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February 10,2017

Federal Reserve Board of Governors
c/o Robert deV. Frierson, Secretary,
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551.

Re: Docket No. R-1547, RIN 7100 AE-58: Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments

Dear Governors.

On behalf of more than 400,000 members and supporters of Public Citizen, Inc., we provide the following comment on Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments.

First, we applaud staff and the Board for developing a fair rule that adopts certain limitations on Financial Holding Company (FHC) involvement in energy commodity markets. We support the Board's recognition that when bank ownership of physical commodities falls outside traditional banking it poses dangers to the bank itself and to the broader economy, and should be limited.

Background

Separating banking from commerce serves as a foundational principle of the American economy. The Bank Holding Company law states that no bank holding company shall own any firm "which is not a bank."[1] This law stems from experience with monopoly power, conflicts of interest, and taxpayers exposure to the bailouts of banks reliant on subsidized, federally-insured deposits.

[1] 12 U.S.C. 1841

The Gramm-Leach Bliley (GLB) deregulation bill of 1999 contains loopholes that allow a few major banks to engage in commodity trafficking or direct ownership of (non-bank) commercial enterprises.[2] Twelve firms exploit the 1999 law's loophole (under 12 U.S.C. 1843(k)(l)(B) to engage in physical commodities activities as complementary to banking. The twelve FHCs are Bank of America, Credit Suisse, BNP Paribas (formerly Fortis SA/NV), Wells Fargo (formerly Wachovia), Societe Generale, Deutsche Bank, JP Morgan Chase, Barclays, UBS, Citigroup, RBS and Scotiabank. Two banks enjoy what's known as the grandfather loophole, namely Goldman Sachs and Morgan Stanley. The grandfather loophole is a little noticed aspect of GLB that lets these firms continue what they did before becoming bank holding companies. Their conversion to BHCs took place in an emergency action during the 2008 financial crisis. Finally, the so-called merchant banking exception is a vague permission that permits nearly any activity, with stated restrictions on the ability of the bank holding company to exercise control, a rule we believe is difficult to enforce. This exception applies to any bank.

The entrance of banks into the world of commerce, including trade in commodities, has not improved the economy. As early as 2008, Public Citizen experts testified before Congress about our concerns with FHCs engaging in physical energy commodity trading, and owning and controlling energy commodity infrastructure.[3] Public Citizen also explored these problems with a report titled Big Banks, Big Appetites. We documented episodes of market abuse (JP Morgan's California energy market manipulation, Goldman Sachs aluminum scam); and explored the contradictions in how the Board could oblige its mandate to promote "public benefits" through commodity ownership by banks bound by fiduciary duty to maximize prices even when it meant limiting supply; and examined how liabilities from disasters such as the BP Deepwater Horizon can far exceed to value of an investment, (contrasted with traditional lending where liability is limited to the value of the loan). We published this piece ahead of the Senate hearings[4] on the issue and the Board's announcement of its intention to address it.[5] Again, we are pleased to see the Board acknowledge our concerns with this rulemaking.

It is worth noting that the public widely agrees with our concerns: Of the 17,000 submitted comments, those from the public support these restrictions; only those from the self-interested industry agents oppose restrictions.

Comment on the proposed rule

[2] See 12 U.S.C. 1843(c)(8)

[3] See, for example, Tyson Slocum, *Excessive Speculation & Compliance with the Dodd-Frank Act,* November 3, 2011 testimony before the Permanent Subcommittee on Investigations, U.S. Senate Committee on Homeland Security & Governmental Affairs; and Tyson Slocum, *Hot Profits And Global Warming: Financial Firm and Oil Company Profits and Rising Diesel Fuel Costs in the Trucking Industry,* May 6,2008 testimony before the U.S. House of Representatives Committee on Transportation and Infrastructure, Subcommittee on Highways and Transit www.citizen.org/documents/House08.pdf

[4] U.S. Senate Committee on Banking, Housing and Urban Affairs, (July 23, 2013); available at www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5d268a77-d49f-4807-9edd-de59483aee7f

[5] Bartlett Naylor, *Big Banks, Big Appetites,* PUBLIC CITIZEN (April 4, 2014) www.citizen.org/documents/banking-commodities-consequences-repport.pdf

To address the dangers of bank entry into commerce, and, in particular, commodities, the Board proposes a number of restrictions: 1. Increased capital requirements; 2. Restrictions on certain energy management and tolling authorities; 3. Increased transparency; 4. Elimination of copper as a commodity "closely related to banking."

Capital

Enforcement of the Board's new rule relies on additional capital. Specifically, the Board proposes the risk-based capital weighting for covered physical commodities exposure held under grandfathered authority of 1,250 percent; risk-based capital weighting of 1,250 percent for covered physical commodities exposure held under merchant banking authority;[6] a risk weight of 300 percent for exposures to covered physical commodities held under complementary authority.

The 1,250% risk-weighting is welcome. In practice, this means that the bank would need to demonstrate $125 million in capital for $100 million in assets subject to the 1,250% risk-weighting requirement. (The $100 million converts to a risk weight of $1.25 billion and then total capital of 10% leverage ratio yields $125 million.)

While Public Citizen prefers an outright ban, we understand the Board may view its authority as limited. We invite the Board to review GLB's provisions that only "well managed" banks are allowed to engage in activities beyond traditional loan making.[7] Records of misconduct at the Board, at related agencies, and the Department of Justice on the mega-banks suggest they are not well managed.[8]

Energy Tolling

Public Citizen applauds the Staff and Board proposal for disallowing FHCs from entering into tolling agreements. Tolling agreements can involve a contract between a power marketing unit of FHC and the owner of a power generation facility. Such tolling contracts can present significant risk, and we strongly support the Board's proposal to ban FHCs from engaging in such tolling agreements.

There are recent examples of tolling agreement abuses by FHCs. JP Morgan had a tolling agreement over several power plants in Southern California owned by AES.[9] When multiple government agencies requested that AES install needed pollution control equipment, JP Morgan insisted that its tolling agreement allowed the company to overrule any decision to install the

[6] There are certain exceptions, such as a risk-weight is 300 percent if the trading portfolio company's shares are publicly listed for trading, and 400 percent with respect to a non-listed trading portfolio company;
[7] See Section 103, L(l)(B)Public Law 106-102,113 Stat. 1338 (1999) www.gpo.gov/fdsys/pkg/PLAW-106publl02/pdf/PLAW-106publ102.pdf
[8] See Chapter 2 of *Too Big,* by Bartlett Naylor, PUBLIC CITIZEN (JUNE 22,2016) http://www.citizen.org/documents/TooBig.pdf
[9] Morgan Lee, "JP Morgan in power market standoff amid nuclear outage," *The San Diego Union-Tribune,* December 19, 2012, www.sandiegouniontribune.com/sdut-jp-morgan-in-power-market-standoff-amid-nuclear-2012decl9-story.html

equipment. That prompted a filing by the California Independent System Operator to say that JP Morgan's use of the tolling agreement was allowing the company to "exercise anti-competitive control over resources needed to avoid the risk of blackouts for thousands of homes and businesses, as well as critical public infrastructure, in Southern California."[10] JP Morgan ultimately was forced to pay $410 million in penalties and disgorgement in relation to this scheme.[11] Disallowing FHCs from engaging in such tolling agreements is necessary to minimize

Transparency

The Board is proposing to modify what it calls "the Consolidated Financial Statements for Holding Companies," or FR Y-9C,[12] to create two new reporting requirements. The first it calls "Physical Commodities and Related Activities," or Schedule HC-W. The second it calls "Risk-Weighted Assets", or Schedule HC- R. This would distinguish between physical commodities, infrastructure assets, and investments in covered commodity merchant banking investments. We welcome these new forms. Because merchant banking may apply to a broad range of assets from technology firms to pharmaceutical or even consulting services, we urge the Board to consider more granular detail. Given the mammoth size of the leading banks, direct ownership of a sizeable percent of the real economy not only poses dangers to the financial system in case these real economy firms fail, but frustrates free market reactions. For example, a JP Morgan-controlled firm may make a decision that is not self-interested at the behest of JP Morgan in the service of another JP Morgan-controlled firm. Co-investors in that first firm would be disadvantaged.

In addition, we urge the Board to amend its proposed rule to require limited public disclosure of this financial reporting data. No public databases currently exist to that document ownership or control of energy infrastructure assets. Given the critical role played by FHCs in the economy and in commodity trading markets, and considering the unique risks associated with energy infrastructure in our economy and national security, the public interest is best served by having the Board publically disclose limited aspects of FHC ownership and control over physical commodity assets such as pipelines, storage terminals and tankers.

In addition to reporting requirements, we ask that the Board consider restrictions on communications between a bank's energy infrastructure and energy trading affiliates. Controlling pipelines, storage facilities and other critical energy infrastructure affords banks' trading affiliates an uncompetitive "insider's peek" into the physical movements of energy products unavailable to other energy traders.[13] Furthermore, rapid advances in technology, exemplified by satellites used by traders to obtain control over non-public commodity data, are influencing the fundamentals of commodity trading to provide uncompetitive leverage to those firms who can afford access to this proprietary data. The Board can restrict communications between infrastructure, trading and data surveillance affiliates. This could be done to mirror the

[10] Federal Energy Regulatory Commission Docket No. EL13-21, http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=13134067, at Page 1.
[11] www.ferc.gov/media/news-releases/2013/2013-3/07-30-13.asp
[12] Here is the form: www.federalreserve.gov/reportforms/forms/FR_Y-9C20160930_f.pdf
[13] www.citizen.org/documents/TysonHSGACspeculation.pdf

Federal Energy Regulatory Commission enforces rules that significantly limit contact between natural gas pipeline and natural gas trading affiliates.[14]

Copper

The Board proposes removing the ownership and storage of copper as a permissible activity "closely related" to banking. The Board explains that copper is now an industrial metal and not something interchangeable with coinage, as otherwise provided under Regulation Y. We support this change. At the same time, this decision invites consideration of what it means for any commodity or activity to be "closely related" to banking. The emergence of BitCoin and other virtual currencies demonstrates that solving Boolean algebra or computational mathematics problems, which is related to the "coinage" or, in the vernacular of cyber currency, "mining" of BitCoin, could be considered "closely related" to banking. For that matter, some inflation-concerned investors turn cash into art work, and as such, the art work could be considered closely related to banking. We believe the Board is best advised to narrow its parameters for what it means to be "closely related" to banking so as to avoid such sophistries.

Section 620 report

While not part of this rule-making, we do applaud the Board's section in its report submitted with other bank regulators regarding basic bank activities and associated the risk and public benefits, as mandated under Section 620 of the Dodd-Frank act. In our report Big Banks, Big Appetites and in our comment letter responding to the Board's invitation regarding its advance notice of proposed rulemaking, we urged the Board to recommend legislative repairs to the erosion of the wall separating banking and commerce. We are gratified that the Board does just that in the Section 620 report.[15]

The Board's recommendations calling for the repeal of authorities and exemptions that currently allow banks to engage in a broad range of commercial activities are very welcome. The Board recommends the repeal of the merchant banking and the "grandfather" authorities, and notes that merchant banking exposes the banks to liabilities well beyond traditional loan making. It acknowledges its own oversight limitations in monitoring such risks, a point highlighted by Public Citizen.

As the Board summarizes, "these changes would create a more level playing field. ... [M]any of these changes would further limit the commercial activities of banking entities and, as a result, help to enhance safety and soundness, minimize the concentration of economic resources by limiting an institution's ability to take on risk associated with commercial activities, and help ensure the separation of banking and commerce."

Conclusion

[14] 18 CFR § 358

[15] *Report to the Congress Pursuant to Section 620 of the Dodd-Frank Act,* (September 8, 2016) https://occ.gov/news-issuances/news-releases/2016/nr-ia-2016-107a.pdf

We submit this comment at a time of transition in Washington, where the president-elect has named a number of Goldman Sachs alumni experienced in some of the very activities at the core of this comment letter to the administration. We invite them along with the Board that they will help to reshape to ensure that the real economy is served by federal policy as opposed to increasing the wealth of financial firms.

For questions, please contact Tyson Slocum at tslocum@citizen.org, or Bartlett Naylor at bnaylor@citizen.org.

Sincerely,

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