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Lawyers in the Best Sense

April 16, 2014

Via electronic submission

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

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

Dear Mr. Frierson:

Many thanks for the opportunity to comment on the Board's proposed rulemaking in connection with (a) the physical commodities activities of bank/financial holding companies and (b) existing and possible further restrictions placed upon these activities in the interest of ensuring that they be conducted in a manner that is safe, sound, and consistent with applicable law.

I offer the following comments in my capacity as a scholar and teacher of finance-regulatory law, a role that I have occupied at the Cornell Law School for nearly a decade now. I offer them also in my role as a regular collaborator with Americans for Financial Reform.

In my view, the definitive catalogue of legal and policy considerations that ought to inform Board decision-making on this subject is that provided by Professor Omarova of the University of North Carolina College of Law, first in her MINNESOTA LAW REVIEW article on the subject, and then in the written and oral testimony that she provided the Senate Banking Committee this past July. I nevertheless have concerns that I hold with particular intensity on the basis of Professor Omarova's work, which I would like here to emphasize.

Your colleague Scott Alvarez graciously met with me and with colleagues of mine at Americans for Financial Reform and other institutions in January of 2013, then with Professor Omarova and me this past August, so I know that he has heard most of what I shall say here. I believe it will nevertheless be helpful to have these comments added to the public record.

I. The potential benefits and potential dangers of direct bank/financial holding company involvement in the physical commodities markets ride decisively on the quantitative and proportional extents of that involvement. Yet there is no required disclosure regime

enabling those extents – as distinguished from the extents of *derivative* bank/financial holding company involvement in commodities markets – to be separately tracked by investors or regulators. At a minimum, then, the Board should condition further bank/financial holding company involvement in physical commodities markets upon compliance with a fine-tuned disclosure regime that enables separate tracking of direct and derivative commodity market exposure.

As I sought to emphasize in conversation with your colleague Mr. Alvarez in January of 2013, much, though not all, of Professor Omarova's important work on this subject is concerned for now with the *potential* dangers posed by bank/financial holding company involvement in the physical commodities markets. She does not claim that we already know that all of the potential dangers have definitively been realized, but argues instead that the *risks* of their being realized are sufficiently real as to warrant being made traceable and measurable now, in *advance* of their (potentially) being realized.

The problem, however, is that the disclosure regime to which bank/financial holding companies are presently subject does not require that they separately track their *direct* involvement in the physical commodities markets on the one hand, and their *derivative* exposures to those markets on the other hand. This is problematic in at least two senses.

It is problematic first in a broad, general sense, in that it means that we can't take the measure of bank/financial holding company involvement in the physical commodities markets as such, hence cannot determine in advance how likely the many potential harms identified by Professor Omarova are to be actually realized. The present disclosure regime is problematic second in a narrower, more specific sense having to do with one very particular concern raised both by Professor Omarova and by others – notably James Collura. That is the concern that direct involvement in the physical commodities markets might be undertaken specifically with a view to manipulating the yield curves associated with derivative instruments in which the same companies also hold positions. To allow firms simply to aggregate information concerning their direct and derivative involvements in the commodities markets is, *eo ipso*, to allow them to prevent regulators and investors from tracking precisely that which must be tracked in order to determine whether physical markets are being cornered or otherwise manipulated in order to affect yields on derivatives markets.

I would strongly urge, then, that the Board render continued direct bank/financial holding company involvement in the physical commodities markets conditional upon compliance with an improved, fine-tuned disclosure regime that separately tracks direct and derivative involvement in those markets. Ideally, the tracking in question would not only trace dollar values of bank/financial holding company exposures in the markets in question, but also would facilitate ready calculation both of the shares of these firms' balance sheets accounted for by those distinct exposures, and of the shares of the relevant markets represented by specific bank/financial holding companies' activities therein. Hence my reference above to both quantitative and 'proportional' extents of bank/financial holding company involvement in the markets in question.

II. As noted above, one of the many potential concerns raised by bank/financial holding company involvement in the physical commodities markets is the prospect of their entry into such markets, or of their remaining in such markets, with a view to manipulating yields on derivative securities referencing those underlying commodities or related commodities. The Board, in virtue of its 'umbrella' regulatory role under the Gramm-Leach-Bliley Act (GLBA) regime, is uniquely situated to monitor for this possibility in a way that the 'functional' regulators – e.g., the CFTC and FERC, which separately monitor the derivatives and physical energy markets, respectively – are not. The Board,

then, should track and monitor bank/financial holding company involvement in the derivatives and physical commodities markets with a view to possible market manipulation of this sort.

As noted above, one of the concerns that Professor Omarova and others identify as being raised by bank/financial holding company involvement in the physical commodities markets is the possibility – not the certainty or even the probability as yet, just the possibility – that in some cases this involvement might take the form of activities aimed at affecting yields on derivative securities in which the companies also have positions. Yield-curve-bending of this sort would of course constitute manipulative activity inimical to the policies that we vindicate through the securities, derivatives, and even the antitrust laws.

Now some bank/financial holding companies might of course engage in this form of prohibited activity, while others of course might not. Some firms might enter the physical commodities markets expressly in order to engage in such activities, others might simply fall into doing so months or years after initial entry into the markets on the basis of altogether legitimate motives. And again, it might even happen that no firms at this point engage in any activity of this sort at all. Either way, we would obviously wish to monitor for the *prospect* of such activity in virtue of its ever-present possibility whenever firms such as bank/financial holding companies are permitted to act in *both* kinds of market. And we would wish to do so even given strict 'firewall' regimes pursuant to which separate physical commodities and derivatives trading subsidiaries of holding companies were, strictly speaking, legally prohibited from coordinating their activities. For such firewall regimes are themselves difficult to enforce absent certain kinds of informations' being available to regulators and others.

Unfortunately, the 'functional' regulators upon which we currently rely for purposes of policing the relevant markets implicated by this concern – the CFTC in the derivatives markets, the FERC and others in the physical commodities markets, all of them legislatively established and enabled *before* we began to *permit* single bank-holding firms to act in both kinds of market – are not optimally situated to monitor for this prospect. The CFTC, for example, has full jurisdiction over and expertise in relation to the derivatives markets, but does not have counterpart jurisdiction or expertise in relation to underlying physical commodities markets. The FERC, for its part, has jurisdiction and expertise in relation to the latter – at least where the commodities in question are energy-related commodities – but of course lacks counterpart jurisdiction and expertise where derivative securities are concerned. Would-be manipulators might accordingly evade detection in virtue of a gappy regime that effectively 'divides and conquers' precisely those regulators that would otherwise act.

Adequate monitoring for the market manipulation possibility, then, rides either on (a) seamless coordination between the CFTC and the physical commodities regulators with a fair bit of knowledge even about one another's subjects of competency, (b) monitoring by an 'umbrella' regulator like the Board, with authority and expertise to monitor and regulate across the jurisdictional boundaries and competencies of those 'functional' regulators, or (c) some combination of (a) and (b). I would thus strongly recommend that continued bank/financial holding company involvement in physical commodities markets be rendered contingent upon the Board's expressly promulgating a robust system of cross-market monitoring of derivative and physical commodity trading activities with a view specifically to detecting and ultimately preventing potential market-manipulative activity. I would also like to repeat that this is not to say that I have evidence that any such activity is actually underway (though one does hear many anecdotal claims to this effect from more than a few market actors); it is only to say that well-built and well- monitored fences will make for better 'neighbors' over time.

III. The 'separation of banking and commerce' has constituted a fundamental tenet of American bank-regulatory law and policy for over a century. Any measure that would make a 'dead letter' of that regulatory ideal, such as permitting permanent large-scale involvement of banking organizations in physical commodities markets would do, would be sufficiently momentous as to call for Congressional and Presidential rather than merely regulatory action. If the Board elects to permit continued bank/financial holding company involvement in the physical commodities markets, then, it should limit the quantitative and proportional extent of that involvement to ensure that it remains but a comparatively small part of holding company activities, and that such holding company involvement in turn remains but a comparatively small part of the aggregate of such activities.

Throughout the modern era, American bank-regulatory law and policy has observed an ideal often referred to as that of 'the separation of banking and commerce.' The reason behind this ideal, as I often tell my students, is two-fold. On the one hand it is about fairness, in that commercial firms with bank affiliates are thought likely to enjoy a funding and consumer confidence (not to mention an associated implicit federal subsidy) advantage relative to other commercial firms operating in the same product or service markets *without* bank affiliates. On the other hand the doctrine is about bank safety and soundness and systemic stability, in that bank affiliation with firms that operate in markets where we do not worry about 'destructive competition,' in the way that we do in connection with banks, is thought likely to expose banks to precisely those forms of destructive competition from which we hope to insulate them.

It is of course possible that the longstanding ideal of the separation of banking and commerce was ill-conceived from the get-go, or that it is obsolete now irrespective of its wisdom when first embraced by our legislators, regulators and courts. Any determination to that effect, however, would be so momentous as to call for an extensive process of empirical investigation and policy deliberation. It would call for, in other words, legislation enacted by Congress after investigation and debate, then signed by the President.
No regulatory agency, even an agency with the considerable expertise and associated authority of the Board, should purport of itself to be situated to make such fundamental and far-reaching determinations. The Board, then, should take special care, in the event that it decides to permit continued bank/financial holding company involvement in the physical commodities markets under the GLBA's and BHCA's merchant banking, complementary powers, or 'grandfathering' authority, to ensure that such involvement remain but a small part of holding company activities, and that the latter in turn remain but a small part of aggregate activity in the markets in question. Adopting a more helpful disclosure regime such as that called for above in connection with Point I will of course help in discharging this task, just as it will in discharging the task specified above in connection with Point II.

A final point in connection with the foregoing bears noting, I think. There seems to be a misconception among some that the longstanding ideal of the 'separation of banking from commerce' was somehow retired to pasture by Congress and President Clinton with passage of the GLBA in 1999. That, in so far as anyone really believes it, is a serious error in my view. Nothing in the language or structure of the statute supports such a reading, nor does anything in the legislative history surrounding enactment. Indeed, quite the contrary is true, as Professor Omarova's interrogation of the legislative history that culminated in the GLBA dramatically shows. Moreover, even *were* the GLBA to be read as signaling some fundamental change in our polity's attitude toward the mixing of banking and commerce, it is hardly as though 1999's GLBA is the most recent important development where our financial system and its regulation are concerned. More proximate events and new legislation more comprehensive even than was the GLBA – most notably but not exclusively the Dodd-Frank Act enacted in response to our most recent global financial calamity – suggest that, whatever the admitted benefits wrought by the Financial Services Modernization Act in 1999, much of the pre-GLBA 'old wisdom' continues to have purchase as well. The traditional separation of banking and commerce lies at the very heart of that 'old time religion,' hence should not be cavalierly treated as though it were no longer operative.

I accordingly conclude, then, again that the Board should for now proceed with great caution in this uncharted new realm. If, in time, Professor Omarova's, my, and many other observers' concerns over potential dangers prove ultimately unnecessary, we shall always be able to open the door incrementally wider to the sorts of activities that we currently view with a sense of provisional precaution. Going too far too fast in this direction right now, however, prior to gathering much more salient information and prior to wider ranging study, as well as in the wake of so complex and calamitous a crisis as we've just experienced, could wreak havoc that proves ultimately difficult to undo. I urge, then, an Edmund Burke style conservative orientation as the Board now considers its next moves in the matter of bank/financial holding company involvement in the physical commodities markets.

Thank you again, Mr. Frierson, for this opportunity to comment. And please do not hesitate to phone me or email me if I might clarify any of the foregoing or be of assistance in any other way as you proceed with deliberations on how best to handle the commodities question. My email address is Robert-Hockett@lawschool.cornell.edu, and my office telephone number is 607.255.4539.

All very best,

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