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Via Agency Website

February 17, 2017

Mr. Robert de V. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: 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, Docket No. R–1547 and RIN 7100 AE–58[1]

The Futures Industry Association ("FIA")[2] appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's (the "Board") Notice of Proposed Rulemaking (the "NPR") relating to the physical commodities activities conducted by financial holding companies ("FHCs"). FIA previously commented[3] on the Board's Advance Notice of Proposed Rulemaking ("ANPR")[4] in April 2014. Although we recognize the Board's investment of time and resources in considering industry participants' comments in moving from the ANPR to the NPR, we continue to have significant concerns regarding any potential new restrictions on

[1] 81 Fed. Reg. 67,220 (Sept. 30, 2016).

[2] FIA is the leading trade organization for the global futures, options and over-the-counter cleared derivatives markets. Its mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system and to promote high standards of professional conduct. FIA's members, their affiliates and their customers are active users of physical commodities, futures and over-the-counter derivatives, and include commodity firms, banks and brokerage firms, among others. Consequently, FIA and its members have a strong interest in this rulemaking and any potential restrictions in the physical commodities markets and corresponding effects on the related derivatives markets.

[3] Letter of FIA to the Board (April. 9, 2014), *available at* https://www.federalreserve.gov/SECRS/2014/April/20140410/R-1479/R-1479_040914_114967_569566386546_1.pdf. We incorporate by reference all arguments in our April 2014 letter here and encourage the Board to consult our prior letter for a full understanding of our position.

[4] Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 3,329 (Jan. 21, 2014).

FHCs' physical commodities activities, including the physical settlement of commodity-linked swaps and other derivatives. As noted in our April 2014 letter responding to the ANPR, restrictions on those activities would likely impair competition and liquidity in physical commodities markets; undermine the critical intermediary, principal and financing role of FHCs in such markets; and lead to inefficient pricing and higher costs, all to the detriment of end users. We submit that any potential benefits of such restrictions do not outweigh these harmful market effects. This is especially true given the lack of empirical analysis and reasoned support for the Board's findings in the NPR. We urge the Board not to adopt the restrictions proposed in the NPR and, at a minimum, not to proceed with final rules before thoroughly studying and publishing for comment the impact of FHCs' activities in physical commodities markets, and in particular the impact their withdrawal would have on such markets.

I. FHCs Provide Numerous Important and Unique Benefits for Physical Commodities Markets and End Users

As set forth in detail in our April 2014 letter, FHCs provide myriad benefits to physical commodities markets, many of which may not be efficiently replicated by other market participants. We reiterate some of these benefits below.

- *Market Depth and Resilience.* FHCs provide depth and breadth of counterparties in physical commodities markets, which has led to greater liquidity and a wider range of available contracts. The markets are more resilient in consequence. The increased number and variety of counterparties reduce volatility and better position the markets to absorb and function in periods of stress.

- *Intermediary, Market-Making and Principal Roles.* FHCs perform unique functions as financial intermediaries that are unlikely to be replicated by other market participants. FHCs provide both cash-settled and physically-settled alternatives for end users, including custom-designed products that meet particular business needs. FHCs also serve as market-makers and bring prospective buyers and sellers together, including those that otherwise would not have an efficient means of contracting. FHCs are also well suited to serve as principal counterparties in commodities transactions. Their large capital profile and diverse book of business allow them to more readily absorb risk and act as counterparties to market participants who, in their absence, could struggle to find willing or suitable counterparties. These services are essential for ensuring a liquid and efficiently-priced market for the numerous physical commodities that are traded and hedged on a daily basis. Reducing FHCs in these markets would necessarily limit options for market participants, especially end users who have bespoke business, and thus hedging, needs.

- *Commodities-Related Financial Services and Products.* FHCs also provide a broad spectrum of important commodities-related financial services to end users. The services include credit intermediation, structured finance arrangements, project finance and risk-mitigating commodity-linked swaps and other derivatives. End users rely on these services and products to provide essential financing for their daily business operations as well as their capital-intensive infrastructure, such as power plants and processing facilities. FHCs are ideal providers of these services due their unique ability to tailor these services and products to the specific needs of end users and their familiarity with end users' businesses from their focus on client services. FHCs are also able to offer the services and products on a larger scale than other market participants. Such efficiencies furnish critical support and reduce costs for end users.

The loss of these benefits is of particular concern to many end-users that currently rely on FHC participation in the physical commodities markets. For example, the reduction of FHC's physical commodities activities could substantially impact certain end-users that rely on financing from banking organizations to support the flow of energy products throughout the US. Specifically, many commercial energy firms rely upon inventory financing to support the building of infrastructure, such as pipelines, movable storage, as well as location based storage tanks to support the efficient movement of energy physical commodities. Because a FHC would take temporarily title to the physical commodity upfront, the inventory financing transaction could become subject to significantly higher capital requirements under the proposal. The increased capital requirements may result in a reduction in the capacity for FHCs to provide these services to end-users, which could increase prices due to lack of availability for consumers, as well as have negative effects on energy firms and liquidity in the commodity markets.

For these reasons, among others, FHCs are key contributors to the health and vitality of physical commodities markets. Any regulatory action that risks curbing their activities in such markets, therefore, should be thoroughly analyzed and understood before being adopted.

II. The NPR Would Curb or End These Benefits without Thorough Understanding of its Effects

The NPR's capital requirements will likely force FHCs to reduce their activities in physical commodities markets despite the important benefits they provide such markets. The NPR itself finds that "the proposed increases in capital requirements could make [an FHC's] activity [in physical commodities markets] significantly less attractive based on its return on capital, and could result in decreased activity."[5] The Board thus concedes that the NPR could have a chilling effect on FHCs' physical commodities activities. The NPR, however, goes on to find, based on commodities market information described as "relatively scarce," that any "such reduction in activity is not expected to have a material impact on the broader physical commodity markets."[6] The Board should not adopt such a consequential regulatory proposal—for FHCs and other market participants alike—on the basis of such summary analysis.

The NPR does not contain sufficient evidence or analysis to support the Board's sweeping conclusion that the proposed regulations are "immaterial" to physical commodities markets. For example, citing only market participants' assertions and "[i]nformation available to the Board," the NPR concludes that "it ***appears*** that the bulk of activity and inventory is

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[5] 81 Fed. Reg. at 67,229.

[6] *Id.*

conducted and held by non-Board-regulated entities (such as energy firms and end users of physical commodities) rather than FHCs" and that, "in general, FHCs' market shares in physical commodity markets are quite low and typically represent less than 1 percent of the market."[7] Neither the assertions nor the purportedly available information is identified in the NPR. It is unsettling that the Board would reach such an important conclusion based on unidentified sources and such a low level of certainty in the accuracy of the information.

Further troubling, the NPR notes with respect to FHCs' involvement in commodity derivatives trading that the market share of U.S. banks "typically ranges from 2 to 15 percent" and that activity of non-bank subsidiaries of FHCs "is estimated to be similar or slightly larger."[8] The NPR, however, does not assess whether or how the removal of counterparties accounting for 15 percent or more of the relevant derivatives market could impact the markets, including price discovery and convergence, the prevalence of suitable counterparties and the capacity of other market participants to fill the vacated roles of FHCs. Without such analysis, it is impossible to conclude that the elimination of 15 percent, or even 2 percent, of the market is "immaterial." The International Swaps and Derivatives Association ("ISDA") and Securities Industry and Financial Markets Association ("SIFMA") have written extensively in their comment letters on the need for further analysis of the effects of reduced involvements of FHCs in physical commodities markets.[9] Like ISDA and SIFMA, we do not believe the Board should adopt the NPR without first endeavoring to thoroughly identify and assess its potential costs and benefits.

Robust physical commodities markets are essential for the end users that depend on them to manage risk and hedge price volatility in the normal course of business. The cumulative effect of the current regulatory environment—including the Commodity Futures Trading Commission's ("CFTC") regulation of derivatives markets under the Dodd-Frank Act and Basel III capital requirements—have made FHCs less likely to participate in these markets. The NPR's regulatory approach will intensify this trend and its disruptions to markets. We urge the Board not to adopt the NPR's further restrictive regulatory measures. At a minimum, we ask the Board to conduct a reasoned and thorough analysis of the potential costs and benefits of such measures and to submit such analysis for public comment before approving any final rules under the NPR.

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

[8] *Id.* at 67,229-30.

[9] Letter from Carter McDowell, Managing Director and Associate General Counsel, SIFMA, to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System (Feb. 17); Letter from Steven Kennedy, Global Head of Policy, ISDA, to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System (Feb. 17).

FIA appreciates the opportunity to comment on the NPR. If the Board or any member of its staff has any questions regarding this submission, please contact Allison P. Lurton, Senior Vice President and General Counsel, at 202.466.5460 or alurton@fia.org.

Sincerely,

Walt L. Lukken

Walt L. Lukken
President and Chief Executive Office