D. Guynn, Luigi L. DeGhenghi & Margaret E. Tahyar, Foreign Banks as U.S. Financial Holding Companies, in REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES §§ 11:2[3], 11:4[9], pp. 957–960, 1025–1029 (Randall D. Guynn, Editor, 7th edition 2013); Gibson Dunn, *Federal Reserve to Re-evaluate the Permissibility of Physical Commodities Trading: The Rationale Historically and Today* (July 22, 2013).

If an FHC fails to comply with the risk-mitigating limitations and conditions contained in its complementary powers order or Section 4(o) of the BHC Act, or otherwise fails to have an effective risk-management program with respect to its commodities activities, it is possible that its positions in physical commodity or energy assets could present a risk to its safety and soundness. I am not aware of any empirical evidence, however, that shows that the risks of holding physical commodity or energy assets is inherently

greater than holding unsecured commercial loans or engaging in a variety of other traditional banking or other financial activities. Indeed, holding long-term loans (or more recently the sovereign debt of certain nations) has been the source of more losses and more bank failures over the centuries than virtually any other asset or activity.

Moreover, as noted in my written testimony and in my answer to Question 1 above, allowing banks and their nonbank affiliates to engage in commodities activities, in addition to all their other permissible activities, will increase the diversification of their revenue streams and their exposures to risk. It has long been well-established that, all things being equal, increased diversification of investments or activities reduces risk. *See, e.g.,* Harry M. Markowitz, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (Wiley 1959); Paul Samuelson, *General Proof that Diversification Pays,* JOURNAL OF FINANCE AND QUANTITATIVE ANALYSIS (Mar. 1967). Such a reduction in risk should result in lower net losses, as the losses from one activity are offset by gains in another activity. See Markowitz and Samuelson. This, in turn, should help diversified institutions to protect and even improve their financial condition over time.

Q.2.b. Do you have any concerns about the Federal Reserve's regulatory capacity, *i.e.,* that bank examiners may be incapable of effectively monitor these financial conglomerates?

A.2.b. Obviously, it is important for the Federal Reserve Board to have the capacity to effectively monitor and supervise FHCs engaged in a diversified range of activities. But the diversity of those activities is as much a risk-reducing benefit for the reasons stated in my answers to Question 2.a. above as the complexity of these institutions may be a challenge to effective supervision. It may be more useful to ask the Federal Reserve Board to do a self-assessment of its own capacity to monitor and supervise diversified financial institutions. That is likely to be far more useful than any observation I could make.

Q.2.c. If so, what are your concerns? If you do not have any concerns, please explain why.

A.2.c. Please see my response to Question 2.b. above.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM JOSHUA ROSNER

Q.1.a.–b. The "grandfathering" provision in the Bank Holding Company Act was clearly included in the Gramm-Leach-Bliley Act by interested parties who foresaw that investment banks would someday want access to the Federal Reserve's discount window and other facilities. Regulators point out that it is a statutory exemption, and argue that they cannot prevent eligible institutions from engaging in many nonfinancial activities. The language is arguably ambiguous and open to a narrow interpretation by the Federal Reserve, if it wanted to do so.

a. Should the Federal Reserve take a tougher line by narrowing the scope of nonfinancial activities that financial holding companies can engage in—both under section 4(k) and 4(o)?

b. As a policy matter, what value does the 4(o) provision add to enable regulatory safety, soundness and capacity?

A.1.a.–b. Did not respond by publication deadline.

Q.2. The Federal Reserve has other tools to address nonfinancial activities that it finds disconcerting or impermissible. For example, Section 5 of the Bank Holding Company Act authorizes the Fed to force a bank holding company to divest a nonbank subsidiary that "constitutes a serious risk to the financial safety, soundness or stability" of any bank subsidiary.

- Should the Federal Reserve use this section 5 authority to force financial holding companies to divest themselves of subsidiaries that expose it to risks—for example, an oil spill or an oil tank explosion—that are not the typical purview of banking regulators?

A.2. Did not respond by publication deadline.

Q.3.a.–c. The Federal Reserve order approving Goldman Sachs' formation into a bank holding company states " . . . Goldman expects promptly to file an election to become a financial holding company pursuant to sections 4(k) and (l) of the BHC Act and section 225.82 of the Board's Regulation Y. Section 4 of the BHC Act by its terms provides any company that becomes a bank holding company 2 years to conform its nonbanking investments and activities to the requirements of section 4 of the BHC Act, with the possibility of three 1-year extensions. Goldman must conform to the BHC Act any impermissible nonfinancial activities it may conduct within the time requirements of the Act."

a. To the best of your knowledge, has the Federal Reserve Board developed a list or given any written guidance of what constitutes as "impermissible nonfinancial activities" at any point during the 2-year conformance period?

b. Has the Federal Reserve Board determined any of the assets held by the two former investment banks, Goldman Sachs and Morgan Stanley, as "an impermissible nonbanking activity" after they were made into federally insured FHCs in 2008?

c. In essence, is it fair to say the Board legally transformed the two largest investment banks into financial holding companies in 2008, and then allowed them to continue to operate as investment banks by enabling them to hold and acquire traditionally impermissible nonbanking commercial and physical commodities assets?

A.3.a.–c. Did not respond by publication deadline.

Q.4.a.–b. In your testimony you note, " . . . reflecting on the Federal Reserve Board's 2005 letter allowing JPMorgan to hold physical commodities while prohibiting them from storing those commodities should lead legislators to reconsider the authorities they have vested in the Fed regarding these activities. One has to look with concern at the poor job of the Fed in policing the limitations of their order allowing banks to enter commodity businesses."

a. What types of considerations should legislators consider?

b. Do you believe the Federal Reserve Board has the appropriate legislative tools to regulate financial holding companies and determine certain commodity and energy assets are impressible?

A.4.a.–b. Did not respond by publication deadline.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM TIMOTHY WEINER

Q.1.a.–d. For the record, please provide the following information:

a. Average LME traded price for aluminum for the following years: 2009, 2010, 2011, 2012, and 2013;
b. Average monthly rental-fee-for metal storage in LME warehouse for the following years: 2009, 2010, 2011, 2012, and 2013;
c. Average total costs for aluminum expenses for the following years: 2009, 2010, 2011, 2012, and 2013; and
d. Number of months to receive the physical delivery of aluminum from the LME warehouses for the following years: 2009, 2010, 2011, 2012, and 2013.

Average LME traded price for aluminum from 2009–2013

A.1.a. Table 1 below shows the London Metals Exchange (LME) price, Midwest Premium (MWP) and all-in Midwest Transaction Price (MWTP=LME+MWP) for 2009–2013. While the underlying LME price has changed very little over this period, the MWP has more than doubled. We trace this increase to the purchase of key LME warehouses by large financial institutions and LME rules that allow warehouses to restrict outflow from warehouses thus allowing them to increase the queues and hold rent-earning metal longer. As the queues extend, the rent charges increase, which means the warehouses can fund larger payments to producers as incentives to direct metal into LME warehouses and way from the spot market. Aluminum users must pay the MWP on top of the LME price to obtain metal directly from a producer. This practice adversely affects the available direct supply of metal.

TABLE 1: London Metals Exchange (LME) price, Midwest Premium (MWP) and all-in Midwest Transaction Price (MWTP=LME+MWP) for 2009–2013.

Annual Averages	2009	2010	2011	2012	2013
LME ($/MT)	$1,665	$2,173	$2,398	$2,019	$1,858
MWP ($/MT)	$105	$138	$169	$218	$258
MWTP ($/MT)	$1,769	$2,311	$2,567	$2,238	$2,116

Source: LME, Platts

Average monthly rental-fee-for metal storage in LME warehouse from 2009–2013

A.1.b. Table 2 below shows the daily rents due on metal stored in LME warehouses. These rents inflate the cost of aluminum as end users choosing to purchase through the LME systems must wait a long time to receive metal, and end users who cannot afford to wait in an LME warehouse queue must pay increased costs to obtain a

direct supply of metal outside the LME. The inflated rents allow the warehouses to reap a significant profit on warehouse operations despite incentives paid to producers to drive metal into those warehouses and royalty payments made to the LME. The inflated rents increased with the acquisition of LME warehouse ownership by large financial institutions. Again, however, aluminum users must match these inflated prices to get more timely physical delivery of metal.

TABLE 2: LME WAREHOUSE RENTS FOR PRIMARY ALUMINUM

(rates in USD per mton per day*)

	DETROIT (METRO INTERNATIONAL)	**VLISSINGEN** (PACORINI METALS)
2009	$0.38	$0.38
2010	$0.40	$0.40
2011	$0.41	$0.45
2012	$0.45	$0.45
2013	$0.48	$0.48

Source: HARBOR Aluminum
*Applicable from April 1st of specified year, to March 31st of following year.

Average total costs for aluminum expenses from 2009–2013

A.1.c. We will assume that the question is asking the all-in cost for aluminum. Aluminum users consider the average total cost of aluminum to be the all-in Midwest Transaction Price, which is the London Metals Exchange (LME) price plus the Midwest Premium (MWP), because that is the price aluminum users actually have to pay to obtain metal. Aluminum supply contracts reference the LME price, and whether they buy through the LME or directly, aluminum users must pay that price plus the MWP to obtain aluminum. In other words, to obtain any supply, aluminum users must pay rent to an LME warehouse or match the incentives offered to producers by LME warehouse owners. Payment of incentives to producers makes sense in times of undersupply, but the United States has been in a period of serious over-supply of aluminum for the entire period. Table 1 above shows the all-in Midwest Transaction Price (MWTP=LME+MWP) for each year from 2009–2013.

Number of months to receive the physical delivery of aluminum from the LME warehouses from 2009–2013

A.1.d. One of the reasons the LME system is not a good option for aluminum users is that it takes an exceptionally long time to get physical delivery of metal. Curiously, while demand for metal is low and inventories in LME warehouses are at an all-time high, Table 3 below shows that delays in physical delivery (queues) of metals from two key LME warehouses (Detroit and Vlissingen) continued to increase between 2009–2013. There is a correlation between the timing of the delays and the acquisition of LME warehouse ownership by large financial institutions. These delays affect pricing for all purchasers whether they buy metal through the LME or acquire metal directly by paying the Midwest Premium shown in Table 1.

TABLE 3: MAXIMUM LOAD-OUT QUEUES FROM KEY LME WAREHOUSING LOCATIONS

(calculated at end of period; calendar days)

	DETROIT	VLISSINGEN
2009	44	3
2010	71	1
2011	117	280
2012	490	420
H1 2013	539	564

Source: HARBOR Aluminum

Q.2. In your written testimony, you stated you met with the LME, U.S., UK and EU financial and banking regulators. You indicated both the U.S. and UK regulatory agencies, the Commodity Futures Trading Commission (CFTC) and Financial Conduct Authority (FCA), "indicated they are uncertain whether they have the regulatory authority necessary." For the record, please provide the following details:

a. The dates of each meeting with the LME, CFTC and FCA; and
b. A description of each meeting's outcomes, including any justifications or explanations for the state of the issue.

A.2. *Meeting with LME:* There was a single October 2012 meeting with LME CEO Martin Abbott and his deputy Diarmuid O'Hegarty. Charles Li, CEO, Hong Kong Exchange (HKE) also participated. The meeting occurred prior to completion of a planned acquisition of the LME by the HKE. The LME representatives indicated they did not intend to adjust current LME practices or make institutional changes. The key takeaways from the meeting were:

1. The LME representatives do not believe the current system harms metal users because it is possible to acquire metal. You have to be willing to wait in a long queue and pay rent or pay a premium to avoid the queue, but it is not impossible to obtain metal, therefore the system does not harm metal users.
2. Metal users could experience supply shortages and increased costs if they tried to change the warehouse rules.
3. The warehouses claim that while they have no trouble loading metal into their facilities, they apparently lack the infrastructure and driver work rules necessary to load out metal in a timely manner.
4. Despite establishing the rules for warehouses and receiving a royalty, the LME claims that it has no authority over the private warehouse owners.
5. The LME representatives see no conflicts of interest in terms of who runs the Exchange, who owns the warehouses, and how the warehouses operate.

Meetings with FCA: There was an October 2012 meeting with representatives of the UK Financial Services Administration (FSA), which is now the Financial Controls Authority (FCA), regarding regulatory oversight activities focused on LME warehouses. The FCA responded that it did not know whether it had authority over the physical delivery of metal or the LME warehouse system. More

recently, in July 2013, different FCA representatives said that they expect to find opportunities to accelerate regulatory oversight activities focused on LME warehouse changes. These FCA representatives were aware of the scope of recent regulatory/legislative activities undertaken by the U.S. Government to investigate the matter and possibly clarify regulatory jurisdiction.

Meetings with CFTC: There have been several meetings with CFTC Commissioners and their staffs and representatives of the CFTC Office of International Affairs, Enforcement Division and Surveillance Branch, among others, since last year. In December 2012, we understood that the Enforcement Division would look into the issue of the agency's jurisdictional authority. In March 2013, we learned that CFTC was not certain as to its authority over the physical delivery of metal or the warehouse system of the LME. In June 2013, we learned that there was strong interest in oversight and enforcement activities. From published news reports, we understand that the CFTC has opened an investigation.

Q.3. In your written testimony, you offer recommendations to improve the LME's business practices and expedite the delivery of LME warehoused aluminum. These recommendations specifically requested that the LME amend their rules to allow:

i. A daily rental to be charged for a limited period following cancellation of a warrant (*i.e.,* 30–45 days).

ii. Daily load out rate for each warehouse shed at each official site, rather than by company at an official site.

iii. A daily load-out rate by warehouse shed that would clear the queue within a reasonable period.

iv. A review and adjustment of load-out rates more frequently so that bottlenecks do not persist.

Please describe the LME 's reaction to your proposal and any explanations the LME provided for "dismissing" your efforts.

A.3. The LME's response was polite, but clearly communicated that what we were asking was, in their view, not achievable. We were very clear that similar to other exchanges, we wanted the LME to be a transparent, open and free centralized place for price discovery where buyers and sellers can come together for this price discovery and timely delivery of goods purchased.

Q.4. The LME issued a proposal to decrease existing queues and prevent new queues from forming on July 1, 2013. The proposal targets warehouses with queues of more than 100 calendar days, and would require warehouses to deliver out at least 1,500 tons per day more than the amount it loads in.

- While this proposal is still under consultation, please explain why this proposal would "make no real impact" as you stated in your testimony?
- What consultative input have you provided the LME?

A.4. As you state, this is only a proposal and there is no guarantee that the LME will make any changes. The proposed changes, even if adopted, would not go into effect, at the earliest, until April of 2014 with the market not feeling the effects until well into 2015 at the earliest. The likelihood of the warehouse rents increasing is

very likely. The proposal does not address this situation. The warehouses could increase rents to compensate for revenues lost if the queues are no longer exaggerated. They could simply charge a higher rent for a shorter period. Moreover, while the proposal might cause warehouse owners to cease paying incentives to producers and traders to bring metal into LME warehouses, they could keep current queues in place for years by loading out minimums at the new 1,500MT/day rate, which is half the current rate.

As the LME load out minimums have become the maximums, so too would the 100-day minimum queues for all warehouses. We ask, why any queues at all? Why would the LME want to delay delivery into the hands of owners of property purchased through their exchange? The rules of other exchanges require reasonable delivery times, and the LME could do the same.

There is nothing addressing the conflicts of interest of being a shareholder/member/rulemaker and warehouse owner.

Attached are comments recently sent to the LME regarding the proposed warehouse rule changes.

Q.5. In your testimony you stated " . . . several banks and a few trading companies have cornered the market on aluminum and other base metal trading . . . These banks are using a Federal Reserve exemption currently allowed under the Bank Holding Company Act . . . [and] through their effective control of the LME, they have created an artificial bottleneck or shortage of aluminum." Furthermore, "they are distorting access to aluminum and through their warehousing practices are artificially impacting the price of aluminum and driving premiums to historic highs." Recent media reports suggest that Goldman Sachs has explored selling its metals warehousing business, Metro International Inc. Goldman Sachs has also said that it will make physical aluminum available for immediate delivery. Does this outcome solve the artificial shortages in the aluminum market?

A.5. No, this outcome will not solve the artificial shortages in the aluminum market. LME warehouse rules have to change before that can happen. Take, for example, Metro, the warehouse system in Detroit, owned 100 percent by Goldman Sachs. The Metro warehouse system has 29 separate warehouse sheds, and 27 of these sheds hold well over 1 million metric tons of aluminum, close to 25 percent of all the aluminum in the LME warehouse system and over 70 percent of all the available aluminum in North America. Goldman may want to sell the business, but a sale by itself of a business hold over 70 percent of all the available aluminum in North America, does nothing to address the underlying issues giving rise to that stockpile and will not alleviate the artificial shortage. Once you look at it closely, Goldman's offer to deliver metal in the queue to consumers as a priority over others in the queue is also meaningless. Goldman knows that no actual consumers have metal in any Goldman queue, because no actual consumers can afford to tie up their money for the 18 months it takes to get metal out of the Goldman queue under ordinary circumstances. The interesting question to ask is why Goldman extended this offer only to consumers they knew were not in the queue? They did not offer to load out aluminum to anyone waiting in the queue. Is Goldman

just going to require everyone else to wait 18 months and charge them rent the whole time? Goldman made a very specific public offer to release specific metal to specific people knowing that the offer was no offer at all, and to avoid the real question—why does 70 percent of all the available aluminum in North America sit in an 18-month queue under Goldman's control.

Q.6. What concerns, if any, do you have with Goldman Sachs plans to exit the aluminum warehousing market?

A.6. The problems could remain if the LME warehouse rules and the practices of those warehouses remain unchanged. Logical warehouse rule changes as we have suggested, in line with other exchanges, are essential prior to any sale of the warehouses by any U.S. financial institution.

ALUMINUM USERS GROUP September 9, 2013

Via email (matthew.chamberlain@lme.com).
Matthew Chamberlin
Head of Strategy and Implementation
London Metal Exchange
56 Leadenhall Street
London, EC3A 2DX, UK

RE: 13/208:A201:W076

Dear Mr. Chamberlin:

Attached is a submission by the Aluminium Users Group (AUG) regarding the 1 July 2013 LME proposal for a linked load-in, load-out mechanism for LME Licensed Facilities.

As the rules of the Exchange and the practices of the LME Licensed Facilities, especially those affecting the ready supply of metal, have a significant impact on all aluminium users, AUG has long advocated for reform of warehouse rules and greater transparency in LME operations and practices. As we understand it, in an effort to alleviate the queues, the LME proposes to measure all of the metal loaded into each Licensed Facility over a three-month period, and to require facilities with queues longer than 100 calendar days to deliver out additional metal based on a formula established by the LME.

By its July 1 announcement, the LME invited all interested parties to submit comments on the proposal on or before 30 September 2013. The attached document reflects the AUG's comments, concerns, questions and recommendations. Because the proposal, if adopted in its current form, may have a significant impact on aluminium users, we request a meeting to discuss the proposal and our concerns in greater depth. For ease of scheduling, please use the following people as points of contact:

Mary Jane Saunders
Vice President & General Counsel
Beer Institute
122 C Street, NW, Suite 350
Washington, DC 20001
Email: mjsaunders@BeerInstitute.org
Tel: +1 (0) (202) 737-2337

Amy Hancock
Deputy General Counsel
American Beverage Association
1101 Sixteenth Street, NW
Washington, DC 20036
Email: ahancock@ameribev.org
Tel: +1 (0) (202) 463-6786

Thank you for your consideration and we look forward to a constructive dialogue on this matter.

Respectfully submitted,

Aluminium Users Group

cc: Martin Abbott
Charles Li
Garry Jones

Linked load-in, load-out

AUG previously expressed concern that policies and procedures developed and followed by the LME and actions and activities of common members of the LME and owners of LME Licensed Facilities adversely affect the ready supply and pricing of non-ferrous metals. We believe that the current system is dysfunctional and prone to manipulation. We also believe that left uncorrected, the deficiencies in the current system could cause long-term harm to the entire aluminum market. We want more transparent and efficient physical delivery settlement with an end to the lengthy queues. We want the Exchange to adopt operational practices that are consistent with the operational practices of other commodity exchanges, and we want the Exchange to act in a timely manner. A system that meets these goals will lead to renewed aluminum user confidence in the Exchange. A system that does not meet these goals will only lead to more dysfunction, more manipulation, and more harm.

AUG applauds the LME for trying to address the lengthy queues with the proposed linked load-in, load-out mechanism, but the proposal falls short in terms of providing an efficient function for physical delivery settlement for the following reasons:

- The proposal suggests that it is reasonable for an aluminum user to wait for metal in a queue lasting at least 100 days. The framework of regulations within a commodity exchange should facilitate physical delivery within the period relevant to the original derivative position, not an arbitrary period that may artificially delay delivery and increase user cost.
- A rule allowing a warehouse to hold metal in a queue as long as 100 days adds no measurable value to the aluminum or supply chain. The LME should not sanction queues of this sort especially since they essentially lead to a price floor in the premium for physical delivery of metal.
- In its current form, the proposal could lead to refusal of new metal at warehouses or a shift of metal to non-LME Licensed Facilities while not actually alleviating the queues for metal remaining in the warehouses. This would not facilitate more efficient physical delivery settlement, and would decrease rather than increase transparency in warehouse operations. Increases in warehouse capacity have been rapid and seemingly unconstrained at certain locations since 2009, and the LME should take

steps to ensure that the proposal does not become a vehicle for further manipulation in this manner.

- The proposal does not address the problem of warehouse locations treating the minimum daily load out requirement as a combined requirement for all warehouse/shed locations at a single LME approved geographic location. The LME should clarify that the minimum load-out requirement and linked load-in, load-out rules, if adopted, apply to each individual warehouse/shed at a single geographic location.
- The proposal does not address the issue of re-tendering of warrants for metal resting in the queue. If the LME does not require an accounting of this metal as part of the load-in, load-out mechanism, metal could effectively stay in the LME loop forever and never leave the warehouse. The LME should clarify that metal that is retendered will be counted as tonnage delivered into the Licensed Facility.

Recommendations

To facilitate more transparent and efficient physical delivery settlement, we urge the LME to implement the following rules for all Licensed Facilities:

- All shipments into or out of the Licensed Facility should be on a first-come, first-serve, non-discriminatory basis.
- No Licensed Facility should constrain or promote the movement of metal into or out of the Licensed Facility by:

    1. giving exceptional inducements or incentives for delivery of metal into a Licensed Facility;

    2. imposing unreasonable charges for depositing, storage or removal of metal into or out of the Licensed Facility;

3. taking or failing to take any action that affects a customer's ability to schedule the delivery or removal of metal from the Licensed Facility in a timely and efficient manner; or

4. treating the minimum daily load-out requirement as a combined requirement for all warehouses/sheds at a single geographic site. The LME should clarify that the requirement applies to each individual warehouse/shed at each LME approved location.

- In the event a Licensed Facility fails to permit the withdrawal of metal by a warrant holder within five (5) business days after the holder tenders the warrant to the Licensed Facility (properly endorsed and all storage charges paid), the LME should require the Licensed Facility to provide immediate notice, in writing, of the reason(s) for the delay. Upon receipt of such notification, the Exchange, at its discretion, may direct, in writing, the Licensed Facility not to accept any more metal for deposit until further notice.

- In the event that written shipping instructions for registered metal are received by the Licensed Facility by the 20th day of the month, all registered metal must be released for shipment no later than the close of business on the last day of that month, provided, however, that the warrant holder pays all storage charges and presents the Licensed Facility with all documents necessary to establish good title.

- If a Licensed Facility fails to release any registered metal as provided above, and assuming that the warrant holder or the warrant holder's agent is not the cause of the delay, the LME should prohibit the Licensed Facility from charging the warrant holder additional storage charges with respect to the metal. We recognize that LME has previously said it cannot impose specific rental rate limits on Licensed Facilities. The aforementioned proposal addresses that concern in that it is time-based limit within the contract, not a limit on the rental rate. This approach is also consistent with operational practices of other commodity exchanges.

- For repeated failure to permit the withdrawal of metal in a timely manner without good cause, the LME should terminate its relationship with a Licensed Facility.

Some may argue that given current stockpiles of metal at various Licensed Facilities, change should occur very slowly. Change is necessary and will only be meaningful if the implemented in a timely manner. We believe the following implementation schedule is reasonable:

- Allow warehouses a 3-month period (1 October to 31 December 2013) to eliminate current queues prior to implementation of the new rules. This is an ample period to load-out or re-warrant metal.
- Implement the new model effective from 1 January 2014.

To ensure that manipulation of the new model does not occur, we also believe that it is necessary to improve transparency at the Exchange through:

- More balanced representation of the key market participants (Users/Smelters/Traders/Warehousemen) on LME committees;
- Implementation of a Commitment of Traders report similar to the CFTC Commitment of Traders;
- More visible information on warehouse rules regarding
    - regularity and duration of audits;
    - structure and content of audits; and
    - statement on results of audit, including remedial actions, if any;
- Increased scrutiny of new capacity and monopolization of delivery locations;
- Enhanced firewalls between related parties that are both common members of the LME and owners of LME Licensed Facilities, stricter conflict of interest rules, and more regular review of the same; and
- A clearly defined process for dispute resolution, managed by an independent third party.

Finally, and although the purpose of this consultation process is not to assess regulation of the LME, we encourage the Exchange to support more coordinated regulatory oversight of its practices, including LME warehouse rules. While regulators in the United States, UK and EU are now examining warehouse rules and practices, the framework for regulator monitoring of physical delivery rules, new capacity approvals, and warehouse requirements varies in terms of functional jurisdiction and geographic scope. We encourage the LME to work towards a coordinated regulatory framework across countries and regions. This will help guard against manipulation of LME rules and ensure a fair and open marketplace for metal. We also believe that the LME should engage regulators in establishing and monitoring rules regarding firewalls between related parties (common members of the LME and owners of LME Licensed Facilities) due to the implications on conflict of interest and competition.

Additional Material Supplied for the Record

Statement for the Record
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?"

23 July 2013

As the world's leading producer of primary and fabricated aluminum, as well as the world's largest miner of bauxite and refiner of alumina, Alcoa appreciates the opportunity to submit this statement for the record in connection with the July 23, 2013 hearing before the Senate Banking Committee, Subcommittee on Financial Institutions and Consumer Protection entitled "Examining Financial Holding Companies: Should Banks Control Power Plants, Warehouses, and Oil Refineries?"

Alcoa raises for the Committee's consideration the need for increased transparency at the London Metal Exchange (LME), which sets the price of aluminum and other non-ferrous metals. Stated simply, the LME does not provide the same quality of information and level of transparency as required by other commodities exchanges, such as those falling under the scope of the U.S. Commodity Futures Trading Commission (CFTC). Alcoa believes that this issue warrants further attention.

The dramatic increase in trading volume on the LME in recent years is predominantly due to the increased trading activity from financial investors who do not participate in the underlying physical markets. While Alcoa recognizes that financial investors are a reality of the current economy, it is imperative that those who participate in the physical aluminum market have confidence in the price setting mechanism of the LME.

Improved transparency into the sources of trading on the LME, which gives all parties concerned the benefit of information that is commonly accessible to market participants in other commodities, is an essential first step toward improving confidence in the marketplace that the LME continues to be the best source of price discovery for aluminum.

To this end, it is Alcoa's view that the LME should establish reporting similar to the CFTC's Commitment of Traders (COT) reports, to improve the understanding in the marketplace of the impact and relative influence that financial investors have on the price discovery process. This type of information, and greater transparency, would lead to more clarity on how the rapid growth in speculative trading may be influencing price.

Enhancing the availability and quality of information for all physical commodities that underlie a financial market contract will improve the reliability of price discovery in financial markets.