

# Memorandum

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## Federal Reserve Seeks More Limits on Physical Commodity Activities of Financial Holding Companies

*Capital Charges and Other Requirements Reflect the Federal Reserve's Continued Concerns with the Risks Associated with Physical Commodities*

September 26, 2016

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Two weeks after it issued a report recommending that Congress repeal longstanding statutory authorities for investments and trading activities, the Federal Reserve announced its intent to impose additional regulatory limits on, and other requirements relating to, the physical commodity trading activities of all financial holding companies (“FHCs”).

On September 23, the Federal Reserve released a proposed rule that would, among other things:

- tighten the quantitative limit on the amount of physical commodity trading activity that FHCs may conduct;
- impose higher capital charges for certain physical commodity activities;
- codify the prohibition on FHCs owning, operating, or investing in facilities for the extraction, transportation, storage, or distribution of commodities;
- rescind orders that have authorized certain FHCs to engage in energy management and tolling activities;
- remove copper from the list of metals that bank holding companies may currently own and store; and
- establish new reporting requirements on the nature and extent of FHCs’ physical commodities holdings and activities.

According to the Federal Reserve, the proposal would help reduce the catastrophic, legal, reputational, and financial risks that physical commodity activities pose to FHCs.

Comments on the proposal are due by December 22.

## Background

Bank holding companies (“BHCs”) and their subsidiaries are permitted to engage in certain types of physical commodity activities under a variety of authorities. Under the Bank Holding Company Act of 1956 (“BHC Act”), BHCs may engage in activities that are “closely related to banking,” including buying, selling, or holding precious metals, participating as a principal in cash-settled commodity derivatives, and trading in physically settled commodity derivatives under certain circumstances. In addition, national banks owned by BHCs may engage in certain limited types of physical commodity activities under the National Bank Act.<sup>1</sup>

BHCs that elect to be treated as FHCs<sup>2</sup> may also engage in activities that are “complementary” to a financial activity, so long as the activities do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.<sup>3</sup> Since 2003, the Federal Reserve has issued a limited number of orders authorizing FHCs to engage in certain physical commodity activities under this “complementary” authority, including physical commodity trading activities and energy management and energy tolling activities.<sup>4</sup>

Additionally, under the “merchant banking” authority of the BHC Act, FHCs may acquire ownership interests in any nonfinancial company, including one that engages in physical commodity activities, so long as the FHC does not routinely manage or operate the nonfinancial company itself and holds its investment only for a limited period of time.<sup>5</sup>

The BHC Act also provides “grandfather” authority for certain FHCs to continue to engage in a broad range of physical commodity activities that would not otherwise be permissible for BHCs, including storing, transporting, extracting and altering commodities.<sup>6</sup> Only Goldman Sachs and Morgan Stanley (which became BHCs in 2008) currently qualify for this grandfather authority.

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<sup>1</sup> State-chartered banks also may be authorized to engage in certain physical commodity activities under applicable state statutes and relevant restrictions under the Federal Deposit Insurance Act.

<sup>2</sup> An FHC is a BHC that is permitted to engage in a broader range of activities. To elect FHC status, the BHC and each of its insured depository institution subsidiaries must be “well capitalized” and “well managed,” and no insured depository institution subsidiary may have less than a “satisfactory” record under the Community Reinvestment Act of 1977.

<sup>3</sup> 12 U.S.C. § 1843(k)(1)(B).

<sup>4</sup> See, e.g., *Citigroup Inc.*, 89 Fed. Res. Bull. 508 (2003); *Barclays Bank PLC*, 90 Fed. Res. Bull. 511 (2004); *UBS AG*, 90 Fed. Res. Bull. 215 (2004); *Société Générale*, 92 Fed. Res. Bull. C113 (2006); *Deutsche Bank AG*, 91 Fed. Res. Bull. C54 (2006); *JPMorgan Chase & Co.*, 91 Fed. Res. Bull. C57 (2006); *The Royal Bank of Scotland Group plc*, 94 Fed. Res. Bull. C60 (2008).

<sup>5</sup> 12 U.S.C. § 1843(k)(4)(H).

<sup>6</sup> 12 U.S.C. § 1843(o).

In recent years, legislative and regulatory scrutiny of the physical commodity activities of banking organizations has intensified. In 2012, the Senate Permanent Subcommittee on Investigations initiated an investigation, which, two years later, resulted in a 400-page report recommending further regulatory action.<sup>7</sup> Several high-profile hearings by the Senate Banking Committee were also held. In January 2014, the Federal Reserve issued an advance notice of proposed rulemaking, seeking public comment to inform its consideration of physical commodity activities conducted by FHCs, including the appropriateness of further prudential restrictions on such activities.<sup>8</sup> After occasional indications from Federal Reserve Chair Janet Yellen and Governor Daniel Tarullo that further commodity-related rulemaking would be forthcoming, Senator Sherrod Brown, the ranking member of the Senate Banking Committee, wrote to Chair Yellen in February 2016 urging the Federal Reserve to propose rules on physical commodity activities “without any further delay.”<sup>9</sup>

## Overview of the Proposed Rule

### [Tighter Quantitative Cap on Physical Commodity Activities](#)

The Federal Reserve has authorized FHCs to engage in physical commodity trading—including purchasing and selling physical commodities in the spot market and taking and making delivery of physical commodities to settle commodity derivatives—as an activity that is “complementary to a financial activity.” However, the total value of physical commodities held by an FHC under such “complementary” trading authority must be limited to 5% of the FHC’s consolidated Tier 1 capital.

In its current form, this 5% limit does not account for an FHC’s physical commodity holdings held pursuant to other authorities. For example, if an FHC’s national bank subsidiary were to hold physical commodities to hedge bank-permissible derivatives transactions under National Bank Act authority, these bank holdings would not count towards the FHC’s 5% limit for commodities held under the BHC Act “complementary” authority.

The proposed rule would tighten this 5% cap on physical commodity holdings by accounting for physical commodities held by an FHC’s consolidated organization under a broader range of authorities, subject to limited exceptions.<sup>10</sup> The proposal would not restrict the ability of an FHC subsidiary to engage in physical

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<sup>7</sup> See “*Wall Street Bank Involvement with Physical Commodities*,” Majority and Minority Staff Report of the U.S. Senate Permanent Subcommittee on Investigations, [available here](#).

<sup>8</sup> See 79 Fed. Reg. 3329 (Jan. 21, 2014), [available here](#).

<sup>9</sup> See Letter from Sen. Sherrod Brown, Ranking Member of the Senate Banking Committee, to Janet Yellen, Chair, Federal Reserve (Feb. 4, 2016), [available here](#).

<sup>10</sup> In particular, the proposed 5% cap would not apply to physical commodities (i) that are held by companies that a FHC controls under merchant banking authority or under similar authority for insurance company investments, or (ii) that an FHC holds in satisfaction of debts previously contracted (DPC holdings).

commodity activities pursuant to any authority other than “complementary” authority, but the parent FHC would be prohibited from trading in physical commodities if the market value of commodities owned by the FHC and its subsidiaries exceeds 5% of the FHC’s consolidated Tier 1 capital.

An FHC would also need to notify the Federal Reserve if the aggregate market value of physical commodities owned by the FHC and its subsidiaries exceeds 4% of the FHC’s consolidated Tier 1 capital, subject to limited exceptions (*e.g.*, merchant banking investments, DPC holdings).

The proposal would provide FHCs with two years from the effective date of the rule to conform to the revised quantitative 5% cap.

#### Higher Capital Charges for Physical Commodity Activities

The Federal Reserve is proposing that additional regulatory capital be held “to better reflect the risk of legal liability that an FHC may incur as a result of its physical commodity activities.”<sup>11</sup> The resulting increase in capital requirements would be in addition to any counterparty credit risk, market risk, or operational risk capital requirements already applicable to the assets involved in physical commodity activities.

The proposed capital requirements would apply only to activities in physical commodities that are substances covered under federal or relevant state environmental law (“covered commodities”), due to the increased likelihood of such commodities exposing an FHC to legal liability under federal or state environmental laws. Covered commodities would include any physical commodity that is (or a component of which is) specifically named as a “hazardous substance” under CERCLA, as “oil” under the Clean Water Act, or as a “hazardous air pollutant” under the Clean Air Act (including regulations interpreting these terms under such statutes). The proposal does not identify specific state environmental laws for FHCs to reference in determining whether its commodities are “covered.” Instead, an FHC would be required to identify any physical commodities it owns that are not covered under certain enumerated federal laws, and determine on a state-by-state basis whether those commodities are subject to liability under the environmental laws of the state(s) in which such commodities are owned.

The increased capital weightings would vary according to the authority pursuant to which an FHC conducts the physical commodity activity, based on the Federal Reserve’s view of the degree of risk associated with such authority. For example, the proposal would assign a 1,250% risk weight to the market value of all covered commodities permitted to be owned only under the “grandfather” authority of Section 4(o) of the BHC Act. This risk weight, which essentially requires \$1 in capital for every \$1 of covered commodities, represents the highest risk weight currently applied by the Federal Reserve under the “standardized”

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<sup>11</sup> According to the Federal Reserve, “FHCs may be subject to legal liability in an amount much greater than the value of the physical commodities they own.” In particular, it noted that “[a]n environmental catastrophe linked to an FHC’s physical commodity activities could suddenly and severely undermine public confidence in the FHC and any of its subsidiary IDIs, limiting its access to funding markets until the market assesses the extent of the FHC’s liability.”

approach to risk-based capital rules. A 1,250% risk weight would also apply to the original cost basis of any on-balance sheet commodity infrastructure assets (such as pipelines and refineries), as well as to an FHC's merchant banking investments engaged in covered commodity activities unless all of the covered commodity activities of the portfolio company would be permissible under the FHC's "complementary" authority.

For covered commodities held by an FHC pursuant to "complementary" authority, the proposed rule would assign a risk weight of 300%. In addition, the proposal would permit a reduced risk weight of 300% for covered commodity activities conducted by an FHC under its "grandfather" authority or by a publicly traded portfolio company under the FHC's merchant banking authority, so long as such activities conducted by the FHC or publicly traded portfolio company would be permissible physical commodity trading under the FHC's "complementary" authority. For non-publicly traded merchant banking portfolio companies that engage in covered commodity activities permissible under "complementary authority," the proposed rule would assign a 400% risk weight.

The following chart summarizes the proposed rule's revisions to the risk-based capital requirements:

<b>Authority For Activity</b>	<b>Activity Fully Comports with "Complementary" Authority Limitations?</b>	<b>Investment / Portfolio Company Publicly Traded?</b>	<b>Proposed Risk-Based Capital Weighting</b>
§ 4(k)(1)(B) "Complementary" Authority	Yes	N/A	300%
	No	N/A	1,250%
§ 4(o) "Grandfather" Authority	Yes	N/A	300%
	No	N/A	1,250%
§ 4(k)(4)(H) "Merchant Banking" Authority	Yes	Yes	300%
	Yes	No	400%
	No	N/A	1,250%

Although the proposal's treatment of merchant banking authority is only in the context of physical commodity activities, the Federal Reserve has requested public comment on whether current capital requirements adequately capture the risks of other merchant banking investments, if additional capital requirements should be applied to merchant banking investments generally, and whether merchant banking investments should continue to be included as "non-significant equity exposures" under existing capital rules.

[Codification of the Prohibition on Owning, Operating, or Investing in Facilities for the Extraction, Transportation, Storage, or Distribution of Commodities](#)

The Federal Reserve has long prohibited FHCs from owning, operating, or investing in facilities for the extraction, transportation, storage, or distribution of commodities as part of complementary authority. Under the proposal, this prohibition would be codified in Regulation Y. The term "operate" would be defined broadly to include: participation in the day-to-day management or operations of the facility; participation in the management and operational decisions that occur in the ordinary course of business of the facility; and managing, directing, conducting, or providing advice regarding operations having to do with the leakage or disposal of a physical commodity or hazardous waste or decisions about the facility's compliance with environmental statutes or regulations. The Federal Reserve noted that it would expect FHCs to take other appropriate steps to limit the FHC's potential environmental liability.

[Rescission of Orders Relating to Energy Management and Energy Tolling Activities](#)

Beginning in 2008, the Federal Reserve expanded the scope of physical commodity activities permissible for FHCs under "complementary" authority by allowing certain FHCs, through regulatory orders, to enter into "tolling agreements" and "energy management" agreements with power generators.<sup>12</sup> In particular, the Federal Reserve found that such agreements would allow an FHC to better manage its commodity risk and help place FHCs on a more level competitive playing field with non-bank competitors in the derivatives markets. Currently, only five FHCs are permitted to engage in energy management services and energy tolling in the United States, but the Federal Reserve noted that only one FHC actually engages in these activities today.

The Federal Reserve is proposing to rescind its prior approvals regarding energy management services and energy tolling on the basis that these two activities do not appear to have been "as directly or meaningfully connected to a financial activity" and "the expected benefits of permitting these activities do not appear to

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<sup>12</sup> A tolling agreement typically allows the "toller" to make periodic payments to a power plant owner to cover the plant's operating costs plus a fixed profit margin in exchange for the right to all or part of the plant's power output. As part of the agreement, the toller typically supplies or pays for the fuel used to run the plant.

An energy management agreement typically requires the "energy manager" to act as a financial intermediary for the power plant, substituting its own credit and liquidity for the power plant to facilitate the power plant's business activities. The energy manager also typically supplies market information and advice to support the power plant's efforts.

have been realized over time.” According to the Federal Reserve, the proposal to rescind such authority would not affect the authority of FHCs to provide derivatives and related financial products and services to power plants or to engage in physical commodities trading. In particular, the Federal Reserve noted that permissible activities may include providing inventory and project finance arrangements involving physical commodities, financially- and physically-settled derivatives to hedge fuel costs and energy prices, buying and selling certain physical commodities in the spot market, and derivative advisory services.

#### Removal of Copper as an Approved Precious Metal

BHCs, not only those that qualify as FHCs, are currently authorized to own and store copper, similar to other precious metals like gold, silver, platinum, and palladium.<sup>13</sup> Under the proposal, copper would be removed from the Federal Reserve’s list of precious metals that BHCs may own and store without limit, on the view that copper has become most commonly used as a base or industrial metal, and not as a store of value. Instead, the purchase and sale of copper would be treated in the same manner as the purchase and sale of other non-precious metals, *i.e.*, as an activity requiring FHC status and subject to the restrictions and limitations (including the 5% of Tier 1 capital cap) imposed on FHCs engaged in physical commodity activities under “complementary” authority. The proposal would also remove copper from the list of metals on which a BHC may enter into physically settled derivatives contracts, although BHCs would still be able to trade in cash-settled derivatives that have copper as a reference asset.

On September 8, 2016, the Office of the Comptroller of the Currency (“OCC”) proposed a similar reclassification of copper under the National Bank Act.<sup>14</sup> The OCC’s rule would supersede OCC Interpretation No. 693 (Nov. 14, 1995), which had concluded that national banks could buy and sell copper under the express authority to buy and sell coin and bullion as part of or incidental to the business of banking.

#### New Reporting Requirements on Physical Commodity Activities

The Federal Reserve is also proposing that FHCs provide more detailed information in their public FR Y-9C (Consolidated Financial Statements for Holding Companies) filings on the nature and extent of, and risk-based capital requirements related to, their physical commodity holdings and activities. The proposed rule would modify the FR Y-9C to (i) create a new Schedule HC-W (Physical Commodities and Related Activities), and (ii) add data items to Schedule HC-R, Part II (Risk-Weighted Assets), each of which would be made

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<sup>13</sup> The Federal Reserve has permitted BHCs to buy, sell, and store precious metals—including, gold, silver, platinum and palladium—for their own accounts and the accounts of others as an activity “so closely related to banking” under Section 4(c)(8) of the BHC Act. In 1997, after trading in copper became permissible for national banks, the Federal Reserve added copper to the list of metals permissible for BHCs to buy, sell and store under its “closely related to banking” authority.

<sup>14</sup> See 81 Fed. Reg. 63428 (Sept. 15, 2016), [available here](#).



publicly available. The new Schedule HC-W would collect specific information on the physical commodity holdings and activities of FHCs, including the total fair value of physical commodities held, broken down by commodity type (petroleum, natural gas, coal, etc.) and applicable authority. FHCs would also be required to disclose whether they engage in certain activities such as the exploration, extraction, production, or refining of physical commodities. Meanwhile, the modifications to HC-R, Part II would require an FHC to report the risk-weighted asset amounts associated with the FHC's engagement in physical commodity activities (including pursuant to "grandfather" authority and merchant banking authority).

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For more information regarding the proposed physical commodity rule, please contact any member of the Firm's Financial Institutions Group, including those listed below.

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