S. HRG. 113–375

REGULATING FINANCIAL HOLDING COMPANIES AND PHYSICAL COMMODITIES

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

SECOND SESSION

ON

EXAMINING NONFINANCIAL ACTIVITIES CURRENTLY BEING PERMITTED UNDER THE BANK HOLDING COMPANY ACT AND THE ECONOMIC IMPACT OF SUCH ACTIVITIES ON THE PHYSICAL COMMODITY AND ENERGY MARKETS AS WELL AS THE SAFETY AND SOUNDNESS OF THE NATION'S BANKING SYSTEM.

JANUARY 15, 2014

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C O N T E N T S

WEDNESDAY, JANUARY 15, 2014

WITNESSES

Additional Material Supplied for the Record

REGULATING FINANCIAL HOLDING COMPANIES AND PHYSICAL COMMODITIES

WEDNESDAY, JANUARY 15, 2014

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

The Subcommittee met at 2:02 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. The Subcommittee will come to order. Thank you to the witnesses, thank you to Senator Reed for joining us. I will make a brief opening statement, then Senator Reed, and a couple other Senators are going to be joining us. Ranking Member Toomey could not make it but was helpful, and I thank him and his staff for working with us on this important hearing.

For years, U.S. banking laws drew sharp lines between banking and commerce, and Congress and regulators and the institutions respected that separation. In 1999, things changed. Congress weakened these laws, and over the last decade regulators have been interpreting and implementing this law, financial institutions have expanded into new and varied lines of business.

As I have said many times, the sixth largest U.S. bank holding companies have 14,420 subsidiaries. The sixth largest U.S. bank holding companies have more than 14,000 subsidiaries; 19 of them are traditional banks. Today we will learn more about the rules for all of these nonbanking activities like trading commodities, owning physical assets, how these rules are applied.

The Fed's proposal yesterday was a timid step. It was too slow in coming. There is still too much that we do not know about these activities and investments. We have still yet to see U.S. regulators address concerns about the aluminum, zinc, and copper markets.

Although the London Metal Exchange, the LME, has adopted new warehouse rules, industrial end users are unconvinced that these reforms will address the problem as premiums and queue lengths have only grown since they were announced.

We are also here to seek answers to some fundamental questions. Let me go through those briefly.

First, what is the appropriate role for banks in the commodities markets?

If their commodities activities provide benefits to customers, do those benefits outweigh the risks and the costs of market manipulation and other harmful practices?

Regulators in Europe and the U.S. have either investigated, or settled with, institutions for manipulating rates in the LIBOR, silver, gold, electricity, and oil markets.

On Monday, it was reported that the FBI suspects that traders at one U.S. bank earned between $50 and $100 million through market manipulation by "front-running" interest rate derivatives orders by Fannie and Freddie.

Today it was reported that the world's largest foreign exchange dealer has suspended several traders suspected of manipulating currency prices. That is one of at least 13 traders at four banks that have been suspended for activities that took place through a group known as "The Cartel" and "The Bandits' Club."

Tim Weiner from MillerCoors testified before this Subcommittee in July that actions by banks in the aluminum market have cost that company tens of millions of dollars in excess premiums over the last several years and cost aluminum users a total of $3 billion last year alone.

Second question: Why are banks allowed to own physical assets?

Most experts that have met with my office agree there is no clear benefit to the economy from banks owning assets like warehouses and tankers and pipelines and coal mines.

Even analyst Dick Bove, author of the book "Guardians of Prosperity: Why America Needs Big Banks", has said that "banks went a little bit too far with the Fed's authorization to get into the commercial side of [the] commodities business[.]"

If everyone but the banks agree, then why are regulators allowing them to do it? This Subcommittee believes that the problems of "too big to fail" are still with us.

Last year, Chairman Bernanke said "too big to fail" is "not solved and gone. It is still here."

Perhaps most importantly, the market believes that "too big to fail" is still with us.

Finally, what are the risks to our financial system, and entire economy when "too big to fail" banks engage in commercial activities?

The Fed's proposal cites the Deepwater Horizon spill; an explosion of a PG&E pipeline; an explosion at a natural gas plant in Middletown, Connecticut; the tsunami and subsequent meltdown at the Fukushima Daiichi nuclear power plant; the derailment of a crude oil cargo train in Quebec; and older disasters like Three-Mile Island and Exxon Valdez.

This morning, the *Wall Street Journal* reported that crude oil railroad shipments have dramatically increased and that cities like Albany and Chicago and Denver and New Orleans may be unprepared to deal with an accident involving this explosive substance.

Morgan Stanley's CEO reportedly told employees that an oil tanker spill at one of its shipping units is "a risk we just can't take." And it is a risk that taxpayers cannot afford to take.

The ultimate question is who pays for mistakes or manipulation that occurs at financial institutions. The answer should be these institutions, their executives, their employees. It should not be customers or taxpayers, but too often that has been the case. It is time for a change.

Thank you again to the witnesses. Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Well, thank you very much, Mr. Chairman, for holding this hearing. It is an extraordinarily important issue, and one aspect that you have alluded to is the energy field. And I can tell you that high energy costs are hurting my constituents. Many of them are struggling just to pay the bills. And according to the U.S. Energy Information Administration, the average wholesale price for natural gas at the New England Trading Point increased 75 percent in 2013 compared to 2012, while the rest of the country saw a 30-percent increase. And EIA's most recent monthly data shows that electricity prices in Rhode Island are nearly 45 percent more than the national average for residential users, 35 percent more for commercial users, and 77 percent more for industrial users. So this is a tremendous burden, and this is one of the things that is inhibiting our growth. Consequently, we have a 9-percent unemployment rate.

So there are many factors involved—infrastructure challenges, pipelines, distribution systems—but I am certainly concerned about the potential for manipulation in the financial markets and the physical natural gas and electric markets. That is why I am looking forward to this hearing.

We already know from the experience in California that it is possible to manipulate energy markets, and we have to be incredibly watchful, and that is why the coincidence of owning physical assets and then participating in trading and other activities has to raise these questions, and I am delighted that the Chairman has seen fit to have this second hearing.

Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Senator Reed.

Let me introduce the panel. Mr. Norman Bay is the Director of the Office of Enforcement at the Federal Energy Regulatory Commission. Welcome. Thank you for your service, Mr. Bay.

Vince McGonagle is the Director of the Division of Market Oversight at the CFTC, Commodity Futures Trading Commission. Thank you for your service to our country.

Mr. Michael Gibson is the Director of the Division of Banking Supervision and Regulation for the Board of Governors at the Federal Reserve System. Thank you also, Mr. Gibson, for your service to our country.

Mr. Bay, if you would begin.

STATEMENT OF NORMAN C. BAY, DIRECTOR, OFFICE OF ENFORCEMENT, FEDERAL ENERGY REGULATORY COMMISSION

Mr. BAY. Chairman Brown and Members of the Subcommittee, thank you for inviting me to testify today. My name is Norman Bay. I am the Director of the Office of Enforcement at the Federal Energy Regulatory Commission. I appear before you today as a staff witness, and the views I present are not necessarily those of the Commission or of any individual Commissioner. I have also submitted prepared testimony that responds to the Subcommittee's questions, and so in my remarks today, I will provide a brief overview of the work of the Office of Enforcement.

In a sense, my office is a legacy of the Western power crisis from 2000 to 2001, and you have alluded to that crisis, Senator Reed. During the crisis Enron and other entities manipulated energy markets in California and the West and ripped off consumers. At the time FERC did not have a general antimanipulation authority, and its penalty authority was limited to $10,000 a day. Thus, a manipulator could manipulate the market every day for a year and face a penalty of $3.65 million, which was hardly even a rounding error for an Enron.

In the Energy Policy Act of 2005, Congress fixed the weakness in FERC's regulatory authority. Congress gave FERC a broad antimanipulation authority based on Rule 10(b)(5) in the Securities and Exchange Act of 1934. Congress also provided a penalty authority of up to $1 million per day per violation. These tools have been critical to FERC's efforts to protect consumers from market manipulation in the wholesale natural gas and power markets.

After receiving its antimanipulation authority, FERC has also built up its enforcement capabilities. By way of comparison, during the Western power crisis, there were 20 staff in the Office of General Counsel who did enforcement work. We now have around 200 staff in a stand-alone office, the Office of Enforcement. We have staff with expertise in the markets who are economists, accountants, and auditors; former traders analysts with highly quantitative skill sets, including mathematics, engineering, statistics, and physics. We also have lawyers who are former prosecutors or who have extensive litigation experience in private practice with some of the finest law firms in the country.

Our staff is organized into four divisions: the Division of Investigations; the Division of Audits and Accounting; the Division of Energy Market Oversight, which focuses on energy market fundamentals, including important trends and developments; and the Division of Analytics and Surveillance, which provides technical support on investigations and which creates and runs automated screens to detect potential market manipulation. These screens are critical to our oversight of the energy markets because, otherwise, there is simply too much data, given the many trading hubs and markets and products, for an analyst to be able to examine that data on a manual basis.

Since receiving its EPAct authority in 2005, FERC has collected about $873 million in civil penalties and disgorgement. One of the top priorities of the office is fraud and market manipulation. Some of our most significant enforcement actions to date include actions against Constellation, which settled for $245 million in 2012 for manipulating the electricity markets in New York; JPMorgan, which settled for $410 million in 2013 for manipulating the electricity markets in California and the Midwest; and Barclays in which the Commission issues a penalty assessment in July of 2013 of $453 million. Barclays has challenged that assessment, and we are currently litigating the matter in Federal district court in the Eastern District of California.

In summary, the antimanipulation authority Congress provided FERC in 2005 has been critical in our efforts to police the energy markets and to detect and to deter and punish market manipulation. You should know that we are committed to doing our best to protect consumers and to further the public interest. Indeed—and I often say this—I am honored and humbled to be working with the many dedicated, talented, and hard-working staff at FERC, particularly in the Office of Enforcement.

In conclusion, I wish to thank the Subcommittee for this opportunity to testify today, and I look forward to answering any questions you might have.

Chairman BROWN. Thank you, Mr. Bay.

Mr. McGonagle, welcome.

STATEMENT OF VINCENT MCGONAGLE, DIRECTOR, DIVISION OF MARKET OVERSIGHT, COMMODITY FUTURES TRADING COMMISSION

Mr. MCGONAGLE. Good afternoon, Chairman Brown and Members of the Subcommittee. Thank you for the opportunity to appear here today. I am Vince McGonagle, and I am the Director of the Division of Market Oversight for the Commodity Futures Trading Commission, CFTC.

The Commodity Exchange Act serves the public interest by permitting derivatives markets, both futures and swaps, to be used to manage and assume price risks, discover prices, or disseminate pricing information. Under the CEA and its mission statement, the CFTC is charged with fostering transparent, open, competitive, and financially sound markets. At the same time, CFTC protects the public and market participants from fraud, manipulation, abusive practices, and systemic risk related to derivatives, while working to ensure the protection of customer funds.

To fulfill these roles, the Commission oversees designated contract markets, swap execution facilities, derivatives clearing organizations, swap data repositories, swap dealers, futures commission merchants, commodity pool operators, and other intermediaries.

The CEA has for many years required that futures transaction, subject to certain exemptions, be conducted on or subject to the rules of a board of trade on a designated contract market. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, DCMs were also permitted to list swap contracts, and various new substantive DCM requirements were established. In addition, the Dodd-Frank Act established an entirely new regulatory scheme for swaps trading and a new category of exchange for swap execution facilities dedicated exclusively to the trading of swaps.

Under the CEA and the Commission's contract and rule review regulations, the terms and conditions of all products are submitted to the Commission before implementation. In listing a new contract, DCMs and SEFs are legally obligated to meet certain core principles. One of the most significant core principles prohibits the listing of contracts readily susceptible to manipulation.

Under this core principle, a DCM or swap execution facility that lists a physical delivery contract must ensure that the contract is designed to avoid any impediments to the delivery of the commodity.

The Commission's responsibilities under the Commodity Exchange Act also include mandates to deter fraud and manipulation of commodities in interstate commerce. Under that authority, the CFTC brings enforcement cases for manipulative activity in both cash and derivatives markets. Notably, the Dodd-Frank Act enhanced the Commission's enforcement authority over manipulative and deceptive actions and expanded that authority to the swaps markets.

The Dodd-Frank Act also established a registration regime for foreign boards of trade who seek to offer U.S. customers direct access to their electronic trading system. An applicants for registration must demonstrate, among other things, that it is subject to comprehensive supervision and regulation by the appropriate governmental authorities in its home country, and that its regulator's oversight of the platform is comparable to the supervision and regulation to which Commission-designated contract markets are subject.

As part of our cooperative enforcement program, the CFTC routinely provides assistance to and coordinates with other domestic financial regulators. In addition, the Commission recognizes that commodity markets are, of course, international in nature and, accordingly, regularly consults with other countries' regulators.

Thank you for the opportunity to appear before the Subcommittee. I will be pleased to respond to any questions.

Chairman BROWN. Thank you very much, Mr. McGonagle.

Mr. Gibson, please.

STATEMENT OF MICHAEL S. GIBSON, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GIBSON. Chairman Brown and other Members of the Subcommittee, thank you for the opportunity to testify at today's hearing. Today I will discuss the history of bank and bank holding company engagement in physical commodity activities, the Federal Reserve's approach to supervising financial institutions engaged in physical commodity activities, and our policy review of commodity activities and investments of bank holding companies.

Prior to the Gramm-Leach-Bliley Act in 1999, bank holding companies were authorized to engage in only a limited set of commodity activities that were considered to be closely related to banking. Under the GLB Act, Congress created the financial holding company framework, which allowed certain bank holding companies to engage in expanded activities under three different provisions.

The first provision, referred to as "Section 4(k) authority," authorizes a financial holding company to engage in an activity that the Board finds to be complementary to a financial activity, but only if the activities do not pose a substantial risk to the firm's safety and soundness or the financial system and the benefits to the public outweigh possible adverse effects.

Second, the GLB Act's merchant banking authority permits a financial holding company to invest in companies that are engaged in activities not otherwise permitted for financial holding companies.

In a third provision of the GLB Act, referred to as "Section 4(o) authority," Congress grandfathered certain commodity activities that are not permissible for bank holding companies if the company was engaged in those activities as of September 1997. No approval or notice is required for a company to rely on this authority for its commodity activities. In contrast to the firms that rely on the Board's authorizations under 4(k) authority, the 4(o) grandfathered firms are also able to engage in the transportation, storage, extraction, and refining of commodities. Only two financial holding companies currently qualify for these grandfathered rights—Goldman Sachs and Morgan Stanley.

The Federal Reserve is the consolidated supervisor of bank holding companies and financial holding companies. As a supervisor of financial holding companies that engage in commodity activities, the Federal Reserve aims to ensure that firms manage the risks of those activities, have strong capital, and have adequate controls over their commodity activities.

The scale and complexity of commodity activities of financial holding companies expanded in 2008 as a number of securities firms with significant commodity activities either became bank holding companies or were acquired by bank holding companies. As a result, the Federal Reserve expanded the scope of its examination and review of physical commodity activities. However, the Federal Reserve has no direct role in overseeing the commodity markets generally. The CFTC regulates commodity futures and option markets and over-the-counter commodity derivative markets. Other agencies, such as FERC, also regulate segments of the physical commodity market.

The Federal Reserve has been conducting a detailed policy review of the commodity activities and investments of financial holding companies. The scope of our review covers all of the 4(k), merchant banking, and 4(o) authorities I listed earlier. Yesterday the Board issued an Advance Notice of Proposed Rulemaking, or ANPR, to seek public comment on a range of issues related to the commodity activities of financial holding companies.

In particular, the ANPR discusses the unique tail risks of commodity activities exemplified by the recent Deepwater Horizon oil spill and many other incidents that you mentioned, Senator Brown, in your opening remarks. The ANPR discusses the additional contagion risks that commodity activities may pose to systemically important financial institutions, the Board's concern that current safeguards and safety and soundness considerations may not be adequate to address those risks, recent evidence that commodity activities may not be as complementary to banking as was previously believed, and what further prudential restrictions or limits on commodity activities are warranted to mitigate these risks.

I look forward to answering any questions you may have.

Chairman BROWN. Thank you, Mr. Gibson. Thank you to all of you.

Mr. Gibson, the Fed, as you have pointed out, sought public comment yesterday to help inform its consideration of physical commodity activities conducted by these financial holding companies. It is encouraging to see the Fed rethinking the issue. These exemptions have existed since 1999. The first complementary order was

2003. Some of the disasters cited by your ANPR we just talked about—for example, the Exxon Valdez—are not recent events. So the questions are: Why now? Why did it take so long? Aside from the vote on the ANPR, have there been any other Board-level discussions or deliberations or meetings about physical commodities?

Mr. GIBSON. I think that the staff and the supervision staff have been working on the issue of banks' and financial holding companies' physical commodity activities since 2008 when, as I mentioned, we got a lot more authority over securities firms that either became bank holding companies or were acquired by bank holding companies, and that dramatically expanded the scope of commodities activities. We started doing more in-depth review at that point, and following on from that, which raised a number of concerns, and is discussed in the ANPR, really the question of whether certain risks such as the unique tail risks that certain commodities pose, along with the expanded activities, as well as the lesson from the financial crisis that contagion risks of systemically important financial institutions can pose a risk to financial stability, those were some of the factors that made us take another look at the risks and have led to the process up to issuing the ANPR.

We have had a number of meetings over the years that have worked on this issue and led up to the ANPR, not open Board meetings, but staff-level meetings.

Chairman BROWN. I still am a bit incredulous about the speed at which this was done. Professor Omarova, who came to this Subcommittee in July, stated that there is "no meaningful public disclosure of banking organizations' assets and activities related to physical commodities and energy." A fundamental difficulty with this type of inquiry seems to be opacity, a lack of knowledge about the size and scope of commodities held by banks and other traders. None of us knows the quantities and the extent of this.

Commissioner Bart Chilton—Mr. McGonagle is one of his bosses—sent me a letter that I got today saying that he has been trying for months to obtain useful ownership information from the Fed about physical commodities—now, this is another regulatory agency—but got not response.

Tell me, if you would, how much aluminum does Goldman Sachs hold?

Mr. GIBSON. I do not know off the top of my head exactly the answer to your question.

Chairman BROWN. Does the Fed know?

Mr. GIBSON. What we do require banks to disclose on their quarterly financial reports, that are public regulatory reports, they do disclose the amount on their balance sheet of physical commodities that they hold, and that is a required public disclosure.

Chairman BROWN. So the answer is yes, the Fed knows. But does the Fed release that to anybody?

Mr. GIBSON. That is available publicly. You can download it from our Web site.

Chairman BROWN. So why would——

Mr. GIBSON. But that is an aggregate number, all commodities. It does not break it out by individual commodities.

Chairman BROWN. So how can we comment on this ANPR? I mean, it just seems to me the process is stacked in favor of the banks, that the information is not forthcoming. The Fed has moved extraordinarily slowly on this. Another regulator of equal stature, as far as I am concerned, cannot get information. How are we going to begin to exercise effective oversight when this information is simply not forthcoming?

Mr. GIBSON. In addition to the aggregate numbers that banks disclose in their public regulatory reports, as public companies, they file SEC quarterly and annual reports that disclose and discuss all their material risks. If a bank holding company has a material exposure to commodities, the commodities business, they are required to discuss those risks in their public SEC disclosures. So this is another public source of information.

Chairman BROWN. So after this hearing, will the Federal Reserve be more—understanding some of this information is not delineated and broken down in the detail that I think other regulators and this Subcommittee and others that want to oversee this can understand and can get access to, but can you promise us that the Fed will be more forthcoming with this information in more detail, and if you do not have all the information, you will ask questions of these financial institutions?

Mr. GIBSON. What we have done in the ANPR is asked a series of questions which we hope elicits some of the information that you are talking about. We have our own information that we get from the supervisory side, but we also are interested in the public comment, comments from the industry and others, to help us inform the discussions as we go forward.

Chairman BROWN. I am not sure, though, that the public comment can be as helpful and as incisive in its questions and as illuminating as it could be if they—because they do not have access to enough of this information. So I implore you to make more of this available in a form that other regulators, like Bart Chilton and congressional oversight and all can see it.

Let me ask you something else. Morgan Stanley currently has 133 legal entities it holds under, you mentioned, the 4(o), including TransMontaigne, a wholly owned subsidiary that stores, refines, transports gas, gasoline fuels, crude oil, and other liquid products. Section 4(o) says that institutions that were not banks before Gramm-Leach-Bliley passage “may continue to engage in”—this was the Morgan Stanley, Goldman Sachs, obviously, as you know, it turned out to be that—“may 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” if they were engaging in “any such activities prior to 1997.” You know all this.

A 2012 article by staff of the New York Fed, you know, the regional Federal Reserve Bank responsible for the largest U.S. banks, said, “The legal scope of the 4(o) grandfathered exemption is widely seen as ambiguous. It is unclear to what extent it allows firms to purchase new hard assets relating to an existing commodities business or to expand into new commodities markets.”

This is staff from the largest—from the regional Federal Reserve Bank responsible for the largest U.S. banks. They say the law is ambiguous, 15 years since the law’s passage, more than 5 years after institutions have become eligible to use this provision.

Can you to this Subcommittee clear up this ambiguity by explaining the meaning of “any such activities”? And can a financial holding company that was not a bank holding company, meaning these two, and was trading a single commodity like silver prior to 1997 begin trading other commodities like zinc or electric generation or a whole host of other things? Would you answer those two questions?

Mr. GIBSON. What is clear is that the authority that Congress granted under Section 4(o) which is currently being used by Goldman Sachs and Morgan Stanley as the authority to do a wide range of commodity businesses is very broad. It allows them to own the storage, transportation, refining, and extraction of physical commodities. And in contrast, the orders that the Board has granted under Section 4(k) authority are more limited, impose tighter limits, do not allow ownership of storage, transportation, extraction, and refining. So that is an important difference that we have taken into account in our review, and we describe this in the ANPR, the fact that—as we ask questions in the ANPR and look ahead to what the next step will be, there are different legal avenues we have to take more restrictive actions against activities that are done under the Section 4(o) authority compared with the Section 4(k) authority.

That is an important issue that we are trying to address in the ANPR, solicit comment on, and decide on the way forward.

I am not a lawyer, so I cannot give you the legal interpretation of what exactly it means. I certainly expect we will get some public comment on that. You are right to focus in on the fact that there is an interpretation issue there, and it is one of the things that is an issue for our review.

Chairman BROWN. You are not a lawyer, and neither am I, and a number of us up here I think are not. But you are enforcing the law, so that is pretty important.

Are there limits, and what are they, on 4(o)? In other words, if a company—prior to 1997, one of these firms traded zinc, can they trade aluminum? If they did not own a warehouse, can they own assets like warehouses and pipelines and tankers under this provision? What are the limits of 4(o)?

Mr. GIBSON. There is a limit under Section 4(o) that states that the aggregate amount of physical commodity assets can be no more than 5 percent of a firm’s total assets. But that is a very wide limit, and compared with the Section 4(k) authorities that the Board has granted, the Board has imposed a much tighter limit of 5 percent of Tier 1 capital. Since the capital is much smaller than the assets, the 4(k) limits are, in effect, much tighter than the 4(o) limits. So that is a big difference.

In terms of what is the legal interpretation of the text in Section 4(o) about activities that were engaged in in 1997, that is one of the issues that we are looking at in our review, and we have asked for public comment on that.

Chairman BROWN. Thank you, Mr. Gibson, for your patience. I get the percentages, the 5 percent, but in terms of activities, so specifically if they traded in zinc prior to 1997, can they now trade in aluminum? If they had no warehouse, can they own a warehouse or own a pipeline or purchase and own an oil tanker?

Mr. GIBSON. You are not asking for a general answer, but starting with generally, they are restricted to activities that they were doing prior to Gramm-Leach-Bliley.

Chairman BROWN. And zinc means zinc, zinc does not also mean aluminum?

Mr. GIBSON. It is going to depend on the facts and circumstances of the particular case, so beyond saying that that is one of the things we are considering in our review, I think that is where we are at.

Chairman BROWN. It really does seem like—and I hate cliches, but I am going to use one—the camel's nose under the tent here. They qualify because they did some of this prior to 1997, but they are getting to do a whole lot more.

But let me close with one other question, and then I will turn it to—then we will do another round if Senators really want to after Senators Reed and Merkley and Warren go. Section 5 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 of its bank subsidiaries." The primary role of all of us is the safety and soundness and stability of our financial system. My editorial comment, of course.

As I said in my opening statement, James Gorman—I did not say his name, but he reportedly told Morgan Stanley employees that an oil tanker spill in one of its shipping units is "a risk we just cannot take." So my question is: Can the Fed use its general safety and soundness authority to curtail some of these 4(o) activities? Could it use Section 5 authority to force these financial holding companies to divest themselves of subsidiaries that expose it to undue risk—a huge oil spill, a tank explosion? Whether they are grandfathered or not, do you have the authority to force their sale of these activities, ceasing of these activities and sale of these commodities?

Mr. GIBSON. We certainly have the authority under general safety and soundness considerations to impose restrictions, impose capital requirements, impose risk management requirements, and other requirements on those activities and any activities. And we also have, as you mentioned, authority under Section 5 to require a financial holding company to terminate certain activities if the activity constitutes a serious risk to financial safety, soundness, or stability and a number of other conditions. So we have both of those.

Chairman BROWN. Have they ever been used?

Mr. GIBSON. Section 5? I do not think so.

Chairman BROWN. OK. It just seems that——

Mr. GIBSON. Again, I am not a lawyer, but my understanding is it is a high bar to use that authority.

Chairman BROWN. Well, it is a high bar except when the CEO of one of these two says it is "a risk we cannot take." When you think of the cost of any institution, you know, if it is owned by an oil company, it is an oil tanker, and there is a terrible problem, that is tragic for everybody involved. But it does not have the potential damage to our economy. These do because these are financial—these are bank holding companies or financial holding companies. And, I mean, you understand risk. And that the Fed in this many years has never acted on the authority it has suggests to me that something is not right in our regulatory system.

Mr. GIBSON. And the concern you mentioned is the same concern we have, that we described in our ANPR, and that we are confronting in our review.

Chairman BROWN. It did not seem to be a concern that—it seemed to be a bit of a distant concern because of just the slowness of getting to this. OK.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

We are talking about simply two categories, Mr. Gibson, 4(k) and 4(o) operations. So let us look a moment at 4(k) complementary authority, which requires the Fed to make a determination that the activity is to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

Just as a specific interest point, how do you measure this issue of undue concentration of resources?

Mr. GIBSON. When that net benefit test is looked at in connection with the 4(k) complementary authority, it is a general balancing of all of those issues and trying to get a sense of on balance do the benefits exceed the costs. But I do not think we have a specific methodology that produces a number that would be that specific.

Senator REED. It is very subjective.

Mr. GIBSON. Yes, it is subjective.

Senator REED. So now you have made the determination under the 4(k) authority that it passes this subjective test. Do you continuously evaluate whether it continues to serve the public interest or do it on a regular basis?

Mr. GIBSON. Generally, the way it works under the Section 4(k) authority is that a bank comes and requests permission to engage in a particular activity.

Senator REED. Right.

Mr. GIBSON. And then we do the review that is required. Once the approval is granted, then we are focused on the risks on an ongoing basis, safety and soundness considerations, making sure that the bank has adequate risk management and capital.

Senator REED. So the public interest aspects of the test sort of go by the wayside, and the concentration is on simply the safety and soundness of the banking institution and risks that they might be taking. That is what you just said.

Mr. GIBSON. That is what we focus on in our ongoing supervision.

Senator REED. Yes. That is what you just said, so the public interest test, it is fire and forget. So you clear that first hurdle, and their activities over time, if they serve the public interest that is incidental to your interest. I mean, I am not putting words in your mouth, but it——

Mr. GIBSON. That is the way it is set up in the statute, but as part of our review, we have asked questions about what information people can give us on the net benefits and costs on those specific factors you mentioned.

Senator REED. So in this issue of being complementary, for example, it could be complementary for a financial holding company to own physical assets, which, through business decisions that are prudent, could increase the value of their financial holdings. Is that what we mean by—even though it would produce additional costs to the public, is that complementary?

Mr. GIBSON. No. What is meant by complementary is that there is some activity that a bank is engaging in that is a financial activity where the physical commodity or other activity is closely related to it. That is what is meant by complementary.

Senator REED. But you do not look at the interaction between holding that physical commodity in some way, shape, or form and the investment portfolio of the banks, the holdings of the banks, and what they are doing? If it is just generically, well, we trade in gold and we can own gold, is that the test?

Mr. GIBSON. We would look at conflicts. We would expect banks to have policies and procedures in place to manage conflicts of interest that could arise from the fact that they might be trading something on one side and investing in something on another side. That is a general issue that we would always worry about and insist on.

Senator REED. Sure. But I think the point—and this is one of the reasons why we have seen these problems that the FERC has reacted to, we all react to, is having a policy and that is what you look at as fine, but having the capacity to look on a fairly regular basis at what they are actually doing, do you have that capacity at the Fed?

Mr. GIBSON. Yes, we do look at what they are actually doing.

Senator REED. So you are looking at their trading activity, is it in any way related to decisions by their commodities subsidiary in terms of pricing, in terms of access to materials in the marketplace? Do you make those judgments?

Mr. GIBSON. We are generally looking at the activities that the firms are engaging in, the risks, the risk management that they have around those activities, and the capital. So——

Senator REED. But you are not looking at the effect on the market in terms of, for example, the brewers, that the price of aluminum is going up dramatically, that you have people that are dealing in financial matters and also dealing in the commodities, you are not concerned about that, or you do not do that?

Mr. GIBSON. We are not the regulator of commodity markets, so if there is market manipulation that is going on in commodity markets, it is not our primary——

Senator REED. I know, but when things happen, they come to you. And you also are responsible for the management of all of these companies, that they have the capacity to manage it, that they just do not have risk policies in place but they are actually doing things that are, according to the 4(k) order at least, in the public interest.

Mr. GIBSON. And we have seen a lot of problems at banks recently with having inadequate compliance functions and inadequate controls.

Senator REED. And what steps have you taken besides reporting——

Mr. GIBSON. We take supervisory measures, and we take enforcement actions. And this is broader than just commodity activities. We have seen——

Senator REED. I understand that, but what enforcement actions have you taken with respect to commodity activities?

Mr. GIBSON. Well, again, with respect to commodity market manipulation, that would not be our province because we are not the market regulator. With respect to——

Senator REED. Well, then, what do you do when you discover it?

Mr. GIBSON. With respect to banks having inadequate controls or compliance functions——

Senator REED. No, no. When you discover—your people who are in those banks every day, unlike FERC, what happens when you suspect that there is something amiss?

Mr. GIBSON. If we find a problem, the first thing we would do is raise it and require the bank to fix the problem. And if it requires an enforcement action, then we would take that extra step to do an enforcement action, put it in writing, and follow it to make sure the problem gets fixed.

Senator REED. And how many enforcement actions have you taken in this regard?

Mr. GIBSON. I do not have a particular count of exactly how many enforcement actions——

Senator REED. Can you——

Mr. GIBSON. We can find out.

Senator REED. Thank you. I appreciate that.

And then, again, two, in the 4(k) realm, I am under the impression that in this process, which is not unusual or unique to the bank holding company or financial holding company, there are certain representations that are made with respect to what they will do. Are you checking those? For example, I have been informed that in order to own some of these ships, the financial holding company represented, that they put age limitations on vessels that are carrying oil and requiring such vessels to carry maximum insurance for oil pollution. Do you regularly check that?

Mr. GIBSON. Yes, we do. There are a number of limits that are imposed as part of the 4(k) orders that we have done. And as part of our follow-up supervision, we look at those, and we follow up on those.

Senator REED. Just a final point because my time is expiring. One of the issues that becomes so clear from 1999 here to today is that the vision of these integrated companies that provide services to their clients, and some of it in a more cost-effective way and a more efficient way, is a good vision. But the presumption is that the company itself has the managerial capacity to do it well, and that Federal regulators have the managerial capacity to supervise them. And there is always this dogging question in my mind of whether you have the capacity—I think you have the intent; I think all of you have the intent, but whether you have the capacity both legally and operationally, with personnel, et cetera, to do this and are doing it on a regular basis so that you can assure not only myself and my colleagues but, more importantly, people that you are on it. For example, those energy prices that are very, very high are not the result of decisions that are being made in these organizations that control both the physical resource and have huge financial levers to move markets.

Can you give us that assurance? Do you have that capacity?

Mr. GIBSON. Our mission in bank supervision is to make sure the banks operate in a safe and sound manner.

Senator REED. Well, see, there is a difference with safety and soundness. I think we found that out. There can be a lot of safe and sound institutions that are not providing significant public benefits versus private benefits which they are earning, which goes to the safety and soundness. A lot of the decisions that were made prior to the collapse were simply because regulators were more concerned about safety and soundness than they were about consumer protections, fair market operations, you know, et cetera. So the notion of that, "Well, we make sure they are safe and sound," that is somewhat reassuring, but that is not the entire scope.

Mr. GIBSON. Yes, I understand, and I already explained others are focused more on market oversight and market manipulation. But we do pay attention to compliance and controls.

Senator REED. I appreciate your response, and thank you.

Thank you, Mr. Chairman.

Chairman BROWN. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chairman.

Mr. Gibson, the AE–10 notice that the Fed put out yesterday, what is behind the timing of this?

Mr. GIBSON. The timing of the ANPR that we put out yesterday? We have had a review underway for a while now on the risks associated with financial holding companies' commodity activities, and we felt like we were at the stage where it was the right time to put out to the public what our concerns were with the risks, what the structure of the legal authorities that we have talked about here today is, and ask for public input on what actions or remedies might be desirable.

Senator MERKLEY. So this conflict between commodities and holding and trading has been in existence a long time. Why not 4 years ago?

Mr. GIBSON. It was in 2008 when the Fed got oversight for a lot of commodity activities that were previously done in securities firms that became bank holding companies or were acquired by bank holding companies. So after that, we really staffed up in our supervisory function to look at some of these new activities that had not previously been that significant within financial holding companies. Based on what we started to learn with the examination starting in 2009 and going forward, that built up then into the policy review that took us to yesterday putting out the ANPR detailing the concerns and asking for public input.

Senator MERKLEY. There have been various articles saying that the FERC was really paying a lot of attention to these types of issues and that the Fed was asleep. Is that a fair characterization?

Mr. GIBSON. Which type of issues?

Senator MERKLEY. They were paying a lot of attention to commodities issues, particularly the trading of electricity, which is in their jurisdiction, but the Fed in its area had been asleep. Is that a fair characterization, the Fed just woke up?

Mr. GIBSON. No. I would say that FERC——

Senator MERKLEY. OK. Let me ask you this question: Firms argue that they have a Chinese wall, that they can own vast amounts of commodities, including the means for delivering those commodities, in one part of their firm. Another part of the firm that is deeply involved in trading through their market making, through their wealth management, that no information travels back and forth, there is no advantage. Do you believe that that is the case?

Mr. GIBSON. Well, we require firms to have policies around——

Senator MERKLEY. No, not policies. Do you believe that a Chinese wall is a perfect creation? And let me just remind you, the public has been following not only what happened in the case of power manipulation with Enron but power manipulation with Goldman Sachs—excuse me, JPMorgan. They have been following the LIBOR manipulation, the hard currency manipulation. Does a Chinese wall—is it a powerful separation in firms that no information passes back and forth?

Mr. GIBSON. I think there have been a lot of problems in some of the firms that you mentioned around market manipulation, and we have seen a lot of investigations, and we have seen a lot of enforcement actions——

Senator MERKLEY. OK. Let me ask all three of you the same question. It is a pretty simple yes or no. Is a Chinese wall a perfect instrument and we should rest easy that you can do these two things in the same firm without information passing back and forth? Mr. McGonagle, is it a perfect instrument, the Chinese wall?

Mr. MCGONAGLE. When people are involved, no instrument is perfect.

Senator MERKLEY. Thank you.

Mr. Bay.

Mr. BAY. I would hesitate to rely on that alone, Senator Merkley.

Senator MERKLEY. Thank you.

Mr. Gibson, one more chance to answer the question.

Mr. GIBSON. No, no Chinese wall is perfect.

Senator MERKLEY. OK. So since under your 4(k) authority you are supposed to be looking out for the soundness of the financial system generally, is this an area you—you are seeking information from the outside, you know, comment if you will. But is there—why allow this to exist? If you were in a policy mode, would you say this is a good policy to allow these two activities to take place where a firm with enormous assets can control the supply and demand of a product while at the same time trading on the product? Is that a good policy strategy if you were advising us on what Congress should pursue?

Mr. GIBSON. What we have highlighted in our ANPR that is asking for comment is the fact that there are a lot of risks which are difficult to size, difficult to dimension, could be very large, associated with some of the commodities activities that financial holding companies are engaged in now. And we learned in the financial crisis about the fragility and contagion risks that those companies are subject to, and that is one of the factors that is making us rethink the current situation.

Senator MERKLEY. OK. Let me ask you about the 4(o) portion. If such a conflict of interest is inappropriate for firms that are currently banks, why should new groups that were, if you will, outside the commercial banking world but then get a commercial banking license, why should they be allowed to do the activity? Why should Goldman be allowed to do it, why should Morgan Stanley be allowed to do it, if other entities in that space are not allowed to do it?

Mr. GIBSON. Congress created the 4(o)——

Senator MERKLEY. I understand. I am asking a policy question. I am not asking a history lesson.

Mr. GIBSON. I think it is a good question why some companies should have different authority than others, and broader authority.

Senator MERKLEY. So it is reasonable to assume that if the risks are such that this rule applies to some groups, that risk would inherently exist for the other firms that are coming in through a doorway that bypasses that restriction.

Mr. GIBSON. Yes, and we talk about in our ANPR the fact that some of the risks are the same. But the limits and restrictions are different because of the different authorities.

Senator MERKLEY. Does the trading—does the fact a firm might hold a lot of aluminum warehouses and proceed to control the supply and demand of aluminum or in any other commodity like that, is that kind of equivalent to a tax on the financial system by inflating the costs that the end user pays?

Mr. GIBSON. Are you asking me?

Senator MERKLEY. Yes.

Mr. GIBSON. I would not call it a tax. I would call it—the way the companies choose to organize themselves, they are dealing with their customers and they are providing the service to their customers. And what we look at is more are they doing it in a safe and sound manner, do they have enough capital to back up the risks that they are taking as they provide those services.

Senator MERKLEY. But aren't you also supposed to look at the impact on the financial system generally?

Mr. GIBSON. Yes.

Senator MERKLEY. And does it impose higher costs on—does everyone buying aluminum cans to put their beer in pay a little bit higher price because of that type of control over supply and demand?

Mr. GIBSON. I do not know the answer to that question.

Senator MERKLEY. Would anyone else like to comment on this and whether there are costs passed on to the end user as a result of some of these conflicts of interest?

Mr. MCGONAGLE. Certainly for the CFTC, one thing that we would be evaluating and trying to get a handle on, market position or price impact, is the size of a position that any trader might hold, and concentration of a position can lead to concerns about impact on price. So that is going to be an area that we would be focused on.

Senator MERKLEY. Thank you, Mr. McGonagle.

And, Mr. Bay, in the case of electricity trading, do you see an impact on the end user?

Mr. BAY. Anytime there is fraud or manipulation, there is an impact on the end user, and, invariably, that cost is borne by consumers.

Senator MERKLEY. Thank you all very much.

Chairman BROWN. Thank you, Senator Merkley.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. Thank you for holding this hearing and for your leadership in this area. I think your focus on this set of issues has already benefited consumers and helped some small businesses. I think you are starting to move things. And I want to echo your comments about the Fed's decision yesterday, certainly a step forward but a meager one.

I think we already have ample evidence that the Fed needs to place additional restrictions on how banks trade and warehouse physical commodities to reduce systemic risk and to protect consumers from market manipulation. And I hope once the public comment period ends that the Fed will act quickly to put those restrictions in place.

You know, the Fed history here is very troubling. We still have not recovered from the failures of the Fed and the other banking agencies to limit systemic risk and protect consumers leading up to the 2008 financial crisis. And as important as it is for the Fed to put time and resources into monetary policymaking, we have learned the hard way that there is also a need for the Fed to pay a lot more attention on the front end through their regulatory functions and to better protect us all.

So let me just start with a quick question for Mr. Gibson. If we reinstituted the protections of the Glass-Steagall Act, as the bill I introduced with Senators McCain, Cantwell, and King would do, would the Fed still be in the position where it had to decide whether trading in zinc is OK but trading in aluminum is not, or how much insurance an oil tanker should carry? Mr. Gibson.

Mr. GIBSON. I do not know the detailed provisions of your bill, but there certainly would—if the authorizations that financial holding companies have to do these commodities activities were removed, then, no, we would not have to worry about that.

Senator WARREN. So the Fed would not be in that business?

Mr. GIBSON. Right, because it would not be a permitted activity, period.

Senator WARREN. That is right. Well, I have to say that sounds pretty appealing to me.

I want to turn to the enforcement side of this issue as well. Senator Markey and I sent a letter to FERC in July with some questions about the settlement with JPMorgan over claims of energy market manipulation. And I appreciated the very prompt and very thorough response that I received back from the FERC Chairman, and I have a few follow-up questions about FERC and the FTC—FCTC—I am saying it backwards—the CFTC's coordination in this area.

So in its response to my letter, FERC said that it needed access to the CFTC's large trader report so that it could effectively look for possible manipulation in the energy markets. And the large trader report identifies individuals and institutions that have made large transactions in the futures market.

Mr. Bay, could we start by having you explain briefly why access to the large trader report is so important to FERC's efforts to monitor the energy market and energy market manipulation?

Mr. BAY. Thank you, Senator Warren. So FERC receives data on the physical gas and power markets, and the Commission has issued a number of rulemakings over the years to get even more data. That data has been very helpful for us in terms of beefing up our market surveillance. But the regulatory construct behind FERC and the CFTC was fashioned years ago when there was basically a physical market for energy and then there was a very, very small financial market.

For example, the first oil derivative was not issued by NYMEX until 1978. The first natural gas futures contract was not issued on NYMEX until 1990. The first electricity derivatives was not issued on NYMEX until sometime after that.

But what has happened is that whereas at one time the physical market was much bigger than the financial market, that is, the derivatives market, the converse has now occurred. And with respect to cross-product manipulation, you can think of them as having three components: there is a tool, there is a target, and there is a benefiting position.

Typically the tool is some sort of trading activity that affects the value of a physical commodity product, right? So you do something, you trade maybe in a way that is even uneconomic with respect to the physical transaction, but you are doing that because you are trying to move prices.

But then, to complete the manipulation, you need to have a benefiting position, and that benefiting position invariably in the investigations that we have done involving cross-product manipulation has involved a financial product.

And so if we had access to more financial data, it would allow us to create both more sophisticated but also more sensitive and efficient algorithms, screens that we would run against the data that we receive.

I am pleased to say, however, that FERC and the CFTC entered into an MOU in which the CFTC agreed to provide data to us for surveillance purposes, and we look forward to having discussions with the CFTC to get that data.

Senator WARREN. Well, so that was actually my question in this because I wanted to follow up about the coordination between the two agencies. It is not just that you decided to do it. Dodd-Frank required that the CFTC and FERC agree on principles for sharing data, so the two agencies together could more effectively monitor market manipulation than either one of you would be able to do alone.

It took 3½ years for you to work this out, but I understand that it was 2 weeks ago that you just entered into an agreement for how to share data. But as I understand it, the CFTC at that point did not commit to share the large trader report with FERC. So I am concerned about this and just want to make sure that I understand this.

Mr. McGonagle, I am concerned if the CFTC is unwilling to share this piece of information. Is it right that you have not yet agreed to that? And if so, can you explain why?

Mr. MCGONAGLE. Thank you, Senator. With respect to surveillance, access to information, we have invited FERC staff to come to CFTC premises while we work out a protocol that ensures that the information that we receive within our records and rules, as mandated by Congress for confidentiality concerns, that that information can be transferred and shared in a way that satisfies our obligations. And so in the interim, we have offered to work with FERC staff so that they can have access to the information.

I should also point out that certainly since 2005 and before, as part of the 2005 Memorandum of Understanding that we have with the FERC, and just as an overall matter, our cooperative enforcement relationships with all other Federal regulators, when it comes to information sharing, particularly with respect to enforcement investigations, we have worked very diligently with FERC, received information from FERC as well, as we do with other agencies. And so this is one additional aspect, surveillance, layered onto what I view as an already strong, cooperative enforcement relationship.

Senator WARREN. So let me just make sure that I understand this, Mr. McGonagle. I do not want to miss this. So you are making the large trader report available to FERC people in any investigation. They have to come to your place to do it, but it is available? Is that right?

Mr. MCGONAGLE. That is right, and then——

Senator WARREN. Fully available?

Mr. MCGONAGLE. Fully available.

Senator WARREN. OK. And that is your understanding, too, Mr. Bay, that it is now fully available?

Mr. BAY. We sent staff to the CFTC last week, and they were able to access the large trader report. That was a step forward. What we are hoping to receive at some point—and this is a detail to be worked out under the MOU. We believe that the MOU supports this. What we are hoping to receive is an ongoing live data stream of the relevant financial data for the gas and power markets from the large trader report.

Senator WARREN. OK. And, Mr. McGonagle, I understand from you that the only reason this has not been done is that you have concerns about working out the details about confidentiality. That is what I thought I heard in your answer, that there is more that FERC needs to do in order to reassure you about the confidentiality of the data they are receiving? Is that right?

Mr. MCGONAGLE. That is effectively correct. The FERC has guaranteed that they would maintain the confidentiality provisions that we are also obligated to under Section 8. The questions—there are questions sort of around data transfer issues, and the technical personnel need to work those things out, and that process is ongoing.

Senator WARREN. I am sorry. So you are saying that the confidentiality issues have been worked out, but you have still got some technical data issues. Forgive me for pushing on this, but I think it is a really important point. Market manipulators do not respect jurisdictional boundaries between agencies. In fact, they try to exploit those boundaries and take advantage of gaps in oversight and in data sharing. And that is why it is absolutely critical that the Commodity Futures Trading Commission be willing to share these data on an ongoing, timely basis with FERC.

And so the reason I ask about this is I want to hear that we are going to protect consumers, we are going to protect the public by making sure that these data are shared. I will follow up on this, but I sincerely hope I will not need to because all of this is resolved and that those data are going smoothly and quickly over to FERC as well. Thank you.

Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Senator Warren.

Before we move on, I want to ask unanimous consent that the following two documents be included in the record of today's hearing: the letter which I cited from Commissioner Chilton and a statement from the North American Die Casting Association, which has been affected by this issue. Without objection, so ordered.

Mr. Gibson, back to you. You give 4(k) orders. You can take them away, right?

Mr. GIBSON. Yes, that is right.

Chairman BROWN. OK. There is an old adage that it is easier to ask forgiveness than it is to get permission. That seems to be the way that Wall Street has approached this in a number of cases. Let me give you an example.

In 2005, JPMorgan requested the authority to engage in complementary activities, requesting the ability to "make or take physical delivery of, and in some instances store, certain commodities." The Board's 4(k) complementary order for JPMorgan said it is not authorized to own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities to protect the bank from storage risk, transportation risk, and legal and environmental risk. They cited—in this complementary order they cited the risks.

Five years later, JPMorgan Chase—or JPMorgan, excuse me, purchased assets from RBS Sempra, including the Henry Bath Company, which owns an LME warehouse. We still do not know the outcome, but we do know that they were turned down for a complementary order in 2005, but in 2010 it still seems to be pending, the 5-year clock not expired by using a different legal provision. Instead of complementary, they are using merchant banking.

But if the risks are there, the risks exist to the financial system that JPMorgan wanted to purchase something in 2005, the risks were there under the complementary order, why would the Fed allow this to happen under the merchant banking provision?

Mr. GIBSON. The risks of certain activity exist regardless of which authority a financial holding company is using, but as we talk about in the ANPR, the restrictions that we can impose and the legal treatment are different, depending on which authority they are using. One of the things we have to evaluate going forward as we look for what actions to take is we might have an ultimate goal that might require different actions with respect to 4(k) authority or with respect to merchant banking, and we already talked about 4(o) authority gives us even less ability to impose restrictions.

Chairman BROWN. So 4(k), under 4(k) authority, you do not have an ability to find a way to minimize that risk to JPMorgan in this case, but under merchant banking you might be able to minimize the risk for the same purchase of the same entity?

Mr. GIBSON. We have the most ability and have imposed the most limits on the 4(k) authorities that we have granted, and we have imposed, as you mentioned, tight limits——

Chairman BROWN. I said it backwards.

Mr. GIBSON. Oh, OK. Under merchant banking there is pretty broad authority granted in Gramm-Leach-Bliley, which does not require any approval, to invest in nonfinancial businesses. Now, one of the limits that is imposed on that is there is a time limit, so it is a 10- or 15-year time limit for merchant banking investments. The company is not allowed to manage or operate it. And we do have capital requirements, which are relatively tough, on merchant banking investments.

Chairman BROWN. And under the merchant banking provision, you expect them to buy it and sell it. That is the purpose of the merchant banking provision.

Mr. GIBSON. Yes.

Chairman BROWN. And they have 10 years to do that.

Mr. GIBSON. That is right.

Chairman BROWN. And they bought this in 2010, and you have not yet given them retroactive, for want of a better word, permission, correct?

Mr. GIBSON. You are talking about Henry Bath?

Chairman BROWN. Yes.

Mr. GIBSON. They purchased it in 2010. It was part of a larger acquisition, as you mentioned, and the way we look at acquisitions like that is that if the bulk of the acquisition is a permissible activity, they are allowed to include a small amount of impermissible activities, but then they are required to divest it. And that is the basis on which they purchased the Henry Bath business. They have not been given any authorization to permanently hold it, and they are in the process of divesting it.

Chairman BROWN. They are in the process of divesting it. What does that mean?

Mr. GIBSON. It means we have given them a time limit, and they are giving us quarterly reports on their progress at divestiture. They have presented a plan for how they are marketing the business, and we are having quarterly updates from them, monitoring their progress on the plan, and they have an ultimate time limit.

Chairman BROWN. And leading up to this hearing, a number of—a couple three reporters said, well, is this still an issue? Because these financial institutions are starting to sell some of these commodities and some of these things they own, but there is no real evidence that they have actually sold them, which sort of begs the question how hard it is to do this. The Fed's order, 2005 order, limited JPMorgan to only exchange-traded derivatives to prevent investments in things like real estate that, in the Fed's words, "lacked fungibility and liquidity." Now that they own fiscal assets, there are reports that the process of selling these warehouses has been awkward and challenging, which isn't that the exact risk the Fed was trying to avoid, to prevent these institutions from investing in things like real estate? Isn't that—I mean, why do we allow these acquisitions when there is some likelihood that they will be very hard to divest themselves of at some point in the future?

Mr. GIBSON. Again, the different authorities allow financial holding companies to do different things. Under merchant banking authority, firms are typically investing in whole companies, which are not very liquid, and that is why there is a long holding period attached to that, because it is intended to be a long-term investment.

Under the 4(k) authorities that we have granted for ownership of physical commodities, those have been limited to a small number of commodities that are judged to be liquid, which the general standard is traded on an exchange or futures exchange. Under those authorities it is a limited set, and it is intended to be liquid. We have turned down applications for certain commodities to be added to the list because they were deemed not liquid enough. But that is separate from the merchant banking authority, which is for long-term investments that could very well be illiquid.

Chairman BROWN. OK. Mr. Gensler—I am sorry, Mr. McGonagle. It is Chairman Gensler. Sorry about that. In 2013, then-Chairman Gensler testify before the Senate Banking Committee that the CFTC "has clear authority to police markets for fraud, manipulation, and other abuses." After Goldman Sachs and other financial companies bought LME warehouses, aluminum delivery queues increased, as we discussed in the hearing in July, and as the *New York Times* wrote about, increased from approximately 7 months in 2011 to more than 550 days last year. This Subcommittee heard testimony from an aluminum consumer who described a variety of unnatural market forces driving up delivery times, increasing the price of aluminum. The LME in its report said it found the fundamental role of the queues is to increase premiums. The evidence shows that as queues increased, so did premiums, 10 cents per ton, roughly, to a record high 19 cents per ton last week.

Do you agree that with the LME, queues increase aluminum prices?

Mr. MCGONAGLE. Thank you, Chairman. I agree that the issue is something that requires some degree of evaluation by CFTC, particularly as it relates to the fact that the LME has applied for registration as a foreign board of trade. And so by doing that, they will represent and have to speak with us, and we are engaged with LME and with U.K. FCA, the LME's regulator, with respect to how this warehousing issue, these questions concerning premiums, rents, incentives, where are the legitimate forces of supply and demand, and how is this activity consistent with commercial practices and potentially where is it not or where can it be fixed.

You began your question by pointing to the former Chairman's authority, discussion of authority for fraud and manipulation, and certainly with respect any price effect, to the extent that there is any conduct that interferes with the price of a commodity in interstate commerce, CFTC separately has jurisdiction for fraud and manipulation, and they would undertake that authority pursuant to a nonpublic investigatory process.

Chairman BROWN. So do you consider this manipulation of queues which leads to higher premiums and higher aluminum prices, do you consider this commodities manipulation under the Commodities Exchange Act?

Mr. MCGONAGLE. I consider the activity with respect to what is the basis for the premium and whether it is due to legitimate commercial activity as an area that can be explored by CFTC through the application process by LME for a foreign board of trade. Separately—and so I do not offer an opinion here whether there is information concerning any activity with respect to any commodity, frankly, that is not borne out by legitimate forces of supply and demand—that can be subject to an enforcement investigation. So I am not making that determination here. I have seen a lot of information certainly in connection with the warehousing study that the LME put forward in November and its proposals going forward, which we are evaluating from a regulatory standpoint within my Division.

Chairman BROWN. Can you use the no-action letter and the FBOT approval process as leverage to force changes? Does that give you the authority to do that?

Mr. MCGONAGLE. Ultimately we can revoke or suspend any no-action letter that is issued by the Division of Market Oversight. My expectation and hope would be, to the extent that we can effect real change short of revoking registration, that we would explore those opportunities. But that is certainly available as a remedy.

Chairman BROWN. Commissioner Chilton said, "Frankly, my experience in this matter is there is surprisingly little CFTC interest, shockingly little interest in physical ownership of banks that could impact derivative markets."

Mr. MCGONAGLE. The focus of CFTC is for price discovery in connection with the derivatives market that we have direct oversight authority for. Our connection to cash markets authority is driven primarily through enforcement and ensuring that there is no fraud or manipulation with respect to commodities and interstate commerce. So to the extent that a bank, for example, has an ownership interest or a trading position on an exchange, they will have reporting obligations already to the CFTC, and we can get further information about their activity. If there is not a trading position, a regulatory sort of mandate about cash market activity I think is a different conversation for the Commission and for this body to consider with respect to what is our current focus, which are derivatives markets and price discovery versus oversight over particular entities in cash market positions.

Chairman BROWN. Thank you.

Senator Warren, other questions?

Senator WARREN. No.

Chairman BROWN. You are done? OK. Thank you.

Thank you to the panel. I want to close with a couple comments. These activities have been justified during this hearing and in other ways by the benefits they are supposed to provide to individuals and companies in the real economy. We are told that they improve the markets that produce the cans that hold your drinks, the gas that fuels your car, the energy that lights your home. But in many ways, speculation in the commodities futures and derivatives markets has become an end in itself. The issue is as much about financial institutions becoming industrial businesses as it is about the financialization of the real economy. It is an important issue because it forces us to ask whom ultimately we want our economy to serve. In my mind, it is time for us to pick workers and consumers and taxpayers over the speculators, over the "too big to fail" banks. I do not think we have done that yet. I think we know what our mission is. Thank you.

Anyone that has some—please, if you would, any additional questions anybody on the panel asks, if they would send you letters, you would get answers back to those as quickly as you could. Thanks very much.

The hearing is adjourned.

[Whereupon, at 3:20 p.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF NORMAN C. BAY

DIRECTOR, OFFICE OF ENFORCEMENT, FEDERAL ENERGY REGULATORY COMMISSION

JANUARY 15, 2014

Mr. Chairman, Ranking Member Toomey, and Members of the Subcommittee: Thank you for inviting me to testify today. My name is Norman Bay. I am the Director of the Office of Enforcement of the Federal Energy Regulatory Commission (FERC or the Commission). I appear before you as a staff witness, and the views I present are not necessarily those of the Commission or any individual Commissioner. In the testimony that follows, I provide an overview of the Commission's Office of Enforcement, focusing on our efforts to combat fraud and market manipulation, and in so doing will respond to the specific questions the Subcommittee asked me to address in its January 6, 2014, letter.

The Commission's core legal authority for investigating and enforcing Congress's prohibition on fraud and market manipulation in FERC-jurisdictional electric and natural gas markets is the Energy Policy Act of 2005 (EPAct 2005) (which added a section prohibiting energy market manipulation to both the Federal Power Act and the Natural Gas Act). In this Act, passed in the wake of Enron's manipulation of Western energy markets, Congress gave the Commission broad authority to protect energy market consumers from any type of fraud or market manipulation affecting FERC-regulated wholesale physical natural gas and electric markets. Congress patterned EPAct's fraud and manipulation prohibition on the similarly broad antifraud and manipulation provisions in the Securities and Exchange Act of 1934—which the Securities and Exchange Commission (SEC) relies on to police misconduct in the securities markets. Shortly after EPAct 2005 was passed, the Commission implemented this statute through its antimanipulation regulations, codified at 18 CFR §1c. The Office of Enforcement relies on the antimanipulation statute and regulations to investigate potential fraud or market manipulation and, when a matter cannot settle on terms favorable to the public interest, bring enforcement actions against companies or individuals who engage in fraud or manipulation affecting FERC-regulated markets.

Another key aspect of EPAct 2005 is its enhanced civil penalty provisions. Before EPAct 2005, maximum civil penalties for violations of many Commission rules, including acts of fraud and manipulation, were only $10,000 per violation per day. EPAct 2005 granted the Commission the authority to impose up to $1 million per violation per day for fraud and market manipulation (and other violations). To date, the Commission has imposed and collected approximately $873 million in civil penalties and disgorgement following EPAct 2005. This consists of approximately $577 million in civil penalties, which goes to the U.S. Treasury, and approximately $296 million in disgorgement of unjust profits. (This amount does not include fines in electric market manipulation matters to be reviewed in Federal court, for example, the approximately $453 million civil penalties assessed by the Commission in the Barclays market manipulation matter.)

Now I would like to address the Subcommittee's request for an assessment of the Commission's ability to detect, investigate, and enforce violations of EPAct 2005's fraud and antimanipulation rules. My view is that with EPAct 2005's antifraud and market manipulation provisions and civil penalty authority, the Commission's implementing regulations, and the Office of Enforcement's enhanced surveillance and investigative capabilities (briefly summarized below), we do have the tools necessary to effectively police FERC-regulated markets to deter fraud and market manipulation. Of course, we continue to think about ways we can expand our capabilities. But we feel we are to up this important task that Congress has given us.

Over the past few years, the Commission's Office of Enforcement has substantially expanded its investigative and analytical capabilities and has developed extensive new surveillance tools. Among the most important achievements is the creation, in February 2012, of the Office of Enforcement's Division of Analytics and Surveillance (DAS). DAS develops surveillance tools, conducts surveillance, and analyzes transactional and market data to detect potential manipulation, anticompetitive behavior, and other anomalous activity in the wholesale electricity and natural gas markets. DAS staff includes approximately 45 professionals, including, for example, economists, energy industry analysts, former traders, and former risk managers.

For its surveillance efforts, DAS has created internal market screens—both for the electric and natural gas markets—that use behavioral and statistical measures and techniques to detect abnormal trading patterns. Statistical analyses are performed through automated market screens that employ disparate market data to detect anomalies and suspicious trading patterns. The data, both physical and financial, is gathered from numerous sources, and the Commission has taken significant steps in rulemakings over the past few years to expand these sources. With more data, and experience learned from past and current investigations, DAS continues to enhance its surveillance screens.

DAS staff also works hand in hand with the Office of Enforcement's Division of Investigations—which houses the attorneys and other staff that conduct investigations, negotiate settlements, and bring enforcement actions. The Division of Investigations has strengthened its staff of attorneys in the past few years, and now has approximately 45 attorneys, including former Federal prosecutors as well as civil litigators and energy regulatory lawyers from top law firms.

I know the Subcommittee is interested in learning more about fraud and market manipulation conduct by financial institutions that has occurred in FERC-regulated markets. As you have asked, let me provide a high-level description of the mechanics of potential manipulation involving the interplay between financial and physical energy markets. Although the mechanics of a manipulative scheme can be highly detailed and complex, and each investigation is different from the next, there is a general framework that cuts across many of the manipulation matters involving the trading of energy products that we have investigated and are currently investigating.

A fundamental point necessary to understanding many of our manipulation cases is that financial and physical energy markets are interrelated: physical natural gas or electric transactions can help set energy prices on which financial products are based, so that a manipulator can use physical trades (or other energy transactions that affect physical prices) to move prices in a way that benefits his overall financial position. One useful way of looking at manipulation is that the physical transaction is a "tool" that is used to "target" a physical price. For example, the physical tool could be a physical power flow scheduled in a day ahead electricity market at a particular "node" and the target could be the day ahead price established by the market operator for that node. Or the physical tool could be a purchase of natural gas at a trading point located near a pipeline, and the target could be a published index price corresponding to that trading point. The purpose of using the tool to target a physical price is to raise or lower that price in a way that will increase the value of a "benefiting position" (like a Financial Transmission Right or FTR product in energy markets, a swap, a futures contract, or other derivative).

Increasing the value of the benefiting position is the goal or motive of the manipulative scheme. The manipulator may lose money in its physical trades, but the scheme is profitable because the financial positions are benefited above and beyond the physical losses. Understanding the nature and scope of a manipulator's benefiting financial positions—and how they relate to the physical positions—is a key focus of our manipulation cases. This is for the simple reason that our antifraud and manipulation rule (like the SEC's) is an intent-based rule: a finding of manipulation requires proving that the manipulator intended (or in some cases, acted recklessly) to move prices or otherwise distort the proper functioning of the energy markets the Commission regulates. A company can put on a large physical trade that may affect market prices, but if the purpose of that trade is to hedge risk or speculate based on market fundamentals—rather than, for example, the intent to move prices to benefit a related financial position—this conduct, without more, would not violate our antifraud and manipulation rule.

Another key point is that the physical trading (the tool) may and usually does occur in FERC-regulated markets, but the benefiting financial position may be held in a non-FERC regulated market such as a futures or swaps market exchange regulated by the Commodity Futures Trading Commission (CFTC). This is not always the case: for example, we have investigated manipulation in which the financial benefiting position is within FERC markets. But, often, the physical trading occurs in FERC markets and the benefiting position is established outside of FERC markets.

We have numerous public examples of market manipulation that fit into this general description (and many others that remain nonpublic). The public matters are either in the form of settlements or "Order to Show Cause" proceedings in matters that have not settled and may be headed to trial. In either case, the settlement or other order sets forth a description of the facts and a discussion of why the Commission concludes that the facts support a finding of market manipulation. (In all instances, the settlement or order will be published on the Commission's Web site, at *www.ferc.gov.*)

A recent settlement fitting the manipulation framework above is our January 2013 settlement with Deutsche Bank. See Deutsche Bank Energy Trading, LLC, 142 FERC Par. 61,056 (2013). Let me briefly describe the mechanics of the manipulative scheme here. Deutsche Bank held a type of energy contract commonly used to hedge against, or profit from, the "congestion" on a transmission line that occurs when, for various technical reasons, the line cannot carry all the electricity needed at a particular supply or delivery point on the grid. These contracts are often called Financial Transmission Rights or FTRs—though in the California Independent System Operator (CAISO) market at issue in the Deutsche Bank matter, they are called Congestion Revenue Rights (CRRs). In early 2010, Deutsche Bank began to lose money on its CRR contracts. The company initially sought to limit its losses by purchasing new CRRs in the CAISO market to reduce its exposure to congestion. But these new CRR purchases did not fully cover its losses. So Deutsche Bank energy traders devised and implemented a manipulative scheme that involved buying and selling physical electricity so as to alter congestion levels, and resulting market prices, at the same point corresponding to their CRR contracts. These physical transactions (in addition to violating the CAISO tariff) were unprofitable and inconsistent with market fundamentals, but did have the effect of increasing the value (i.e., by limiting losses) of Deutsche Bank's CRRs.

In short, to use the framework above, Deutsche Bank used a "tool" of physical energy transactions to "target" congestion levels and corresponding energy prices within CAISO in order to increase the value of CRR "benefiting positions"—in violation of EPAct 2005 and the Commission's antimanipulation rule.

A recent order also fitting this framework is the Commission's July 2013 Order Assessing Civil Penalties in Barclays. See Barclays Bank, PLC, et al., 144 FERC Par. 61,041 (2013). The Commission's assessment of civil penalties and disgorgement in Barclays will be reviewed in Federal district court, so the litigation is ongoing and my comments will have to be limited. That being said, I can nonetheless provide a brief description consistent with published Commission orders.

Barclays and its energy traders amassed substantial positions of physical electricity contracts through their transactions on the IntercontinentalExchange (ICE) trading platform. Barclays and its traders also assembled a financial swaps position at four important trading points in Western energy markets, whose value was pegged to published electricity price indices set by the physical electric contracts Barclays traded. The Commission found that Barclays engaged in manipulative physical trades to "flatten out" the physical electricity positions it had amassed on its trading books in a manner designed to influence the index prices that determined the value of its swaps. Barclays's physical trading was uneconomic and not based on market fundamentals; indeed, the company often lost money in the physical markets. But Barclays's physical trading nonetheless profited the company overall because its trades helped move the index price that set the value of its larger financial swaps benefiting position.

Fraud and manipulation can take other forms, and many of our manipulation matters, including with financial institutions, do not neatly fit within the tool-target-benefiting position framework described above. A notable example is the Commission's July 2013 settlement with a wholly owned subsidiary of JPMorgan which, among other terms, required JPMorgan to pay a combined $410 million in civil penalties and disgorgement to ratepayers. See In Re "Make-Whole Payments and Related Bidding Strategies", 144 FERC Par. 61,068 (2013).

This settlement resolved the Office of Enforcement's investigation into 12 manipulative bidding strategies designed to make profits from power plants that were usually out of the money in the marketplace. In these manipulative strategies, which are described in greater detail in the settlement agreement and order approving it, the JPMorgan subsidiary defrauded market operators in California (CAISO) and Michigan (MISO) by making bids into these markets that were not grounded in the normal forces of supply and demand, and were expected to, and did, lose money at market rates. The JPMorgan subsidiary's purpose in submitting these bids was not to make money based on market fundamentals, but to create artificial conditions that would cause the CAISO system to pay the company outside the market at premium rates. Enforcement staff also determined that JPMorgan knew that the CAISO and MISO markets received no benefit from making these inflated payments and, thus, the company defrauded these market operators by obtaining payments for benefits they did not deliver.

The Subcommittee has also asked whether there are regulatory limitations on the Commission's antifraud and manipulation oversight efforts. There are two such limitations I would like to highlight today. The first concerns our ability to obtain certain financial data that is of great importance to our surveillance and investigation efforts. I have noted above that financial and physical natural gas and electric markets are interrelated—and have also noted that our surveillance screens, among other features, seek to detect anomalies in both physical and financial trading. But our surveillance program has limitations because we do not have access at present to certain financial data from the related financial markets. This missing financial data creates a gap in the Commission's ability to conduct effective and comprehensive surveillance of the natural gas and electric markets.

Much of the relevant financial data we seek is traded on markets regulated by the CFTC. Despite negotiations over several years, the CFTC has not yet provided FERC with access to the financial information and data our Office of Enforcement needs, except on an ad hoc case-by-case basis. This obstacle prevents Commission staff from seeing the complete picture of what is occurring in its jurisdictional markets and from fully integrating the financial information into its automated screens. Although the Commission's screening program is robust and has enabled Commission staff to detect potential manipulation, this program would be improved with access to the CFTC data. However, earlier this month, FERC and the CFTC signed a Memorandum of Understanding that is intended to result in broader information sharing than currently occurs and is, therefore, a first step toward sharing appropriate data in a timely manner. It will be essential for the agencies to work together and to make an institutional commitment to, as well as the resources necessary for, the day-to-day, nuts-and-bolts implementation of the concepts established in this Memorandum of Understanding.

A second limitation follows from the decision by the U.S. Court of Appeals for the District of Columbia Circuit last year in Hunter v. FERC, 711 F.3d 155 (D.C. Cir. 2013). In Hunter, the court ruled that the CFTC's exclusive jurisdiction over futures contracts deprives FERC of authority to bring an action based on manipulation in the futures market, even if the activity affected prices in the physical markets for which FERC has exclusive jurisdiction. Although the Commission reads the Hunter decision as narrow in scope, some market participants interpret the decision more broadly to cover not only manipulation in the futures market, but also many additional transactions and products, including those squarely within FERC's jurisdictional markets. Accordingly, a legislative fix to eliminate uncertainty on this matter could ensure that FERC has the full authority needed to police manipulation of wholesale physical natural gas and electric markets.

The Subcommittee has also asked about the potential market risks and economic consequences of financial holding companies' direct involvement in FERC-jurisdictional markets. The Commission has not taken any view on the participation in its regulated markets by financial holding companies (or any trading firm, bank, or other financial institution) versus more traditional energy companies like generators, utilities, or natural gas pipeline owners. Instead, the Commission's general view has been that financial institutions of all kinds, as well as energy companies of all kinds, can benefit markets in numerous ways, for example, by providing liquidity to market participants who may want to hedge their risk. However, the Commission expects financial institutions, like all other participants in FERC-regulated markets, to have good compliance programs, transact in a manner that follows market rules in letter and spirit, work cooperatively with grid operators and the Commission when there are concerns, and self-report potential violations. The Subcommittee has asked for information about written guidance the Commission has issued internally or otherwise regarding the direct activities of financial institutions in the energy market. I am not aware of any specific rules under our Federal Power Act ratemaking authority that would apply uniquely to financial institutions that participate in Commission-jurisdictional markets. However, any rules that govern those markets would apply equally to financial institutions as well, such as the rules governing the eligibility for market-based rate authority, rules prohibiting market manipulation, creditworthiness rules in the organized markets, and any tariff rules governing the organized markets, including those regarding bidding into the markets. Further, financial institutions that are public utilities by virtue of their ownership or operation of jurisdictional facilities are subject to the requirements of section 203 of the FPA concerning the acquisition or disposition of jurisdictional facilities.

With respect to whether there are emerging trends, including fraud and manipulation associated with financial institutions' operations in the energy market, I note that banks and financial holding companies have generally played a role in the physical wholesale electric market. Based on year-to-date electric industry reports to the Commission, sales by banks and financial holdings companies represent 13 percent of total revenues for energy and "booked out power" (energy or capacity contractually committed for delivery but not actually delivered because of an offsetting trade). Moreover, full year electric sales by financial institutions were approximately $15 billion in 2012, down from $45 billion in 2008 for those companies, when sales represented approximately 20 percent of the market. Combined bank and financial institution revenues from electricity sales have declined during this time by tens of billions of dollars; Commission electric sales data, however, do not include sales in the ElectricReliability Council of Texas, which are nonjurisdictional.

Banks and financial institutions also play a role in the direct ownership of physical electric assets—owning less than 4 percent of total U.S. generator nameplate capacity (basically, the maximum rated output of a generator) as of June 2013. (Banks and financial institutions may have greater economic rights to revenues from generators through leasing arrangements called tolling agreements; but the percentage of direct ownership has been relatively small.)

Banks also play a role in the ownership of U.S. natural gas storage facilities and pipelines. For example, financial institutions own less than 1 percent of total U.S. natural gas storage capacity and about 14 percent of total U.S. natural gas pipeline miles (both intrastate and interstate).

With respect to natural gas, FERC data shows that physical natural gas sales by banks represented about 6 percent of total U.S. reported sales in 2012, down from 8 percent in 2011. This decrease may be due to a combination of low volatility and low prices in natural gas markets, which has caused banks and other financial institutions to shift their capital to more profitable opportunities in other markets. Sales by nonbank financial institutions represented only 2 percent of total reported sales in both 2011 and 2012.

I would also like to note, because it is especially relevant to manipulative conduct, that the market share of a given bank or financial institution at a particular natural gas trading hub or electric market trading point could nonetheless be high and have a significant effect on the price formed at that hub or point. That is, banks and financial institutions as a whole may have a relatively lower percentage of sales and generation ownership interest compared to more traditional energy companies, but, as we have seen in our investigations, they may retain the ability to move prices in a manipulative manner.

In response to the Subcommittee's question about trends, I would also like to note that although the Commission has recently approved settlements and orders assessing civil penalties against banks and financial institutions, in a few of these matters the manipulative conduct occurred several years ago, including as far back as 2006–2007. Also, now that the Office of Enforcement has had several years to implement a robust enforcement regime following EPAct 2005, the Commission is in a better position to promptly detect, investigate, and seek sanctions against fraudulent and manipulative conduct. In particular, I would highlight the surveillance efforts and sophisticated staff we have developed, as discussed earlier in my testimony. Given that the Commission's enhanced enforcement capabilities are relatively new, it is difficult for me to draw conclusions that there are emerging trends associated with financial institutions' potential misconduct in FERC-jurisdictional markets. Our recently announced manipulation matters, in other words, may be as much a product of our enhanced detection and enforcement abilities over the past few years rather than any uptick in manipulative conduct by financial institutions or other market participants.

The Subcommittee has asked for a description of our coordination efforts with other U.S. banking or financial market regulators. With respect to investigations, the Commission's Office of Enforcement has coordinated or shared information regarding various matters with other Federal Government agencies, in particular, the Department of Justice and United States Attorneys' Offices, the CFTC, the SEC, the Federal Trade Commission, the Federal Reserve, and the Environmental Protection Agency. Our coordination on investigations with the CFTC has been routine given the relationship between electricity and natural gas products traded on CFTC-regulated futures and derivatives markets and FERC-jurisdictional physical markets. Notwithstanding the above-noted concerns over the need for greater information sharing, FERC and CFTC enforcement staff have worked together on manipulation investigations involving improper trading conduct. We have also worked with the Department of Justice and the Federal Reserve in providing information about investigations involving financial institutions. And we have consulted with the SEC enforcement office, particularly relating to "best practices" in market surveillance and investigative techniques and procedures. The details of our coordination between FERC and these agencies, including the information we have provided, is nonpublic under Commission regulations, but we are happy to report to the Subcommittee that we have worked with these other Federal Government regulators and will continue to do so as a matter of good Government and for the good of our Nation's energy markets.

We are also happy to report that we are working with international regulators. In our discussions with them, they have commented on our innovation and leadership in market surveillance and oversight and in our use of sophisticated algorithmic screens to sift through vast amounts of trade data to detect potential manipulation in the wholesale gas and power markets. We have consulted with or provided technical assistance to regulators from a number of different countries, and we are exploring information sharing MOUs with international regulators. That being said, we are always looking for ways to upgrade our capabilities and to do our best to protect and to advance the public interest.

In conclusion, I want to thank the Subcommittee again for this opportunity to testify today.

PREPARED STATEMENT OF VINCENT MCGONAGLE

DIRECTOR, DIVISION OF MARKET OVERSIGHT, COMMODITY FUTURES TRADING COMMISSION

JANUARY 15, 2014

Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee, thank you for the opportunity to appear before you today. I am Vincent McGonagle and I am the Director of the Division of Market Oversight of the Commodity Futures Trading Commission (CFTC).

Background on Commodity Exchange Act and the CFTC Mission

The purpose of the Commodity Exchange Act (CEA) is to serve the public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information. Consistent with its mission statement and statutory charge under the CEA, the CFTC is tasked with protecting market participants and the public from fraud, manipulation, abusive practices and systemic risk related to derivatives—both futures and swaps—and to foster transparent, open, competitive, and financially sound markets. In carrying out its mission and statutory charge, and to promote market integrity, the Commission polices derivatives markets for various abuses and works to ensure the protection of customer funds. Further, the agency seeks to lower the risk of the futures and swaps markets to the economy and the public. To fulfill these roles, the Commission oversees designated contract markets (DCMs), swap execution facilities (SEFs), derivatives clearing organizations, swap data repositories, swap dealers, futures commission merchants, commodity pool operators, and other intermediaries.

The CEA has for many years required that any futures transaction, unless subject to an exemption, be conducted on or subject to the rules of a board of trade which has been designated by the CFTC as a DCM. Sections 5 and 6 of the CEA and Part 38 of the Commission's regulations provide the legal framework for the Commission to designate DCMs, along with each DCM's compliance requirements with respect to the trading of commodity futures contracts. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), DCMs were also permitted to list swap contracts. Along with this expansion of product lines that can be listed on DCMs, the Dodd-Frank Act also amended various substantive DCM requirements, under CEA Section 5, and adopted a new regulatory category for exchanges that provide for the trading of swaps (SEFs). [1] The Commission revised its DCM regulations to reflect these new requirements, and also adopted regulations to implement the Dodd-Frank Act's SEF requirements.

Under the CEA and the Commission's contract and rule review regulations, all new product terms and conditions, and subsequent associated amendments, are submitted to the Commission before implementation. In submitting new products and associated amendments, DCMs and SEFs are legally obligated to meet certain core principles; one of the most significant being the prohibition, in DCM and SEF Core Principle 3, on listing contracts that are readily susceptible to manipulation. [2] DCMs and SEFs self-certify most of their products to the Commission, as allowed under the CEA, [3] and self-certified contracts may be listed for trading shortly after submission. [4] The Commission has provided Guidance to DCMs and SEFs on meeting Core Principle 3 in Appendix C to Part 38 of the Commission's regulations. Failure of a

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[1] In addition to the provisions regarding listing of swaps on DCMs and SEFs, the Dodd-Frank Act provides that, unless a clearing exception applies and is elected, a swap that is subject to a clearing requirement must be executed on a DCM, SEF, or SEF that is exempt from registration under CEA, unless no such DCM or SEF makes the swap available to trade.

[2] DCM and SEF Core Principle 3 states, "Contract Not Readily Subject to Manipulation—The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation."

[3] For example, while contracts can be submitted for approval, of the almost 5,000 contracts submitted by DCMs and SEFs since the Dodd-Frank Act was enacted, all were submitted on a self-certification basis, and over 2,000 contracts were certified in calendar year 2013 alone.

[4] A DCM or SEF need wait only one full business day after the contract has been submitted to list the contract for trading.

DCM or SEF to adopt and maintain practices that adhere to these requirements may lead to the Commission's initiation of proceedings to secure compliance.

Among other things, a DCM or SEF that lists a contract that is settled by physical delivery should design its contracts in such a way as to avoid any impediments to the delivery of the commodity in order to promote convergence between the price of the futures contract and the cash market value of the commodity at the time of delivery. The specified terms and conditions considered as a whole should result in a deliverable supply that is sufficient to ensure that the contract is not susceptible to price manipulation or distortion.[5] The contract terms and conditions should describe or define all of the economically significant characteristics or attributes of the commodity underlying the contract, including: quality standards that reflect those used in transactions in the commodity in normal cash marketing channels; delivery points at a location or locations where the underlying cash commodity is normally transacted or stored; conditions that delivery facility operators must meet in order to be eligible for delivery, including considerations of the extent to which ownership of such facilities is concentrated and whether the level of concentration would render the futures contract susceptible to manipulation; delivery procedures that seek to minimize or eliminate any impediment to making or taking delivery by both deliverers and takers of delivery to help ensure convergence of cash and futures at the expiration of a futures delivery month.

Commission staff utilizes considerable discretion and can request that DCMs and SEFs provide full explanations of their compliance with the Commission's product requirements. Commission staff may ask a DCM or SEF at any time for a detailed justification of its continuing compliance with core principles, including information demonstrating that any contract certified to the Commission for listing on that exchange meets the requirements of the Act and DCM or SEF Core Principle 3.

Expansion of CFTC Enforcement Authority Under Dodd-Frank

The Commission's responsibilities under the CEA include mandates to prevent and deter fraud and manipulation. The Dodd-Frank Act enhanced the Commission's enforcement authority by expanding it to the swaps markets. The Commission adopted a rule to implement its new authorities to police against fraud and manipulative schemes. In the past, the CFTC had the ability to prosecute manipulation, but to prevail, it had to prove the specific intent of the accused to affect prices and the existence of an artificial price. Under the new law and rules implementing it, the Commission's antimanipulation reach is extended to prohibit the reckless use of manipulative schemes. Specifically, Section 6(c)(3) of the CEA now makes it unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity. In addition, Section 4c(a) of the CEA now explicitly prohibits disruptive trading practices and the Commission has issued an Interpretive Guidance and Policy Statement on Disruptive Practices.[6]

In addition, the Dodd-Frank Act established a registration regime for any foreign board of trade (FBOT) and associated clearing organization who seeks to offer U.S. customers direct access to its electronic trading and order matching system. Applicants for FBOT registration must demonstrate, among other things, that they are subject to comprehensive supervision and regulation by the appropriate governmental authorities in their home country or countries that is comparable to the comprehensive supervision and regulation to which Commission-designated contract markets and registered derivatives clearing organizations are respectively subject.

CFTC Coordination with Foreign and Domestic Regulators

The Commission recognizes that commodity markets are international in nature and, accordingly, regularly consults with other countries' regulators. In particular, staff regularly consult with staff of the FCA (the LME's home regulatory authority) as to market conditions with respect to products of mutual interest, including the LME's recent introduction of warehouse reforms. The two agencies also participate in mutual information-sharing agreements for both market surveillance and enforcement purposes.

Similarly, the Commission formally and informally consults and coordinates with other domestic financial regulators. For example, the CFTC and the Federal Energy Regulatory Commission (FERC) have had a memorandum of understanding (MOU)

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[5] Deliverable supply means the quantity of the commodity meeting the contract's delivery specification that reasonably can be expected to be readily available to short traders and salable by long traders at its market value in normal cash marketing channels at the contract's delivery points during the specified delivery period, barring abnormal movement in interstate commerce.

[6] Antidisruptive Practices Authority, 78 FR 31890 (May 28, 2013), *http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-12365a.pdf.*

in place since 2005 that provides for information exchange related to oversight or investigations. Earlier this month, FERC and the CFTC signed two Memoranda of Understanding (MOU) to address circumstances of overlapping jurisdiction and to share information in connection with market surveillance and investigations into potential market manipulation, fraud or abuse. The MOUs allow the agencies to promote effective and efficient regulation to protect the Nation's energy markets and increased cooperation between the agencies.

Again, thank you for the opportunity to appear before the Subcommittee. I will be pleased to respond to any questions you may have.

PREPARED STATEMENT OF MICHAEL S. GIBSON

DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Chairman Brown, Ranking Member Toomey, and other Members of the Subcommittee, thank you for the opportunity to testify at today's hearing. First, I will discuss the history of bank and bank holding company engagement in physical commodity activities. I will then address the Federal Reserve's approach to supervising financial institutions engaged in physical commodities activities. I will close my remarks by discussing the Federal Reserve's ongoing review of the physical commodities activities of the institutions we supervise.

History of Physical Commodities Authority

Before the enactment of the Gramm-Leach-Bliley Act in 1999 (GLB Act), bank holding companies were authorized to engage in a limited set of commodities activities that were considered to be "so closely related to banking as to be a proper incident thereto." [1] These activities included the authority to buy, sell, and store certain precious metals (for example, gold, silver, platinum, and palladium) and copper, which are activities that national banks were generally permitted to conduct at the time. Bank holding companies were also authorized to engage as principals in cash-settled derivative contracts based on commodities. In addition, bank holding companies were permitted to engage in commodity derivatives that allowed for physical settlement if the bank holding company made reasonable efforts to avoid delivery of the commodity.

Additionally, under the National Bank Act, the Office of the Comptroller of the Currency (OCC) has authority to approve national banks to engage in commodity-related activities under national banks' authority to "exercise . . . all such incidental powers as shall be necessary to carry on the business of banking." [2] The OCC has approved some national banks to engage in customer-driven, perfectly matched, cash-settled derivative transactions referencing commodities; certain types of commodity derivatives transactions settled by transitory title transfer; the purchase and sale of coin and bullion, precious metals, and copper; and the holding of physical commodities to hedge customer-driven, bank-permissible derivative transactions.

Under the GLB Act, Congress created the financial holding company framework, which allowed bank holding companies with bank subsidiaries that are well capitalized and well managed [3] that elect such status to engage in expanded financial activities. [4] There are three provisions in the GLB Act that have enabled a limited number of financial holding companies to engage in commodities activities. The first provision—section 4(k)(1)(B) of the Bank Holding Company Act—authorizes a financial holding company to engage in any activity that the Board finds to be "complementary to a financial activity." This provision in the GLB Act enables financial holding companies to engage in commercial activities that complement their financial activities, so long as the activities do not pose a substantial risk to the safety

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[1] Section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. 1843(c)(8).

[2] 12 U.S.C. 24 (seventh).

[3] In addition to the capital and management requirements, the GLB Act also requires the subsidiary depository institutions of financial holding companies to have at least a "Satisfactory" rating under the Community Reinvestment Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act added a requirement that the financial holding companies themselves must be well capitalized and well managed.

[4] Many bank holding companies of various sizes are financial holding companies. The Board maintains a list of financial holding companies on its Web site at *www.federalreserve.gov/bankinforeg/fhc.htm*.

and soundness of depository institutions or the financial system generally.[5] In reviewing requests for complementary authority, the Board is required to consider whether performance of the activity can reasonably be expected to produce benefits to the public—such as greater convenience, increased competition, or gains in efficiency—that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.[6]

Beginning in 2003, the Board issued a series of orders permitting individual financial holding companies to engage in specified commodities-related activities as 4(k) complementary activities. These activities included physical settlement of commodities derivative contracts and spot trading of certain approved commodities.[7] A dozen financial holding companies currently have this 4(k) authority.[8]

In addition, a subset of these companies has been granted additional authority to engage in energy tolling and energy-management activities. Energy tolling involves making fixed, periodic payments to power plant owners that compensate the owners for their fixed costs in exchange for the right to all or part of their plants' power output. Energy-management activities are transactional and advisory services provided to power plant owners.

The Board's orders placed prudential limits on financial holding companies that engage in commodities activities under complementary authority. The Board limited the total market value of all commodities held under this authority, including periodic payments under tolling agreements, to 5 percent of the financial holding company's tier 1 capital. In addition, the Board prohibited financial holding companies from owning commodity transportation, storage, extraction, or refining facilities under complementary authority. Moreover, firms are required to demonstrate risk-management processes sufficient to support their activities and to put in place additional risk mitigants, such as insurance.

A second provision that Congress included in the GLB Act permits financial holding companies to make merchant banking investments, without prior Board approval, in companies engaged in activities not otherwise permitted for financial holding companies.[9] There are a number of conditions imposed by statute on merchant banking investments. These include restrictions on the ability of a financial holding company to routinely manage or operate a merchant banking portfolio company and requirements that merchant banking investments be held for a limited period. The Board's regulations require merchant banking investments to be disposed of within 10 years after purchase (or within 15 years for investments made through a qualifying private equity fund). As a result, merchant banking investments must be limited in duration and generally must be passively managed.

Congress included a third provision in the GLB Act that is relevant to the commodities trading activities of financial holding companies. Under section 4(o) of the Bank Holding Company Act, a company that is not a bank holding company and becomes a financial holding company after November 12, 1999, may continue to engage in activities related to the trading, sale, or investment in commodities that were not permissible activities for bank holding companies if the company was engaged in the United States in such activities as of September 30, 1997.[10] This grandfather provision allows these activities up to 5 percent of the company's total consolidated assets. In contrast to section 4(k) complementary authority, this authority is automatic—meaning no approval by or notice to the Board is required for a company to rely on this authority for its commodities activities. Also, unlike the firms subject to 4(k), the 4(o) grandfathered firms are able to engage in the transportation, storage, extraction, and refining of commodities. And, the cap on activities under section 4(o) is 5 percent of the firm's total assets, while the cap on com-

[5] Section 4(k)(1)(B) of the Bank Holding Company Act, 12 U.S.C. 1843(k)(1)(B).

[6] 12 U.S.C. 1843(j)(2).

[7] This authority is generally limited to commodities for which derivatives contracts have been approved by the Commodity Futures Trading Commission for trading on a U.S. exchange. In a few cases, other commodities with comparable fungibility, liquidity, and other relevant characteristics have been approved.

[8] The financial holdings companies currently authorized by the Board to engage in complementary physical commodities activities are Bank of America Corporation, Barclays Bank PLC, BNP Paribas, Citigroup Inc., Credit Suisse Group, Deutsche Bank AG, JPMorgan Chase & Co., Scotiabank, Societe Generale, The Royal Bank of Scotland Group pie, UBS AG, and Wells Fargo & Company. The Board's approvals regarding section 4(k) are publicly available.

[9] 12 U.S.C. 1843(k)(4)(H). The merchant banking authority permits a financial holding company to acquire or control any amount of shares, assets, or ownership interests of any company or other entity that is engaged in an activity not otherwise authorized for the financial holding company under section 4 of the BHC Act.

[10] 12 U.S.C. 1843(o).

plementary activities is much lower at 5 percent of tier 1 capital. Only two financial holding companies currently qualify for these grandfather rights—Goldman Sachs and Morgan Stanley.

The commodities activities of financial holding companies expanded considerably as the composition of the banking sector shifted in the wake of the financial crisis. During 2008, several firms with significant commodities operations either became financial holding companies or were acquired by financial holding companies. Goldman Sachs and Morgan Stanley became bank holding companies and elected financial holding company status. Both companies claim the right to conduct commodities activities under the grandfather provision found in section 4(o). In addition, during this same period, JPMorgan Chase & Co. acquired Bear Steams and Bank of America Corporation acquired Merrill Lynch; both Bear Steams and Merrill Lynch engaged in a substantial amount of commodity trading activities. However, the range of permissible physical commodities activities of these companies is limited because they are not grandfathered under section 4(o).

Federal Reserve Supervision of Commodities Activities

The Federal Reserve has supervisory authority for State member banks, bank holding companies (including financial holding companies), and savings and loan holding companies, as well as foreign banks that operate branches or agencies in the United States. The Federal Reserve's basic supervisory responsibility is to oversee the financial soundness of these institutions and their adherence to applicable banking laws. To this end, we monitor the largest of these institutions on a continuous basis and routinely conduct inspections and examinations of all of these firms to encourage their safe and sound operation.

The Federal Reserve has no direct role in the supervision of the commodities markets generally. The Commodity Futures Trading Commission (CFTC) was created by Congress in 1974 as an independent agency with the mandate to regulate commodity futures and option markets. Congress significantly expanded the authority of the CFTC to regulate the over-the-counter commodity derivative markets in the Dodd-Frank Wall Street Reform and Consumer Protection Act. Additionally, the Securities and Exchange Commission (SEC) oversees our Nation's securities exchanges and markets and disclosures by public companies, among other things. Other independent agencies, such as the Federal Energy Regulatory Commission (FERC), also regulate segments of the physical commodity market.

The prudential supervision of the largest, most complex banking firms is a cooperative effort in which the Federal Reserve acts as the prudential regulator and supervisor of the consolidated holding companies, but with some of the principal business activities of such firms supervised by other functional regulators. The Federal Reserve's supervisory program focuses on the enterprise-wide risk profile and risk management of those firms, with particular focus on financial strength, corporate governance, and risk-management practices and competencies of the firm as a whole.

As a result of lessons learned from the financial crisis, the Federal Reserve has taken a number of steps to strengthen its ongoing supervision of the largest, most complex banking firms. Most importantly, we established the Large Institution Supervision Coordinating Committee (LISCC) to ensure that oversight and supervision of the largest firms incorporates a broader range of internal perspectives and expertise; involves regular, simultaneous, horizontal (cross-firm) supervisory exercises; and is overseen in a centralized process to facilitate consistent supervision and the resolution of challenges that may be present in more than one firm. The committee includes senior bank supervisors from the Board and relevant Reserve Banks as well as senior Federal Reserve staff from the research, legal, and other divisions at the Board and from the markets and payment systems groups at the Federal Reserve Bank of New York. To date, the LISCC has developed and administered several horizontal supervisory exercises, notably the capital stress tests and related comprehensive capital reviews of the Nation's largest bank holding companies. The LISCC has also been actively engaged in the supervision of physical commodities activities.

Bank holding companies that conduct commodities activities pursuant to either section 4(k) complementary, merchant banking, or section 4(o) grandfather authority are typically subject to continuous supervision by the Federal Reserve. That supervisory oversight, for example, includes review of internal management reports, periodic meetings with the personnel responsible for managing and controlling the risks of the firm's commodities activities, and targeted examinations of those activities. The primary goals of our supervision of commodities activities are to monitor the management of risks of those activities to the financial holding company and assess the adequacy of the firms' control environments relating to commodities.

As the scale and complexity of commodities activities of financial holding companies accelerated in 2008 in the wake of the financial crisis, the Federal Reserve expanded the scope of its examination and review of the firms engaged in physical commodities activities. Additional targeted reviews were completed by examination staff specializing in commodities risk management practices. During these reviews, the teams have examined exposures, valuations, and risk-management practices across all relevant firms, and conducted deeper reviews of the firms' operational risk quantification methodologies. On an ongoing basis, supervisory experts have monitored the firms' exposures and assessed the strength of the corresponding risk management and control processes.

The Board requires financial holding companies that engage in commodities activities to hold regulatory capital to absorb potential losses from those activities. Financial holding companies have long been required to hold capital against the counterparty credit risk from commodity derivatives (and other types of over-the-counter derivatives) and against the market risk of all commodity positions. Moreover, following the financial crisis, the Board has strengthened its capital requirements for the credit risk and market risk of these transactions. Further, under the Basel III advanced approaches capital rules, financial holding companies would be required to hold capital against the operational risk of their activities, including their commodities activities.

Federal Reserve Review of Physical Commodities Activities

Firms engaged in physical commodities activities rely on a variety of legal structures that attempt to limit liability for catastrophic and environmental events, as well as on the purchase of insurance and the allocation of capital aimed at mitigating operational risk. However, physical commodities activities can pose unique risks to financial holding companies. Indeed, estimating probabilities and costs related to environmental or catastrophic incidents is an imperfect science at best.

The Federal Reserve has been conducting a detailed policy review of the commodities activities and investments of financial holding companies. We are performing this review for a number of reasons. As I noted above, there has been a substantial increase since 2008 in the amount and types of commodities activities conducted by the firms we supervise. Moreover, recent catastrophic events involving physical commodities have increased concerns regarding the ability of companies to mitigate potentially extraordinary tail and other risks. Finally, the financial crisis demonstrated the effects of market contagion and highlighted the danger of underappreciated tail risks associated with certain activities.

The scope of our ongoing review covers commodities activities and investments under section 4(k) complementary authority, merchant banking authority, and section 4(o) grandfather authority. The Federal Reserve recently sought public comment through an advance notice of proposed rulemaking on a range of issues related to the commodities activities of financial holding companies, and we expect to engage in additional rulemaking in this area. As the notice explains, we are exploring what further prudential restrictions or limitations on the ability of financial holding companies to engage in commodities-related activities as a complementary activity are warranted to mitigate the risks associated with these activities. Such additional restrictions on complementary commodities activities could include reductions in the maximum amount of assets or revenue attributable to such activities, increased capital or insurance requirements on such activities; and prohibitions on holding specific types of physical commodities that pose undue risk to the company. We also are exploring what restrictions or limitations on investments made through the merchant banking authority in companies engaged in physical commodities activities would appropriately address those or similar risks.

The Federal Reserve is also considering whether additional restrictions on physical commodities activities grandfathered under section 4(o) could help ensure that such activities do not pose undue risks to the safety and soundness of financial holding companies and their subsidiary depository institutions, or to financial stability. However, our ability to address the broad scope of activities specifically permitted by statute under the grandfather provision in section 4(o) is more limited than it is for complementary and merchant banking activities. Further, the amount of exposure to commodities activities authorized by Congress under section 4(o)—which is up to 5 percent of the organization's total assets—is much greater than the level of activity permitted by the Board under the section 4(k) complementary authority—which is up to 5 percent of tier 1 capital.

Conclusion

Our review of the commodity-related activities of our supervised firms is ongoing. We intend to do a careful and thorough assessment of the costs and benefits of financial holding company engagement in these activities. We are committed to using our supervisory and regulatory authorities to the maximum extent possible to protect financial holding companies and the financial system from the safety and soundness risks or other potential adverse effects of combining banking and physical commodities activities in a single corporate enterprise.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM NORMAN C. BAY

Q.1. To address market surveillance and interagency coordination issues, the CFTC invited the FERC to CFTC premises to gain access to market surveillance data while information sharing protocols are being finalized. The CFTC expressed concerns about confidentiality, specifically that information shared with the FERC is protected in a way that satisfies CFTC's congressionally mandated confidentiality obligations.

Please elaborate more specifically on these concerns and how the FERC is addressing them.

A.1. We believe we have resolved any issues related to data confidentiality or creating a secure data transfer. On March 5, 2014, the CFTC made an initial transfer of data to FERC under the information-sharing MOU. FERC and the CFTC also announced the creation of an interagency surveillance and data analytics working group.

Q.2. When will these protocols be finalized?

A.2. We believe the protocols have been finalized.

Q.3. Are there any obstacles in the way of finalizing the protocol? If there are, please describe what they are, and how are they being addressed?

A.3. As noted above, we believe the protocols have been finalized.

Q.4. A document released to the *New York Times* on FERC's investigation into JPMorgan's manipulative pricing schemes in California and Michigan's electricity market revealed that FERC investigators believed that Ms. Blythe Masters, the head of JPMorgan's commodities operation, had "falsely" denied under oath her awareness of the activities. Reportedly, the document also found that JPMorgan made "scores of false and misleading statements and material omissions" to FERC authorities. Ultimately, JPMorgan agreed to pay $410 million without admitting wrong doing, including Ms. Masters.

Could you provide a copy of the document to Members of the Senate Banking Committee?

A.4. FERC did not release any internal documents to the *New York Times* or any other media outlet. The only documents relating to FERC's investigation of JPMorgan that were publicly released were the Commission Order approving the JPMorgan settlement and the settlement agreement itself. The Commission does not make staffs "Wells Notice" public even after an investigation concludes. When, as occurred in the JPMorgan matter, the investigation leads to a settlement that the Commission finds to be in the public interest, the settlement agreement itself typically provides details about the conduct underlying the investigation. The JPMorgan settlement agreement contains stipulated facts about JPMorgan's conduct, and both the settlement agreement and the Commission's Order approving the settlement set forth conclusions reached by Enforcement staff and the Commission. If the Committee feels that it is necessary to obtain access to certain nonpublic materials from the investigation, we certainly would be willing to discuss the matter.

Q.5. Can you speak to the challenges associated with holding Wall Street executives individually accountable for their illegal actions, as was presumably the case in the JPMorgan settlement? Can you please explain the specific decision made in this case, including the process and rationale for this decision.

A.5. Fraud and market manipulation cases, particularly against large, sophisticated institutions, can present challenges in holding the entity as well as its executives accountable. Similar to white collar matters, these cases can be challenging to investigate and litigate, particularly where the participants take steps to communicate in ways that are not memorialized or are otherwise difficult to discover. Notwithstanding these challenges, PERC's Office of Enforcement has been and remains committed to holding entities and individuals accountable for fraud, manipulation, and other serious misconduct.

Reflecting that ongoing commitment, the Commission is fully prepared to proceed against executives and individuals when that course of action is in the public interest. We have done so in the past in both enforcement actions and settlements, and will continue to do so. For example, the Commission is currently litigating the Barclays market manipulation matter in Federal district court and is pursuing claims and civil penalties not only against Barclays Bank PLC, but also against four individual traders. (See FERC v. Barclays Bank PLC, Daniel Erin, Scott Connelly, Karen Levine, and Ryan Smith, Case No. 2:13-cv-02093-TLN-DAD (E.D. Cal. 2013).)

In the JPMorgan case, however, the Commission determined that acceptance of the settlement was in the public interest as it provided a fair, equitable, and timely resolution of the investigation. In particular, the JPMorgan settlement: (a) guaranteed full and complete relief to California Independent System Operator (CAISO) and Midcontinent Independent System Operator (MISO) ratepayers through the disgorgement of $125 million, along with the assurance that CAISO ratepayers would not be exposed to additional claims from JPMorgan that CAISO calculates have a value of $262 million; (b) ensured that JPMorgan paid a civil penalty of $285 million, which goes to the U.S. Treasury; (c) sent a strong message to market participants about the types of behavior the Commission considers manipulative, through the inclusion of a detailed set of facts to which JPMorgan stipulated; (d) highlighted for market participants the consequences of engaging in manipulative activity; and (e) memorialized that the traders who engaged in the manipulative conduct would no longer participate in bidding in PERC-jurisdictional markets while employed by JPMorgan. The Commission concluded that, on balance, acceptance of the settlement containing these substantial, immediate benefits for ratepayers and the public was preferable to jeopardizing those benefits through the considerable delay and uncertainty posed by pursuing actions against individual JPMorgan employees.

It is worth highlighting one aspect of the JPMorgan settlement agreement relating to the individual traders involved in the alleged misconduct. The agreement memorialized the fact that the traders who engaged in the bidding strategies at issue had been reassigned and were no longer participating in bidding generation into the organized markets, or otherwise engaged in power market trading. Because the Federal Power Act does not give the Commission the authority to ban traders from electricity markets for market manipulation, this result could not have been achieved by taking the matter to trial.

Q.6. How can regulators more effectively hold these firms, particularly individual executives, accountable in order to deter manipulative and fraudulent activities in markets that have a direct impact on consumers?

A.6. In my view, there are several preconditions that must be met for an enforcement office to improve its capability to deter market manipulation and fraud. First, the agency must have the legal authority to pursue wrongdoing, with strong enforcement tools and a civil penalty authority that creates adequate deterrence. FERC received such an authority in the Energy Policy Act of 2005, which includes a broad antimanipulation authority based on Rule 1 Ob-5 in the Securities and Exchange Act of 1934 and a penalty authority of up to $1,000,000 a day per violation.

Second, the agency must have the resources and human capital—the technical and legal expertise—to detect, investigate, and prosecute market manipulation. These are not easy cases, and they require highly qualified staff who understand the markets and the products traded on them. FERC's Office of Enforcement has almost 200 staff and includes auditors and accountants, former traders and risk managers, economists, energy analysts with highly quantitative skill sets with backgrounds in engineering, statistics, mathematics, and physics, and lawyers who are skilled investigators and litigators, including former Federal prosecutors and lawyers with extensive litigation experience.

Third, the agency must create a robust oversight and surveillance program that has the capability to track market fundamentals and to identify market anomalies. In order to create a surveillance program, the agency must receive the relevant trading data and devise algorithms to screen the data. This, in turn, requires technical staff who have the quantitative and analytical skill sets to create the algorithms, as well as the necessary IT support and infrastructure. FERC's Office of Enforcement has created algorithms that it uses to screen the natural gas and electric markets for suspicious trading patterns, and it continually looks for ways to enhance its surveillance capabilities.

Fourth, to further good Government and to better protect the public interest, the agency must work closely with other agencies and share information on matters of mutual concern. With respect to investigations, FERC's Office of Enforcement has coordinated or shared information with other Federal Government agencies, including the Department of Justice, the CFTC, the SEC, the FTC, the Federal Reserve, and the EPA. We have also established relationships with international regulators and consulted with or provided technical assistance to them.

Fifth, as a matter of policy, the agency must be committed to the core principle of holding wrongdoers accountable. This means that in appropriate cases individuals, and not just firms, are held responsible for their misconduct. To promote accountability and deterrence, the agency should also shed light on unlawful conduct through detailed settlement agreements and Orders to Show Cause and bring enforcement actions when a settlement cannot be achieved that is in the public interest. FERC has sought to do all of that in its enforcement actions. A recent example is Barclays in which the Commission issued a penalty assessment of $453 million against the firm and four traders. The matter is currently being litigated in Federal court in the Eastern District of California.

Finally, regulators must never become complacent in their market oversight and surveillance. Markets are not static constructs, and as they change, regulators must be aware of the change and their oversight and surveillance program must evolve as well.

I am pleased to say that enforcement staff at FERC have worked hard to implement these measures since EPAct 2005, will do so in the future, and will continue to look for ways to improve our ability to detect and remedy fraud and manipulation.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM VINCENT MCGONAGLE

Q.1. On the issue of market surveillance and interagency coordination, you stated the CFTC has invited FERC to CFTC premises to gain access to market surveillance data while information sharing protocols are finalized. You further shared the CFTC's concerns about confidentiality, specifically that information is shared and protected in a way that satisfies CFTC's congressionally mandated confidentiality obligations.

Please elaborate more specifically on these concerns.

A.1. Pursuant to section 8(e) of the Commodity Exchange Act, 7 U.S.C. §12(e) (CEA), the Commission may furnish to any department or agency of the United States Government acting within the scope of its jurisdiction any information in its possession obtained in connection with the administration of the CEA. However, any information furnished under this provision cannot be further disclosed except in an action or proceeding under the laws of the United States to which the recipient agency or department, the Commission or the United States is a party. Accordingly, when undertaking to share nonpublic information with another Federal agency or department, the CFTC must satisfy itself that such information is received and used consistent with these confidentiality obligations. As a threshold matter, on January 2, 2014, the CFTC and FERC executed a Memorandum of Understanding Regarding Information Sharing and Treatment of Proprietary Trading and Other Information (Information-Sharing MOU) establishing the commitments of the two agencies with respect to the sharing of nonpublic material and the treatment of proprietary and/or privileged information, including appropriate restrictions on the onward sharing of such information. The Commission's initial transmission of market data to FERC commenced on March 5, 2014. Pursuant to and consistent with the Information-Sharing MOU, this transmission was preceded by written undertakings by FERC, dated March 5, 2014, with respect to data transmission and logistics and management of CFTC confidential information.

Q.2. What protocols would alleviate the CFTC's confidentiality requirements?

A.2. The Information-Sharing MOU substantially addressed the Commission's concerns related to its statutory confidentiality requirements and set forth the general terms and conditions for future information sharing. FERC's initial information request to the CFTC under the MOU was accompanied by a letter dated March 5, 2014, which: (1) articulated specific encryption protocols to be followed for the secure transmission of data from the CFTC to FERC; (2) included an undertaking by FERC to work with the CFTC to establish and maintain appropriate safeguards to protect the confidentiality of files for which access is granted and the information derived therefrom; and (3) included a specific commitment to keep confidential any information furnished by the CFTC, consistent with the provisions of the MOU and section 8(e) of the CEA.

Q.3. When will these protocols be finalized?

A.3. The above-described MOU was finalized on January 2, 2014; FERC provided associated written undertakings by letter dated March 5, 2014.

Q.4. Are there any obstacles in the way of finalizing this protocol? If there are, please describe what they are, and how are they being addressed?

A.4. The essential elements of the confidentiality protocols have been finalized and information sharing has commenced.

Q.5. When asked about the CFTC's jurisdiction over the London Metal Exchange (LME) aluminum warehouses, you stated, "the issue is something that requires some degree of evaluation by the CFTC, particularly as it relates to the fact that the LME has applied for registration as a foreign board of trade . . . we [CFTC] are engaged with LME and with the U.K.'s FCA [Financial Conduct Authority], the LME's regulator, with respect to how this warehousing issue, these questions concerning premiums, rents, incentives . . . [and] where are the legitimate forces of supply and demand and . . . potentially where can it be fixed."

Please elaborate on the "degree of evaluation" the CFTC has taken on the LME aluminum warehouse issue.

A.5. Under the registration regime established by the Dodd-Frank Act, registration as a foreign board of trade (FBOT) pertains to FBOTs who seek to offer U.S. customers direct access to their electronic trading and order matching system separate from other means of trading access; FBOT registration is not otherwise required.

As part of the FBOT review process, Commission staff are examining LME's aluminum warehouse operations including, among other things, how the warehouses operate, the relationships between LME and the warehouse operators, how storage policies and prices are determined, how effective the load-out rate is and the basis for incentives charged by warehouse operators.

On November 7, 2013, LME provided notice to the market of its adoption of a 12-item package of measures, which it described as "designed to further enhance the LME's physical delivery network, optimize contract price convergence, and continue to deliver best-in-class price discovery and hedging solutions for all market users." (LME Notice 13/326 : A312 : W125) As provided by that Notice, the package was to take effect on April 1, 2014. These reforms and their associated reports can be accessed at the LME Web site: *http://www.lme.com/trading/warehousing-and-brands/warehousing/warehouse-consultation/*.

However, on March 27, 2014, in response to a complaint by United Company Rusal plc (Rusal), a U.K. High Court of Justice handed down a judgment in respect to one aspect of LME's 12-item package—LME's proposal to implement a linked load-in load-out rule, which was intended to address warehouse issues. Although metal buyers backed stricter rules to cut wait times for aluminum and other metals, some producers disagreed. And Rusal, a large aluminum producer, filed a U.K. lawsuit this past December that challenged LME's changes to its warehouse policy. In its filing, Rusal described the changes as "irrational and disproportionate. The High Court decided to uphold certain aspects of Rusal's complaint and so quashed the LME's implementation of the linked load-in load-out rule. On April 7, LME stated that "the LME's commitment to address queues, and their consequent impact on efficient price discovery, remains unchanged. The LME is taking legal advice to establish the quickest effective route by which action can be taken to reduce queue lengths at Affected Warehouses." (LME Notice 14/121 : A117 : W056)

While this decision prevented an April 1 implementation of the linked load-in load-out rule, it did not interfere with the implementation of the other items of LME's package, which are also aspects of LME's plan to improve warehouse operations. These other measures came into effect on April 1st of this year, and the Division is currently reviewing the impact of those changes. We are also considering what additional steps are appropriate in light of the delayed implementation of the linked load-in load-out rule.

Q.6. Please describe how the CFTC has engaged the LME and the U.K.'s FCA, including the frequency with which the CFTC has communicated with the LME FCA and any outcomes from these meetings.

A.6. Since July of 2013, staff has been in contact with LME on an ongoing basis to discuss LME's plan to address the warehouse issues. More recently, staff met with LME and has had at least three telephone conferences since early January. Staff has also been in contact with the FCA on several occasions. Both the LME and the FCA have consistently voiced the desire to resolve the warehouse situation.

Q.7. Have there been any challenges working with the FCA on this issue?

A.7. The Division is satisfied that it has a good working relationship with FCA on this matter.

Q.8. There is a no-action letter between the CFTC and the LME allowing the LME to operate in the U.S. country provided the LME ensures fairness to market participants. You stated that, "ultimately, we [CFTC] can revoke or suspend any no-action letter that is issued by the Division of Market Oversight."

Do you view the current activities of the LME and the LME warehouses as consistent or inconsistent with the existing no-action letter?

A.8. The existing no-action letter, issued on March 12, 2001, generally provides, in pertinent part, that subject to LME's compliance with the terms and conditions stated in the no-action letter, the Division of Trading and Markets, (now the Division of Market Oversight) will not recommend that the Commission institute enforcement action against LME or its members solely based upon LME's failure to seek designation as a DCM or registration as a DTEF pursuant to Sections 5 or 5a, respectively, of the CEA, if LME makes its electronic trading and order matching system, known as LMEselect, available to LME members in the U.S. (now referred to as direct access). Although the no-action letter policy for permitting direct access was superseded by the Dodd-Frank Act's FBOT Registration policy, found in section 4(b)(1) of the CEA and Commission regulation Part 48, LME may continue to provide for direct access pursuant to the no-action letter until such time as the Commission addresses its application for registration.

No-action letters such as the one issued to the LME were issued after a thorough evaluation of, among other things, the Exchange's trading system, rule enforcement practices, disciplinary system, etc., to determine if persons in the U.S. could reliably and safely trade on the Exchange.

In addition, there is a condition in LME's no-action letter that states as follows: "The laws, systems, rules, and compliance mechanisms of the United Kingdom applicable to LME will continue to require LME to maintain fair and orderly markets; prohibit fraud, abuse, and market manipulation; and provide that such requirements are subject to the oversight of the FSA (now FCA)." In the U.K., the Financial Services and Markets Act 2000 (FSMA) prohibits market abuse including, among other things, misuse of nonpublic material information, the creation of false or misleading market impressions, and market distortion. As a Recognized Investment Exchange pursuant to the FSMA, LME is subject to a comprehensive regulatory regime in the United Kingdom which includes, among other things, reporting and record keeping requirements, procedures governing the treatment of customer funds and property, conduct of business standards, provisions designed to protect the integrity of the markets, and statutory prohibitions on fraud, abuse, and market manipulation.

Q.9. You further stated that it was your expectation that the issue could be addressed without revoking the letter, and those opportunities were being explored. Can you please elaborate on the opportunities and solutions being explored by the CFTC?

A.9. As with all no-action letters, the issuing Division, in its discretion, retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided. The Division is continuing to monitor the effectiveness of the steps that LME has taken to address the issue of warehouse congestion. Steps included: changes to LME's Warehousing Agreement (giving LME enhanced powers to investigate the formation of queues, and to impose additional load-out obligations on warehouses that have paid incentive fees in order to artificially create or maintain queues), and the formation of: (1) a Logistical Review group (to "provide LME with an independent view on reasonable operational expectations and requirements for the loading in, holding and loading out of metals"); and (2) a Physical Market Committee (to "provide a forum for all sectors of the physical industry to represent their views to the Exchange"). As noted above, LME's intention to implement a "linked load-in load-out requirement" was blocked by a U.K. court on March 27, 2014. Going forward, the Division intends to review the steps LME takes in response to the court's decision.

The Division will also continue discussions with LME's primary regulator, the U.K. FCA, regarding its review of the effectiveness of the warehousing steps. If the outcome of LME's corrective measures is unsatisfactory, the Division may require additional or alternative measures to address warehouse congestion as a condition of its no-action relief. Moreover, as noted above, Commission staff is examining the current activities of LME and the LME warehouses' operations as part of staff's review of LME's FBOT application.

Q.10. At what point would revoking the no-action letter be an appropriate remedy to the LME aluminum warehouse issue? If you need more information to answer this question, what steps have you taken or do you need to take to get the information you need?

A.10. Revoking FBOT no-action letters may be an appropriate remedy where there has been a determination that the FBOT no longer meets the conditions required in its no-action letter to retain relief, and where an FBOT is not responsive to Commission staff-suggested corrective measures. Commission staff is taking a number of steps to evaluate aluminum pricing within the United States as set forth in further detail above.

Q.11. In 2006, the CFTC subpoenaed Platts, the leading provider of spot and contract prices in the global metals market, to investigate the accuracy of trade data submitted to Platts. McGraw-Hill, Platts's parent company, publicly acknowledged that "some energy companies and individual traders have repeatedly attempted to manipulate the price indexes produced by publishers such as Platts." In 2002, during another CFTC investigation regarding energy prices, two power companies "disclosed that some of their traders provided inaccurate pricing information to Platts." Such benchmarks by "price reporting agencies" based on producer announcements, negotiations, or gathering of market information have come under scrutiny. The first thing that comes to mind is LIBOR.

What was the outcome of the CFTC's investigation into the Platt's pricing mechanism?

A.11. As part of its investigations of possible misconduct in the energy markets, including whether traders at certain energy companies submitted trade data reflecting manipulated prices to Platts for use in calculating index prices of natural gas published by Platts in order to benefit financial trading positions tied to the same index, the Commission filed four actions in the United States District Courts court to compel the McGraw-Hill Companies, Inc.'s production of energy reporting-related documents requested in an administrative procedure. In each of these actions, McGraw-Hill was compelled by a Federal court, overcoming McGraw-Hill's claim of privilege, to comply in substantial part with CFTC subpoenas directed to McGraw-Hill. See CFTC v. McGraw-Hill Companies, Inc., 507 F. Supp.2d 45 (D.D.C. 2007); CFTC v. McGraw-Hill Companies, Inc., 390 F. Supp.2d 27 (D.D.C. 2005); CFTC v. Whitney, 441 F. Supp.2d 61 (D.D.C. 2006); and CFTC v. Bradley, et al., Case No. 05-cv-62, 2006 WL 2045847 (N.D. Okla. July 20, 2006).

From December 2002 through July 2007, the Commission filed 28 enforcement actions charging, in part, false reporting and attempted manipulation relating to natural gas price indexes in the energy markets, and obtained over $280 million in settlement of these matters. See In re Dynegy Marketing & Trade, et al., CFTC Docket No. 03-03 (CFTC filed Dec. 18, 2002) ($5 million civil monetary penalty); In re El Paso Merchant Energy, L.P., Docket No. 03-09 (CFTC filed March 26, 2003) ($20 million civil monetary penalty); In re WD Energy Services Inc., Docket No. 03-20 (CFTC filed July 28, 2003) ($20 million civil monetary penalty); In re Williams Energy Marketing And Trading, et al., Docket No. 03-21 (CFTC filed July 29, 2003) ($20 million civil monetary penalty); In re Enserco Energy, Inc., Docket No. 03-22 (CFTC filed July 31, 2003) ($3 million civil monetary penalty); In re Duke Energy Trading And Marketing, L.L.C., Docket No. 03-26 (CFTC filed Sept. 17, 2003) ($28 million civil monetary penalty); CFTC v. American Electric Power Company, Inc., et al., No. C2 03 891 (S.D. Ohio filed Sept. 30, 2003) ($30 million civil monetary penalty); In re CMS Marketing Services and Trading Company, et al., Docket No. 04-05 (CFTC filed Nov. 25, 2003) ($16 million civil monetary penalty); In re Reliant Energy Services, Inc., Docket No. 04-06 (CFTC filed Nov. 25, 2003) ($18 million civil monetary penalty); In re Aquila Merchant Services, Inc., Docket No. 04-08 (CFTC filed Jan. 28, 2004) ($26.5 million civil monetary penalty); In re Calpine Energy Services, L.P., CFTC Docket No. 04-11 (CFTC filed Jan. 28, 2004) ($1.5 million civil monetary penalty); In re ONEOK Energy Marketing And Trading Company, L.P., et al., Docket No. 04-09 (CFTC filed Jan. 28, 2004) ($3 million civil monetary penalty); In re Entergy-Koch Trading, LP, Docket No. 04-10 (CFTC filed Jan. 28, 2004) ($3 million civil monetary penalty); In re e prime, Inc., Docket No. 04-12 (CFTC filed Jan. 28, 2004) (a wholly owned subsidiary of Xcel Energy, Inc.; $16 million civil monetary penalty); In re Knauth, Docket No. 04-15 (CFTC filed May 10, 2004) ($25,000 civil monetary penalty); In re Western Gas Resources, Inc., Docket No. 04-17 (CFTC filed July 1, 2004) ($7 million civil monetary penalty); In re Coral Energy Resources, L.P., Docket No. 04-21 (CFTC filed July 28, 2004) ($30 million civil monetary penalty); In re Cinergy, CFTC Docket No. 05-03 (CFTC filed November 16, 2004) ($3 million civil monetary penalty); In re Mirant, CFTC Docket No. 05-05 (CFTC filed Dec. 6, 2004) ($12.5 million civil monetary penalty); In re Dominion Resources, Inc., CFTC Docket No. 06-06 (CFTC Sept. 27, 2006) ($4,250,000 civil monetary penalty); CFTC v. Foley, No. 2:05 849 (S.D. Ohio filed Sept. 14, 2005, settled Sept. 28, 2006) ($350,000 civil monetary penalty); CFTC v. McDonald, et al., No. 1:05-CV-0293 (N.D. Ga. filed Feb. 1, 2005, settled Nov. 17, 2006, Nov. 7, 2007) ($750,000 total civil monetary penalties); CFTC v.

NRG Energy, Inc., No. 04-cv-3090 MJD/JGL (D. Minn. filed July 1, 2004) ($2 million civil monetary penalty); CFTC v. Reed, et al., No. 05-D-178 (D. Colo. filed Feb. 1, 2005, settled March 13, 2007, Nov. 13, 2000) (total $2,075,000 civil monetary penalties); CFTC v. Richmond, No. 05-M-668 (OES) (D. Colo. filed April 12, 2005, settled March 20, 2007) ($60,000 civil monetary penalty); CFTC v. Bradley, et al., No. 05CV62-CVE-FHM (N.D. Okla. filed Feb. 1, 2005, settled May 25 and June 25, 2007) (Bradley $100,000 civil monetary penalty; Martin $25,000 civil monetary penalty); CFTC v. Johnson, et al., No. H-05-0332 (S.D. Texas filed Feb. 1, 2005, settled Nov. 7, 2007) (Johnson, Moore, Tracy, Harp and Dyer $1 million civil monetary penalty; April 24, 2008 judgment for Dizona); CFTC v. Whitney, No. H 05-333 (S.D. Texas filed Feb. 1, 2005, settled March 5, 2008) ($55,000 civil monetary penalty); and CFTC v. Energy Transfer Partners, L.P., et al., No. 3-07CV1301-K (N.D. Tex. filed July 26, 2007, settled March 17, 2008) ($10 million civil monetary penalty).

Q.12. Why is this benchmark used to determine the price of aluminum?

A.12. One benchmark used in the aluminum market is the LME futures price adjusted by the "Midwest premium." As stated by Platts, the Midwest premium (or discount) is determined by an analysis by Platts of "physical spot deals, bids and offers reported through a daily survey of spot buyers and sellers, using a representative sample of producers, traders and different types of end users." (See *http://www.platts.com/IM.Platts.Content/methodologyreferences/methodologyspecs/metals.pdf*).

According to Platts, some privately negotiated "floating" term contracts and swaps settle on the basis of the spot price as determined by Platts. (See *http://www.apdtesting.com/wordpress/wp-content/uploads/2012/11/2011-5-12__platts__karen__mcBeth__copper__aluminum__magnesium.pdf*).

Our understanding is that aluminum end users execute swaps that are priced off of a Platts reported price of the LME price plus an additional premium—the published Midwest premium—plus shipping to their specific location. The LME price is not location-specific and delivery of LME stock can occur at any of their global warehouses. Therefore, end users who need aluminum at a specific location may use other instruments (swaps) that give them certainty of delivery location as well certainty of timing of delivery.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM VINCENT MCGONAGLE

Q.1. Is the CFTC working with the U.K. and European regulators to ensure that the LME proceeds with the transparency commitments announced late last year? Do you have a sense of the timetable?

A.1. CFTC market oversight staff hold routine, periodic telephone conference calls with counterparts at the U.K. Financial Conduct Authority (FCA). During the course of these calls in 2013 and 2014, CFTC and FCA staff discussed concerns raised by aluminum market participants relating to slow load-out rates of metals stored in

LME approved warehouses. The purpose of these conversations was to learn what steps the FCA was taking with regard to LME and the status of any reforms. We have not had any formal discussions with other European regulators in this regard, as the FCA is the only European regulator responsible for oversight of LME.

In this regard, many of the reforms adopted by the LME following its 2013 consultation were, as noted above, implemented on April 1. These reforms and their associated reports, as well as LME's statements of March 27 (LME Notice 14/106 : A103 : W046), and of April 7, 2014 (LME Notice 14/121 : A117 : W056), both issued in response to the decision of the U.K. High Court, can be accessed at the LME Web site: *http://www.lme.com/trading/warehousing-and-brands/warehousing/warehouse-consultation/*.

While most of the changes adopted by LME were implemented on April 1, 2014, timeline for the implementation of the linked load-in load-out rule, was, as noted above, affected by the March 27, 2014, decision of the U.K. High Court, issued in response to the U.K. lawsuit filed this December 2013 by Rusal. According to its statement of April 7, "the LME's commitment to address queues, and their consequent impact on efficient price discovery, remains unchanged. The LME is taking legal advice to establish the quickest effective route by which action can be taken to reduce queue lengths at Affected Warehouses." (LME Notice 14/121 : A117 : W056)

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM MICHAEL S. GIBSON

Q.1. In your testimony, you stated the FRB's primary concern is the safety and soundness of individual financial institutions and the financial system as a whole, while market oversight is entirely the task of Commodity Futures Trading Commission (CFTC), Federal Energy Regulatory Commission (FERC) and other market regulators.

What is the specific statutory language that explicitly relieves the FRB of broader oversight responsibilities given the FRB's function as the consolidated regulator of Financial Holding Companies (FHCs) and systemic risk?

A.1. The Board's supervisory and regulatory authority regarding financial holding companies and systemic risk is limited to that granted by statute, in particular, the Bank Holding Company Act (BHC Act) and the recently enacted, Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] The BHC Act directs the Board to monitor through reports and examination the operations and financial condition of bank holding companies and "compliance of the bank holding company and the subsidiary with (I) [the BHC) Act; (II) Federal laws that the Board has specific jurisdiction to enforce against the company or subsidiary; and (III) other than in the case of an insured depository institution or functionally regulated subsidiary, any other applicable provisions of

[1] See, e.g., Board of Governors v. Dimension Financial Corp., 474 U.S. 361 (1986); Western Bancshares, Inc. v. Board of Governors, 480 F.2d 749 (10th Cir. 1973). The Board also has authority to take supervisory actions, including enforcement actions, to prevent or address unsafe and unsound practices. 12 U.S.C. §1818(b)(3).

Federal law."[2] The BHC Act specifically includes within the definition of "functionally regulated subsidiary" "an entity that is subject to regulation by, or registration with, the Commodity Futures Trading Commission" with respect to activities subject to the CFTC's jurisdiction.[3] In addition, the BHC Act specifically provides that, in exercising its authority, the Board must, to the fullest extent possible, rely on examination reports made by other Federal or State regulatory agencies and avoid duplication of examination activities, reporting requirements, and requests for information.[4]

The authority to oversee the securities, derivatives, and commodities markets is vested in agencies such as the Commodity Futures Trading Commission, Federal Energy Regulatory Commission, and Securities and Exchange Commission, which have specific oversight authority including the jurisdiction to address market manipulation. In addition, these agencies have access to information regarding the practices of a wide range of market participants, whereas the Federal Reserve only has access to the activities of the participants that are banking firms. As a result, the agencies with direct market oversight authority are in the best position to tell whether certain practices deviate from market practices, including trading and pricing practices.

However, if Federal Reserve staff suspects a problem as a result of its review, staff would refer and cooperate with the appropriate market regulator(s).

Q.2. Independent of the FRB's request for public comment on the issue of FHC ownership of physical commodities and energy assets through the Advanced Notice of Proposed Rulemaking (ANPR), does the FRB consider the ability of a FHC to combine its trading and dealing in commodity derivatives with direct ownership of the underlying physical commodity, such as ownership of the physical infrastructure to extract, store, deliver and transport commodities, as potentially systemically risky, unfair or dangerous from the viewpoint of market integrity, consumer protection, and macroeconomic stability?

A.2. Because of its concern that ownership of the physical infrastructure to extract, store, deliver, and transport commodities may pose risks to the safety and soundness of bank holding companies, the Board has not approved bank holding companies to engage in these activities. Indeed, the Board's exercise of authority under section 4(k) of the BHC Act permitting financial holding companies to engage in activities that are complementary to financial activities specifically prohibited financial holding companies from using that authority to engage in extraction, storage, delivery, or transportation of physical commodities.

A limited number of financial holding companies engage in these activities under authority specifically provided by statute that does not require Board approval: grandfathering authority under section 4(o) of the BHC Act and merchant banking authority under sections 4(k)(4)(H) and (I) of the Act. These authorities are broad and

[2] 12 U.S.C. §1844.
[3] Id.
[4] Id.

place no limits on their combination with other authorities or activities.

As part of the January 2014 advance notice of proposed rulemaking (ANPR), the Board will consider how to address the potential risks to safety and soundness and U.S. financial stability that may be presented by the activities authorized under sections 4(o), 4(k)(4)(H), and 4(k)(4)(I) and whether additional prudential requirements such as capital, liquidity, reporting, or disclosure requirements, could help ensure such activities do not pose undue risks to the safety and soundness of the bank holding company or to financial stability.

Q.3. You stated the FRB's supervision staff held meetings to review FHCs' physical commodity activities since 2008. According to your testimony, these reviews raised a number of concerns about certain risks systemically important financial institutions' commodities activities can pose to financial stability. Many of these concerns are posed in the ANPR the FRB issued on January 14, 2014.

Please publicly disclose the discussion minutes and any policy conclusions made at the staff-level meetings on the issue of FHC ownership of physical commodities. Specifically, elaborate on the FRB's policy concerns beyond issues associated with the institutions' safety and soundness to include a detailed list of the policy concerns discussed, and the number of meeting, with specific dates.

A.3. Since 2009, Federal Reserve staff has conducted a series of horizontal examinations of the commodities activities of certain financial holding companies, including Bank of America Corporation, JPMorgan Chase & Co., Goldman Sachs, and Morgan Stanley. In 2008, Goldman Sachs and Morgan Stanley became bank holding companies, and Bank of America Corporation and JPMorgan Chase & Co. acquired companies with substantial commodities activities. Ongoing continuous monitoring work on the commodities activities of the firms has also been conducted.

The overall conclusions of these examinations helped to inform the ANPR, including the concerns reflected in the ANPR regarding the potential tail risk of physical commodities activities, the limitations of insurance and capital requirements to mitigate the potential risks of commodities activities, and the difficulty to quantify these risks.[5]

The content of the meetings held, and examinations conducted, by Federal Reserve staff regarding physical commodities activities involves confidential supervisory information and trade secrets. Disclosure of this information could prejudice the examination process and is subject to protections from disclosure under Federal law.

Q.4. Please describe the subsequent actions the Fed staff has taken to address each of these policy concerns, and demonstrate how the FRB communicated these concerns with the FHCs through orders granted or approval of specific activities or acquisitions in the course of supervising and monitoring FHCs' commodities and energy activities.

[5] See 79 Fed. Reg. 3329, 3332-34 (January 21, 2014).

A.4. In cases where Federal Reserve examiners identified risk management or other weaknesses as part of the horizontal examination of the firms involved in physical commodities activities, this information was communicated to each of the firms, and examiners monitored the firms to ensure that the firms were taking appropriate steps to remediate these weaknesses. For example, Federal Reserve examiners have required:

- modification of value-at-risk calculations pertaining to commodities positions,
- more granular risk limits for commodities positions,
- consistent valuations of physical and derivative positions in the same commodity,
- divestiture of impermissible commodity assets, and
- a more robust compliance function for commodities activities.

In the case of JPMorgan Chase & Co., Federal Reserve staff notified the firm that Henry Bath & Sons Ltd (Henry Bath) was not a bona fide merchant banking investment and consequently, JPMorgan Chase & Co. is required to divest its investment in Henry Bath.

Q.5. Aside from the vote held by FRB Governors to approve the ANPR, are there any plans for any board-level meetings on this subject? If not, why has this issue not been considered or discussed by the Board?

A.5. A key purpose of the ANPR is to provide the Board with additional information in order to determine the appropriate course of action to address the risks of physical commodities activities. The Board will consider appropriate additional steps to address these risks after the comment period on the ANPR concludes. Currently, the comment period is scheduled to close on April 16, 2014.

Q.6. You stated in your testimony that FHCs publicly disclose in their quarterly filings with the FRB one metric directly related to their physical commodity holdings, which presents an aggregate market value of physical commodities on their balance sheet.

How does this metric help the FRB and the public understand the specific physical commodity activities these institutions conduct, including the commodity and energy companies they own or control, or the influence the FHCs may, or may not, have on the prices of individual commodities?

A.6. The Board's Reporting Form Y-9C and its schedules provide disclosure on commodities, including commodity and other exposures, gross fair value of commodity contracts, gross fair value of physical commodities held in inventory, commodities specified according to derivative position indicators, and the notional principal amount of commodity contracts. This information helps the Board track compliance with the limits it has placed on the commodity activities of firms relying on complementary authority, but the Board does not solely rely on this information to understand the breadth of commodities activities that these firms conduct or the risks that those activities pose. This disclosure informs the public of the size of physical commodity activities that the institutions conduct. The ANPR solicits comments on a broad array of issues concerning physical commodities' impact on safety and soundness and what additional criteria the Board should consider concerning physical commodities, including whether the public has a need for more information in this area that exceeds the burden that would be imposed on the financial holding companies to supply that information.

Q.7. Is the FRB considering other disclosure alternatives given this line item only provides an aggregate number of all commodities activities conducted by a single FHC?

A.7. Yes, the Board inquires in its ANPR about the advantages and disadvantages of requesting additional reporting or disclosure requirements for bank holding companies and requests suggestions on how the Board should formulate such requirements. In addition, the Board specifically stated in the ANPR that it is considering a number of actions to address the potential risks associated with merchant banking investments, including enhanced reporting to the Board or public disclosures regarding merchant banking investments.

Q.8. You also mentioned that FHCs disclose their physical commodities activities in their SEC filings. Bank holding company (BHC) disclosures are governed by Guide 3, a rule promulgated in the 1970s, well prior to the Gramm-Leach-Bliley Act. Guide 3 only requires disclosure of the securities held in a BHC's investment portfolio. Should these rules be revised to provide better disclosures of commodities activities?

A.8. The Board supports robust disclosures that result in transparency and encourage market discipline. The SEC's Guide 3 governs certain types of required disclosures and may not govern all physical commodity activities or investments. The SEC is best able to determine whether Guide 3 is consistent with the mandate in the Federal securities laws.

Q.9. The following questions address the process by which the FRB scrutinized, authorized, and continues to oversee the former investment banks', i.e., Goldman Sachs and Morgan Stanley, physical commodities and energy holdings after their conversion from investment banks to FHCs:

When Goldman Sachs and Morgan Stanley applied to the FRB to be registered as FHCs in the fall of 2008, did the FRB staff conduct a review of their existing commodities assets and investments?

A.9. The Board approved applications by Morgan Stanley and Goldman Sachs to become bank holding companies in September 2008. In light of the unusual and exigent circumstances affecting the financial markets at the time, the Board determined that emergency conditions existed that justified expeditious action and waiver of public notice of the applications. In approving the applications, the Board considered all of the statutory factors required under the BHC Act. In connection with its review of the Morgan Stanley and Goldman Sachs applications, the Board did not conduct a targeted review of the commodities activities and investments of the two organizations. Section 4(a)(2) of the Bank Holding Company Act permits a newly formed bank holding company to retain any otherwise impermissible activities for up to 2 years, with the possibility of three 1-year extensions. Moreover, section 4(o) of the BHC Act permits a qualifying financial holding company to engage in physical commodity activities without seeking or obtaining Board approval. Both Morgan Stanley and Goldman Sachs are section 4(o) qualifying financial holding companies.

Morgan Stanley and Goldman Sachs also filed elections to become financial holding companies that ultimately became effective. Morgan Stanley's election was filed in August 2008, Goldman Sachs' in July 2009. These elections were considered under the factors enumerated in the Bank Holding Company Act and the Board's Regulation Y at the time, including the requirement that all of the depository institution subsidiaries of the bank holding company be well capitalized and well managed.

Q.10. If yes, please describe the scope of the review, and explain how this review found these institutions' commodity holdings did not pose sufficient risks to the financial system?

A.10. Please see response for Question 9.

Q.11. If not, why wasn't a review of these activities conducted?

A.11. Please see response for Question 9.

Q.12. Please describe any discussions between the FRB supervisors and representatives from Goldman Sachs and/or Morgan Stanley held between 2008 and present with respect to their ability to continue, and to expand, their pre-2008 physical commodity activities under any legal authority after their conversion into bank holding companies. For example, was the Fed aware of, and did it approve, Goldman Sachs' acquisition of Metro International in 2010?

A.12. As discussed more fully in the response to Question 9, the 2008 Morgan Stanley and Goldman Sachs applications were processed using expedited procedures due to the emergency conditions that existed at the time.

Goldman Sachs has indicated that it is holding Metro International under merchant banking authority. Merchant banking investments are not subject to prior approval of the Federal Reserve. The policies and procedures that Goldman Sachs employs to ensure that its merchant banking investments conform with the Federal Reserve's merchant banking rules have been reviewed by supervision staff, as has the control framework that Goldman Sachs uses to minimize the financial and reputational risks posed by such investments. Subsequent to Goldman Sachs and Morgan Stanley becoming bank holding companies, supervision staff conducted extensive reviews of the commodities activities of both companies. The reviews catalogued the activities in which the two firms engaged, and assessed the control environment that the two firms utilize to manage their commodities business. Supervisory staff has periodic discussions with Goldman Sachs and Morgan Stanley regarding their physical commodities activities including the authorities under which they are engaging in the activities.

Q.13. Please describe specific factors and reasoning for the FRB's decision to allow JPMorgan to acquire Henry Bath, a metal warehouse business, and other commodity assets from RBS Sempra in 2010.

A.13. The BHC Act and the Board's Regulation Y permit financial holding companies to make acquisitions of firms that engage in various activities that are financial in nature. Financial holding companies often seek to acquire firms that engage in financial activities, but are not subject to the BHC Act and its restrictions. These firms often engage in some amount of activities that are related to the firm's financial business, but are not permissible for bank holding companies to conduct under the BHC Act. To address this, the Board's Regulation Y permits a financial holding company to acquire a firm that is engaged in a mix of permissible financial activities and impermissible activities under certain conditions. In particular, at least 85 percent of the activities of the target firm (as measured by assets and revenues) must be permissible financial activities, and the acquiring financial holding company must divest or otherwise conform the impermissible activities within 2 years of the acquisition, unless a limited extension is granted by the Board. JPMorgan Chase & Co. acquired Henry Bath as part of the acquisition of the financial businesses and assets of RBS Sempra. The Board's Regulation Y required JPMorgan Chase to conform, terminate or divest its investment in Henry Bath within 2 years of its acquisition, subject to limited extensions.

In connection with the RBS Sempra acquisition, the Board approved JPMorgan Chase's request to engage in energy tolling and energy management services as complementary activities under section 4(k) of the BHC Act. The Board did not approve the retention of Henry Bath under this authority. The Board subsequently informed JPMorgan Chase that its investment in Henry Bath would not qualify as a merchant banking investment.

Q.14. If an investment bank applied to the FRB to be registered as a FHC under normal circumstances (i.e., not under the crisis conditions when Goldman Sachs and Morgan Stanley became FHCs), what would have been the review process of these institutions physical commodity and energy activities? Please describe the types of inquiries the Fed would have made, and specific criteria it would have used, to assess whether these applicants' existing commodity activities complied with the requirements of the Bank Holding Company Act (BHCA) and were consistent with the public interest in preserving systemic financial stability in the long-term?

A.14. A company seeking to become a financial holding company must make at least two filings with the Federal Reserve, an application to become a bank holding company (as a result of either acquiring a bank or converting an existing depository institution subsidiary into a bank) and a declaration stating that the company elected, and qualified for, financial holding company status.[6] In connection with these filings, the Federal Reserve would request that the applicant describe its nonbanking activities and the legal authority for conducting these activities. In approving a bank holding company application, the Federal Reserve is required to consider, among other things, the financial and managerial resources and future prospects of the companies and banks concerned. A com-

[6] See 12 U.S.C. §§1842, 1843; 12 CFR225.11, 225.82.

pany's commodities-related and energy-related activities, like its other activities, would be considered in this context.

A company, such as Goldman Sachs or Morgan Stanley, that meets the requirements of section 4(o) of the Bank Holding Company Act may engage in commodities-related activities without the approval of the Board. By its terms, section 4(o) authorizes certain companies that become financial holding companies to engage in physical commodity activities that are not otherwise permissible for financial holding companies and have not been authorized by the Board.

A financial holding company may also seek Board approval to engage in activities that are complementary to financial activities.[7] In connection with requests under this section, the Federal Reserve obtains information about the types and scope of the requested activities, the financial condition of the applicant, the programs for monitoring and limiting risk from the activities, and other relevant information. Based on all the information available to the Board, the Board then considers whether the proposed activity is complementary to a financial activity, would pose risk to the safety and soundness of depository institutions or the financial system, and whether the public benefits, such as greater convenience, increased competition, or gains in efficiency, outweigh the possible adverse effects, such 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.

Q.15. The following are questions related to the FRB's legal and supervisory interpretation and use of the Section 4(o)'s grandfather provision under the BHCA. During the hearing, you stated that you are not a lawyer and thus could not offer an interpretation of what section 4(o) means.

How does the FRB's legal staff interpret the scope of the commodity grandfathering provision in Section 4(o)? Does the term "any such activities" permit an institution eligible for grandfathered treatment to engage in all commodities and physical asset trading an ownership of they were engaged in the ownership or trading of a single commodity or physical asset prior to 1997?

A.15. Section 4(o) of the BHC Act provides that "a company that is not a bank holding company or foreign bank and becomes a financial holding company as of November 12, 1999, may 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 that were not permissible for bank holding companies to conduct in the United States as of September 30, 1997, if the holding company, or any subsidiary of the holding company, lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States" and certain other requirements[8] are met.

[7] See 12 U.S.C. §1843(k)(1)(B).

[8] Section 4(o) also limits such activities and investments to 5 percent of the financial holding company's total consolidated assets and prohibits cross-marketing activities between subsidi-

Continued

Through this provision, Congress specifically authorized any company that becomes a financial holding company after November 1999 to engage in physical commodities activities (i.e., the physical commodities activities authorized by the provision) that were not otherwise permissible for bank holding companies to conduct in September, 1997. Companies that qualify for this statutory grandfather provision may continue to engage in commodities activities to the extent permitted by that provision without obtaining the Federal Reserve's approval.

Prior to September 30, 1997, bank holding companies claiming grandfather rights under section 4(o) were engaged in a broad range of commodities related activities that the Board had not authorized for bank holding companies. These included trading, mining, storing or transporting coal, oil, natural gas, fertilizer, electricity, and various metals. Thus, even under the narrowest reading of the statute, grandfathered bank holding companies are permitted by statute to engage in a broad range of commodities-related activities.

Some have argued that the statute is plain on its face that a grandfathered firm engaged in any commodity activity prior to the relevant date may engage after the relevant date in all of the commodities activities listed in the statute, namely "activities related to the trading, sale, or investment in commodities and underlying physical properties that were not permissible for bank holding companies to conduct in the United States as of September 30, 1997," in addition to the activities noted above that these firms conducted prior to the grandfather date. This reading would permit a grandfathered bank holding company to expand its commodities activities after the grandfather date.

As part of the ANPR, the Board will consider the scope of the grandfather provision in section 4(o). In addition, the Board will consider how to address the potential risks to safety and soundness and U.S. financial stability that may be presented by the activities authorized under section 4(o) and whether additional prudential requirements such as capital, liquidity, reporting, or disclosure requirements, could help ensure such activities do not pose undue risks to the safety and soundness of the bank holding company or to financial stability.

Q.16. Does that provision impose any limitations—including limitations related to the nature, volume, range-on the relevant FHC's physical commodities assets and activities? Would any such limitations help to limit potential risks presented by grandfathered commodity activities?

A.16. In addition to the scope of the grandfathered activities and investments discussed above, section 4(o) imposes two requirements: (1) the attributed aggregate consolidated assets of the company held by the financial holding company grandfathered pursuant to section 4(o), and not otherwise permitted to be held by a financial holding company, must not be more than 5 percent of the total consolidated assets of the financial holding company; and (2) the financial holding company must not permit any company, the

aries held pursuant to section 4(o) and affiliated depository institutions. 12 U.S.C. 1843(o)(2)-(3).

shares of which it owns or controls pursuant to section 4(o), to offer or market any product or service of an affiliated depository institution or any affiliated depository institution to offer or market any product or service of any company, the shares of which are owned or controlled by such holding company pursuant to section 4(o).

As the Board noted in the ANPR, financial holding companies grandfathered under section 4(o) may engage in a broader set of physical commodities activities than financial holding companies may otherwise conduct. Moreover, financial holding companies that engage in physical commodities activities under section 4(k)(1)(B) (complementary authority) or make merchant banking investments in companies engaged in physical commodities activities must conform to more restrictive prudential limitations than those of section 4(o) described above.

As noted in the ANPR, the Board is considering how to address the potential risks to safety and soundness and financial stability that may be presented by activities authorized under section 4(o). The ANPR seeks public comment on whether additional prudential requirements could help ensure that activities conducted under section 4(o) of the BHC Act do not pose undue risks to the safety and soundness of the bank holding company or its subsidiary depository institutions, or to financial stability.

Q.17. Please describe any internal discussions among the FRB staff, between 2008 and now, on the proper interpretation of the scope and purpose of Section 4(o). Were there any competing interpretations and, if so, what was the basis for the current view to prevail?

A.17. As noted in the response to question 5, part a, there are multiple possible interpretations of section 4(o) of the BHC Act. The Board will consider this matter in connection with its review of physical commodities activities.

Q.18. What type of research and analysis did the FRB staff conduct to arrive at its current interpretation?

A.18. The scope of section 4(o) of the BHC Act is an issue of statutory interpretation. Therefore, staffs research and analysis employed the tools associated with statutory interpretation, which included the language of section 4(o), applicable maxims of statutory construction, the legislative history of the Gramm-Leach-Bliley Act (GLB Act), and the purpose of the GLB Act and the BHC Act.

Q.19. As we discussed, Section 5 of the Bank Holding Company Act authorizes the FRB to force the sale of a nonbank affiliate if it threatens the safety and soundness of an insured depository institution. If a particular grandfathered activity poses a serious risk to the safety and soundness of the FHC, its deposit-taking subsidiary, or long-term stability of the U.S. financial system, would the Fed be both justified and obligated to use its powers under Section 5 of the Bank Holding Company Act, including its power to order the relevant institution to terminate such an activity?

A.19. Section 5(e) of the BHC Act permits the Board, under limited circumstances, to require a bank holding company to either terminate an activity or terminate the company's control of its subsidiary bank(s). The Board may require action under section 5(e) "notwithstanding any other provision of [the BHC] Act," which would include section 4(o) of the BHC Act.

As noted, the circumstances under which the Board may act under section 5(e) are limited. The Board must have "reasonable cause to believe that the continuation by a bank holding company of any activity or of ownership or control of any of its nonbank subsidiaries, other than a nonbank subsidiary of a bank, [(1)] constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank and [(2)] is inconsistent with sound banking principles or with the purposes of [the BHC] Act or with the Financial Institutions Supervisory Act of 1966." Section 5(e) requires the Board to make both findings. Moreover, the first required finding (i.e., "a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank"), is focused on risk to the subsidiary bank.Section 5(e) also includes procedural requirements; the Board must provide the bank holding company due notice and an opportunity for a hearing and consider the views of the bank's primary supervisor. Moreover, section 5(e) leaves the bank holding company, not the Board, the choice whether to divest the activity or divest the affiliated depository institution.

Finally, section 5(e) does not obligate the Board to act. Rather, section 5(e) provides an additional authority by which the Board may choose to address serious supervisory concerns with a bank holding company. The Board has successfully addressed a range of concerns related to the safety and soundness of bank holding companies and their subsidiary depository institutions, as well as financial stability concerns, through other authorities such as Board supervision, applications functions, and lesser enforcement actions.

Q.20. The following are questions related to the FRB's legal and supervisory interpretation and use of the Section 4(k)'s complementary provisions under the BHCA:

Please describe how exactly the FRB monitors and supervises FHCs' physical commodity activities and investments made under the "complementary" authority.

A.20. Similar to other aspects of its program for prudential supervision, the focus of the Federal Reserve's assessment of physical commodities activities is the risk management framework that supports them. The primary goals of the Federal Reserve's supervisory oversight of commodities activities are to (1) monitor the management of risks of those activities to the financial holding company, and (2) assess the adequacy of the firms' control environments relating to commodities. The supervisory oversight, for example, includes a review of internal management reports, periodic meetings with the personnel responsible for managing and controlling the risks of the firm's commodities activities, and targeted examinations of the activities. Supervisory staff also reviews policies and procedures, risk limits, risk mitigants, and internal audit coverage at institutions relating to physical commodities activities.

The Federal Reserve has a number of supervisory staff with knowledge and expertise in physical commodities activities. These experts work to understand the exposures, risks, risk management, accounting treatment, and broader commodities markets extensively. They evaluate the different manner in which commodities could present risks to financial holding companies, including from a market, operational, legal and reputational risk perspective.

Staff has conducted horizontal reviews on physical commodities, based on the greater involvement of the largest financial holding companies in commodities activities, to better compare risks and practices across institutions, providing feedback to institutions where appropriate. During these reviews, the teams have examined exposures, valuations, and risk management practices across all relevant firms, and conducted deeper reviews of the firms' operational risk quantification methodologies that relate to commodities.

Financial holding companies that engage in commodities activities also must hold regulatory capital to absorb potential losses from those activities. Financial holding companies have long been required to hold capital against the market risk of all commodity positions. Moreover, following the financial crisis, the Federal Reserve strengthened its capital requirements for the credit risk and market risk of these transactions. Further, under the Board's advanced approaches capital rules (12 CFR part 217, subpart E), financial holding companies subject to these rules are required to hold capital against the operational risk of their activities, including their commodities activities.

As stated previously, the Federal Reserve is seeking public comment in the ANPR on the sufficiency of its current supervisory and regulatory framework for constraining the risks in the physical commodities activities of financial holding companies.

Q.21. How does the FRB supervisory staff ensure that such policies and procedures are, in fact, effective in addressing all of the potential risks posed by such activities?

A.21. Please see response for Question 20.

Q.22. In your testimony, you stated the FRB has the authority to rescind any previously authorized "complementary" powers to any individual FHC.

On what grounds can the FRB rescind a 4(k) order?

A.22. An activity is permissible under section 4(k)(1)(B) of the BHC Act only if the activity, in the Board's determination, is "complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally." As noted in its advance notice of proposed rulemaking released January 14, 2014, the Board is considering whether the physical commodities activities continue to meet the requirements of section 4(k)(1)(B). Also as noted, the Board is evaluating the potential costs and other burdens (to financial holding companies and the public generally) associated with narrowing or eliminating the authority to engage in such activities.

Q.23. Can a 4(k) order be reversed if the terms of the order itself, as established by the FRB, are violated?

A.23. The Board noted in its orders approving certain financial holding companies to engage in specified physical commodities activities under section 4(k)(1)(B) of the BHC Act that the Board's decisions are specifically conditioned on compliance with all the commitments made in connection with each company's notice to the Board. Moreover, the commitments and conditions relied on in reaching such decisions are enforceable in proceedings under applicable law.

Q.24. Section 4(j) requires a determination that a complementary activity "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such 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." Can a 4(k) order be revoked if the conditions laid out in section 4(j) no longer apply?

A.24. Section 4(j) of the Bank Holding Company Act requires, in connection with a notice under the subsection, the Board to consider whether the performance of the proposed activity by the bank holding company can reasonably be expected to produce benefits to the public that outweigh possible adverse effects. In its ANPR regarding physical commodities activities, the Board also has requested comment on this matter.

Q.25. In light of public discussions on this issue, is the FRB considering rescinding its prior grants of "complementary" powers to engage in physical commodity activities to individual FHCs? If not, please explain public policy reasons for not ordering individual FHCs to cease some or all of their "complementary" commodity activities.

A.25. As noted in its ANPR regarding physical commodities activities, the Board is evaluating the potential costs and burdens on financial holding companies and the public associated with narrowing or eliminating the authority to engage in Complementary Commodities Activities. The ANPR specifically poses the question about the ways in which financial holding companies would be disadvantaged if they did not have authority to engage in Complementary Commodities Activities, and how the elimination of the authority might affect financial holding company customers and the relevant markets.

Q.26. The following are questions related to the FRB's legal interpretation and use of the Section 4(k)'s merchant banking provision under the BHCA:

Please describe how the FRB monitors and supervises FHCs' physical commodity activities and investments made under the merchant banking authority.

A.26. The Federal Reserve's examinations of the merchant banking activity of financial holding companies focus on a firm's merchant banking risk management policies and procedures, compliance and audit, and portfolio risk ratings. Federal Reserve staff meets regularly with the largest financial holding companies to assess their merchant banking activities.

These meetings focus on the performance of merchant banking investments and on changes in business strategy that might warrant a closer examination. Federal Reserve staff also reminds the firms of their obligation to avoid involvement in the routine management of portfolio companies held under merchant banking authority.

The Federal Reserve's capital rules for bank holding companies also impose significant risk based capital requirements on merchant banking investments.[9]

In addition, the ANPR regarding physical commodities activities seeks comment on whether the Federal Reserve should revise its implementing regulation for merchant banking authority or otherwise change its supervisory or regulatory approach to merchant banking activities of financial holding companies. The Board is interested in public comment on ways to better constrain the risks of merchant banking activities and ways to better ensure that holding companies avoid engagement in the day-to-day operations of portfolio companies.

Q.27. How does the FRB supervisory staff verify that such policies and procedures are effectively in compliance with the spirit and intent of the law that prohibits the use of merchant banking authority as a way for FHCs to get into impermissible commercial businesses?

A.27. Please see response for Question 26.

Q.28. Does the FRB collect and analyze specific data on individual FHCs' merchant banking portfolios, other than the information on their market value?

A.28. The Federal Reserve collects the Annual Report of Merchant Banking Investments Held for an Extended Period (schedule FR Y-12A). This report collects data on merchant banking investments that are approaching the end of the holding period permissible under Regulation Y. Data collected include the name and location of company held, primary activity of company held, type of interest held by the financial holding company (e.g., common stock, preferred stock, general partner, limited partner), percent of ownership, acquisition cost, carrying value, and plan and schedule for disposition of the covered investment. A financial holding company generally has to submit an FR Y-12A if it holds shares, assets, or other ownership interests of companies engaged in nonfinancial activities for longer than 8 years (or 13 years in the case of an investment held through a qualifying private equity fund).

Q.29. What are the penalties for violating the relevant provisions of section 4 of the Bank Holding Company Act?

A.29. Section 8 of the BHC Act provides civil and criminal penalties for companies and individuals that violate provisions of the act or regulations or orders issued thereunder.[10] Civil and criminal monetary penalties in amounts of up to $25,000 and $1,000,000, respectively, may be assessed for each day during which the violation continues.[11] Violations of section 8 of the BHC Act also may result in up to 5 years of imprisonment for criminal violations.[12] A com-

[9] See 12 CFR part 225, Appendix A, section II.B.5.; 12 CFR 217.152.
[10] 12 U.S.C. §1847.
[11] Id. Fines of more than $100,000 per violation per day only may be assessed for knowing violations made with the intent to deceive, defraud, or profit significantly. Id.
[12] Id. Imprisonment for a term of more than 1 year per violation only may be assessed for knowing violations made with the intent to deceive, defraud, or profit significantly. Id.

pany that fails to make, submit, or publish reports or information required under the BHC Act or the Board's regulations issued thereunder or that submits or publishes any false or misleading report or information is subject to fines ranging from $2,000 to $1,000,000 (or 1 percent of the total assets of the company, if such amount is less than $1,000,000).[13]

[13] Id. Section 8 of the BHC Act provides a tiered penalty structure for such actions generally based on the seriousness of the violation. Id.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

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January 15, 2014

The Honorable Sherrod Brown
Chairman, Subcommittee on Financial Institutions
and Consumer Protection
713 Senate Hart
Washington, DC 20510

Dear Mr. Chairman:

Thank you for your leadership related to the matter of bank holding companies and their physical ownership. Ironically, the amendments to the Bank Holding Company Act of 1956—BHA—has permitted a haunting policy that could be termed the "White Whale of financial reform" in that the provision and information about the use of the provision by bank holding companies remains mysterious and elusive. Just as regulators and policymakers knew little about over-the-counter (OTC) dark markets leading up to the financial crisis, this ownership issue is a matter that deserves, at the very least, increased attention and transparency—something heretofore sorely lacking.

In the past, banks focused on loans and mortgages, keeping our money safe and providing venues for saving and investing. Now, however, there has been a grand expansion of ownership into all sorts of other businesses: transportation, physical commodities, warehousing, refineries, and electric companies…to name a few. In 2003, using the new BHA authorities, the Federal Reserve Board (Fed) began issuing "orders" that permitted bank participation in commodity trading while actually owning physical commodities—the goods grown in fields, or mined or pumped out of the ground.

We all understand that market prices are supposed to be based, by and large, upon the fundamentals of supply and demand. However, what if a bank actually owns something which can impact supply, demand—or both? For example, say they own a commodity warehouse and store metal or agricultural commodities. They can charge storage and they can slow down delivery. At the same time, they can trade the very commodities being warehoused. Or, what if a bank trades oil or gasoline, but leases a ship full of crude oil and parks it in the Port of Houston waiting to deliver based upon a certain price point? What about banks owning a natural gas pipeline and trading nat gas? The point is: if they have significant ownership in the actual commodity, the storage or warehousing, or the delivery mechanisms, they *may* be able to manipulate prices. At the very least, it is a potential conflict of interest.

As you know well, last year aluminum users, like those putting beer and soda into cans, claim they found this out the hard way when warehouse supplies could not be accessed. They suggest banks owning warehouses charged end-users storage but backlogged delivery for up to 18 months. Some have suggested it could have been an effort to reap more storage fees, or worse yet, an attempt to drive up the price of aluminum and better their trading positions?

For months, I've been trying (most unsuccessfully) to obtain *useful* ownership information from the Fed. After all, the Commodity Futures Trading Commission (CFTC) is charged with ensuring commodity derivatives markets are operating efficiently and effectively, devoid of fraud, abuse and—importantly—manipulation. Yet today, the CFTC only requires derivative *exchanges* to guard against such potential concerns. We've essentially deputized the exchanges, which of course have a profit motive for more and more trading. By not fully focusing on the banks' participation in these markets, we have dodged our due diligence responsibilities, not knowing what is actually taking place in regulated markets.

At a minimum, one might think the CFTC and Fed should have a formalized memorandum of understanding (MOU) whereby the Fed shares, on a regularized basis, bank ownership information. However, I fear that is not enough. There is zero interest in such an information-sharing effort on the part of the professional staff at the CFTC. Frankly, my experience on this matter is that there is surprisingly little CFTC interest, shockingly little interest, in physical ownership of banks that could impact derivative markets. On one hand, our staff is already over-worked and the Agency is under-funded. On the other hand, this is clearly an area that deserves more attention. Nevertheless, it is unlikely the Agency will take on a new responsibility voluntarily. Therefore, Congress may consider requiring such information sharing (and data review by the CFTC) as part of the reauthorization of the Commodity Exchange Act (CEA) to be considered this year.

My view on the policy question is more straightforward. I question why the ownership policy should remain in place at all. Bankers have argued they need such ownership to accommodate customer business needs. I'm unconvinced and see limited value is allowing such ownership to continue. I have no issues with banks making boatloads of cash, just not owning the boats (and some apparently do, in the form of oil tankers).

It's time for Congress to harpoon the White Whale of financial reform by repealing the 1999 BHA ownership amendments. Banks should get back to what they've been so very good at for most of their history—taking deposits, making loans, and helping to create jobs that fuel-inject the economic engine of our democracy. Banks should get back to banking.

Thank you again for your leadership. Feel free to call upon me if I may ever be of assistance.

Sincerely,

Bart Chilton

Cc: Hon. Patrick Toomey
Hon. Tim Johnson
Hon. Mike Crapo
Hon. Debbie Stabenow
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Statement for the Record

North American Die Casting Association

Senate Banking Subcommittee on Financial Institutions and Consumer Protection

Hearing on

"Regulating Financial Holding Companies and Physical Commodities"

January 15, 2014

Thank you for the opportunity to submit this statement for the record regarding the Senate Banking Subcommittee on Financial Institutions and Consumer Protection hearing titled, "Regulating Financial Holding Companies and Physical Commodities." This is an important issue which warrants significant public and regulatory scrutiny. Actions of some parties are restricting the supply of aluminum, lengthening wait times, and artificially inflating prices. Members of the North American Die Casting Association (NADCA) need reliably priced and stable supplies of aluminum to continue manufacturing castings for everything from cars to toys.

Founded in 1989, NADCA represents more than 300 die casters in the U.S. Part of an industry with roughly 50,000 employees; the typical NADCA member has annual sales around $30 million with 150 full-time workers. The industry has facilities in roughly forty states manufacturing products for the agriculture, aerospace, automotive, defense, energy, medical, and other industries that serve as the backbone of our nation's security and economy.

A subject of this hearing is aluminum, a critical component of the die casting process. Die castings require massive amounts of aluminum and are among the highest volume, mass-produced items manufactured by the metalworking industry. Aluminum has also become increasingly critical to the automotive industry. In 2012, U.S. aluminum manufacturers produced 1.4 billion pounds for automotive use. To put consumption in perspective, there are 785 million pounds of aluminum content on transmissions alone.

This level of aluminum use will only increase as autos become more lightweight and energy efficient to meet government standards. Total automotive aluminum die casting content is expected to grow from 114 pounds per vehicle in 2012 to over 143 pounds in 2020. Meanwhile, overall global aluminum consumption will increase from 58 million metric tons in 2015 to nearly 120 million by 2025.

This is why any volatility in the aluminum market sends a ripple effect throughout the entire economy. Many businesses, including NADCA members, purchase their aluminum through a North American Special Aluminum Alloy Contract (NASAAC) managed by the London Metals Exchange (LME). In the U.S., the Commodity Futures Trading Commission (CFTC) holds regulatory oversight of the LME and, thus, the aluminum trading.

"The current situation impacts all die casters, whether directly or indirectly. Even for those of us who do not purchase direct from an LME warehouse, we still see the ripple effect throughout the aluminum supply market," said a representative for an Ohio die casting manufacturer.

Aluminum is traded as a commodity, and just like the oil used in gasoline for vehicles, its price fluctuates. Imagine for a minute if the supply of gas had a 9-16 month wait time, was subject to limited release in each city, and the owner of the warehouse where the gas is stored incentivized the producers to keep gas in storage longer in order to increase their margins on Wall Street. The American public would express such an outrage it would unite even members of this divided Congress. However, this is business as usual in the domestic aluminum industry where certain parties are working together to control the industry and reap massive benefits at the expense of small and medium sized manufacturers.

"There are a lot of factors involved with the price of the aluminum today that have nothing to do with the cost of manufacturing the actual metal itself," said a representative a die caster in Tennessee. "If the current LME system keeps operating the way it is, it will go away on its own as no one will want to buy and sell on it."

Lead Times Lead to Lost Time

In any business, delivering a product on time is essential. This is especially the case with the manufacturing supply chain where even the slightest disruptions can send a ripple effect through an entire economic sector. In February 2013, according to data from the LME, the queue to remove metal from warehouses they oversee in Detroit reached 400 days. In June 2013, some users reported 16-month wait times for aluminum from order to delivery. When customers cannot receive their products on time, they begin to turn to overseas suppliers to meet their needs. As we all know too well, when these customers go offshore, so do thousands of American jobs with them.

This is by far one of the most important challenges facing die casters today. These lengthy lead times create a massive backlog in the supply chain, create uncertainty in planning, and force manufacturers to purchase aluminum on the more expensive spot market. Businesses like NADCA members are downstream middle market manufacturers who typically cannot pass along increased costs to their much larger customers.

The LME controls over 97 percent of the aluminum forward and futures contracts trading in the U.S. and has regulatory oversight of its warehouses, including approval of storage and load-out rates. While most warehouses saw reductions in their storage during months following the Great Recession, LME warehouses continued to increase their aluminum stockpiles. In many parts of the country and across several industries, this restricted supply led to slower economic recovery due to longer wait times, increased costs, and lower output.

In May 2013, NADCA met with representatives of the LME to discuss concerns over wait times, among other issues, with the NASAAC. The Association considered withdrawing its support of the NASAAC and remains concerned about terms applied to aluminum contracts and the more than 700 LME warehouses storing the nation's supply.

Following complaints by NADCA and other stakeholders, LME agreed to shorten the wait time to 100 days. While the shortened wait time was an improvement, it still fell far short of meeting market demand. While LME's recognition of the problem was a welcome development, NADCA continued to call for more action. The LME's latest proposal of 50 calendar days is yet another admission that the current NASAAC does not reflect the demand for aluminum in the United States. NADCA strongly believes that the wait times should be as short as possible to meet manufacturers' needs.

Prior to LME actions last year, warehouses took a number of systematic and deliberate steps to reduce the supply of aluminum. For example, no limits are placed on the amount of metal entering the storage facility, but operators capped the amount permitted to exit the warehouse at 3,000 metric tons. At this rate, it would take four years to move an estimated 5 million metric tons of inventory.

We believe pressure from regulators and industry groups has led to some positive changes to the NASAAC. The LME recently announced that warehouses with wait periods over 50 days must ship out 1,500 more metric tons of metal every day than they take in. Again, while this is a positive step in the right direction, it is still unlikely to meet the market's current demand.

Since LME announced that warehouses would restrict holding times to 100 days, the price of aluminum alloy only dropped $.04 per pound. Additionally, even the new 50 days limit, does not take effect until April 2014. As a result, NADCA members and thousands of manufacturers will continue to face aluminum supply shortages and suffer increased costs while Wall Street profits.

Warehousing Fees and Controlling Supply

Since 2011, it is becoming increasingly clear that warehouses, many of which are owned by banks and holding companies such as JP Morgan Chase and Goldman Sachs, are generating significant profits due to the longer wait times. Much of this is a result of the LME system itself, which incentivizes warehouses to hoard metal.

Until their latest policy changes, warehouses faced limits on the amount of metal permitted to "load-out" of the facility. Not only did they face caps on the metals exiting, they also increased fees when aluminum is removed. This provided another incentive for owners of the aluminum to leave it in the warehouse and out of the supply chain. When the metal did exit, it came with the increased fees paid by NADCA members and other industrial consumers. Studies have shown that delivery charges for aluminum have added up to 10 percent to its futures prices.

These fees and charges pale in comparison to the profits the warehouse owners rake in at the expense of manufacturers and average consumers. For example, a Detroit facility under LME oversight set a $.45 per day per ton storage fee for aluminum. Based on its stockpile, this warehouse, owned by Goldman Sachs, generates almost $625,000 per day and over $225 million a year. Furthermore, Goldman reportedly offers incentives such as $250 per ton to firms who store aluminum in their warehouses for a long period of time. This further incentivizes aluminum storage rather than use for manufacturing and infrastructure.

A lawsuit filed in Michigan contends that "Goldman and LME restrained approximately 1.5 million tons of aluminum in LME Detroit Warehousing constituting more than 75% of LME aluminum in storage in the U.S. and more than 50% of total aluminum warehouse storage in U.S. Meanwhile, the market has seen the levels of aluminum stored at non-LME Detroit warehouses decline by 50%."

Investors' Gain is Manufacturers' Pain

Not only do the LME, holding companies, and warehouses benefit from the restricted aluminum supply, Wall Street investors also make a profit at the expense of manufacturers. In recent years, investors recognized they could generate a greater return on purchasing and holding aluminum contracts than other financial instruments.

For example, some investors could earn eight percent over a 15-month period on the aluminum held in a warehouse. This is higher than the three to five percent interest earnings on other investments and has become more prevalent in the past few years. Most significantly, that particular aluminum is now out of circulation for the duration of the 15-month warrant, restricting the supply and artificially increasing the prices.

All the while, many of these same investors who are purchasing the warrants also own the warehouse which is now charging the higher fee. This double dipping by holding companies and their teams of investors is generating massive profits for their shareholders while manufacturers face increased costs and short supply.

It is clear that the holding companies and banks which own the warehouses have a significant motivation to restrict the domestic aluminum supply and stockpile the metal in their own storage facilities. They go about this not only with the tacit approval of the LME, but often with its encouragement in the form of holding and load-out policies and incentives.

LME Price vs. Platts and Spot Market Price

The automotive companies, or Original Equipment Manufacturer (OEM), in North America, with support from the LME, created the North American Special Aluminum Alloy Contract (NASAAC) hoping to provide a reliable assessment of the market pricing for aluminum. The contract, which is tied to a terminal market, provides OEM's with the opportunity to hedge commodity risk. Conversely, Platt's Metals Week provides a weekly assessment of the market by surveying buyers and sellers and using the information gathered to establish a weekly average price. Secondary aluminum smelters rely on the purchasing scrap in order to provide the specification alloy that their NADCA die casters require. Scrap price elasticity is tied more closely to supply and demand.

Historically, the price difference between NASAAC contract and Platt's Metals Week averaged $0.08-$0.10. Beginning in August 2011, this difference began to grow. The 2012 average difference was $0.133. By 2013, the average difference grew to $.205. The majority of NADCA die casters would enter into an annual contract with a smelter which would include formula pricing tied to the NASAAC contract. The smelter would build in a surcharge that would take into consideration the difference between NASAAC and Platt's (or what they can sell it for on the spot market). This enabled them to maintain some margin, and mitigate some risk in market conditions resulting from NASAAC vs. Platt's pricing differences. By 2012, however, the smelters, which were being badly harmed by the changes in pricing between NASAAC and Platt's, would no longer participate in providing annual contracts.

When determining the price of aluminum, the market typically turns to the Platt's Metals Week and the LME's NASAAC formula. The LME holds a near monopoly on contract aluminum; however, the secondary scrap market trades much more freely. Reports have shown that the controls owners place on their warehouses, combined with LME policies, creates a price difference between the free market and LME contracts. Furthermore, smelters' refusal to sell on NASAAC only exacerbates this problem.

Another unique aspect to this system is the constraints it places on American exporters. For many businesses shipping overseas, the customer requires the die caster to quote at the LME NASAAC price. This further constrains their options, especially when the price spread between the NASAAC and actual market continues to grow. A NADCA member from Pennsylvania reported of their efforts to grow their exporting business but having to meet such requirements.

Die casters are trapped between warehouses and customers. Their much larger customers, typically the OEM, require that the caster supply them a product based on the LME NASAAC rather than the actual market price paid by the die caster. This generates significant losses for the downstream supplier, which they must absorb. Similarly, when a manufacturer cannot secure the aluminum they need, the business is forced to turn to the more expensive spot market, increasing their costs also not passed along.

For example, a die casting company who produces roughly 300,000 pounds of aluminum castings a month will commit to manufacturing a product based on a fixed price LME NASAAC. An examination of the price basis differential between the NASAAC and the Platts/Spot markets show the NASAAC underpaying by up to $.23 per pound in the March-May 2012 Platt's period. That amounts to a $62,640.00 cost differential which the die casting business had to absorb. Studying the entire calendar year, the caster paid $195,006.21 more for their aluminum than set under the NASAAC, which amounts to nearly $200,000 the business could have used to hire more employees or invest in new equipment.

In the die casting industry, some who sell their product based on the LME NASAAC believe they are generally fortunate to recognize a $.10 margin, before taxes. If the price differential between NASAAC and the market fluctuates even $.05 as it has, that cuts in half the pre-tax profit margins for the die caster. At such a low level, the business will not have the resources needed to invest in equipment and employees, let alone turn a reasonable profit.

Conclusion

Manufacturers need a stable and free market driven aluminum industry. Unfortunately, that is not the case today and it is costing die casters millions each month while slowing economic growth. The current system incentivizes warehouse owners to hoard aluminum and profit from the market shortages the hoarding creates. NADCA is working with its members on ways to minimize their risk and seek relief from their customers due to this unfair metal pricing policy.

However, these businesses should not have to turn to their customers when it is the place of federal regulators to oversee the actions of the LME, banks, holding companies, and warehouses holding the nation's aluminum supply hostage.

Thank you for your consideration of our views and we look forward to working with you to answer any questions you may have.