



# Big Banks: Big Appetites

The Consequences When Banks Swallow Commodities

## **Acknowledgments**

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## Summary

This spring, the Federal Reserve is revisiting critical economic policy concerning whether Wall Street mega-banks may be owners of, instead of simply lenders to, businesses. This currently centers on commodities ownership.

Separating banking from commerce serves as a foundational principle of the American economy. Banking law dating from 1787 has repeatedly stated that banks may not own or affiliate with non-banking firms. The prevailing law states that no bank holding company shall own any firm “which is not a bank.”<sup>1</sup> Architects of this principle point to dangers of monopoly power, conflicts of interest, and taxpayers exposure to the bailouts of banks reliant on subsidized, federally-insured deposits.

A few major banks have nevertheless exploited imprecise statutory wording created in 1999—likely at the behest of bank lobbyists—to persuade the Federal Reserve Board to use its discretion and grant exceptions to the principle. As a result, a few large banks—JP Morgan, Goldman Sachs, and Morgan Stanley, in particular--have taken major positions in commodities.

Under the Federal Reserve’s interpretation of these statutes, the Board can permit banking firms to own commodities if the investment is “complementary,” part of “merchant” banking, or if the firm became a banking company after 1999.

The constituents that support maintaining the banking commerce wall include community bankers, commodity users, grocers, real estate firms, labor unions and others.

Financial institution ownership and control over energy infrastructure assets also threaten higher prices for consumers. Coupled with proprietary trading, banks can use control over petroleum pipelines and other physical infrastructure as an “insider’s peek” into the market, exploiting their non-public knowledge of physical movements of energy to share with their trading affiliates for financial gain. It is important to note that even if the Federal Reserve restricts *ownership* of such assets, it appears as though consumers are still at risk through increasingly common *control* strategies, such as leasing agreements, or exploitation of advanced third-party surveillance firms. We must understand that market reconnaissance technology is evolving rapidly, and it may be increasingly advantageous for banks to pursue control strategies that do not involve actual ownership. As a result, consumer protections must be adopted to address these various market surveillance strategies employed by banks.

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<sup>1</sup> 12 U.S.C. 1841

The Federal Reserve should use its existing discretion to uphold the foundational principle separating banking and commerce. Where the statute lacks precision, Congress should sharpen the statutory wording that has been exploited by large banks. The 21<sup>st</sup> Century Glass Steagall Act serves to correct this imprecision and insulate banks funded by subsidized, government guaranteed loans through FDIC-insured deposits from the inevitable manipulation, conflicts and systemic risks when banks break through the wall into commerce.

## Why Separate Banking and Commerce?

Since 1787, commercial and agrarian interests have endorsed the need to separate banking from commerce, which became expressed in law.<sup>2</sup> The National Bank Act of 1863 limited nationally chartered banks to “the business of banking.”<sup>3</sup> The Banking Act of 1933 further separated loan-making from selling and trading in securities. In 1956, Congress approved the Bank Holding Company Act and declared: “No bank holding company shall ... acquire direct or indirect ownership or control of any voting shares of any company which is not a bank.”<sup>4</sup>

With these statutes, Congress responded to problems when banking spilled into commerce. In the 19th century, JP Morgan monopolized railroads, driving up rates. In 1907, an attempt to corner the copper market ignited panic and revealed an asset bubble.<sup>5</sup> In the 1920s, bankers created illusory value in stock pools. In the 1980s, real estate developers found ready access to credit by acquiring savings-and-loans and erected endless “see-through” office buildings void of tenants.<sup>6</sup>

Today, the banking commerce wall enjoys wide support from various sectors, including labor, retailers, and even bankers. Progressive organizations have long championed the separation of banking and commerce. Public Citizen warned of bank control of commodities in 2008.<sup>7</sup> Labor representatives call the separation “bedrock economic

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<sup>2</sup> Arthur Wilmarth, “The Separation of Banking and Commerce,” (May 2007), Connecticut Law Review, available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=984103&download=yes](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984103&download=yes)

<sup>3</sup> J.B. Walter, “Banking and Commerce,” Federal Reserve Bank of Richmond *Economic Quarterly* Volume 89/2 (Spring 2003), available at:

<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.200.1161&rep=rep1&type=pdf>

<sup>4</sup> 12 U.S.C. 1841

<sup>5</sup> Hearings of the House Subcommittee of the Committee on Banking and Currency,” (1913), available at: /

<sup>6</sup> See list of hearings from Senate Committee on Banking, Housing and Urban Affairs, 1987-1988, available at: [http://www.banking.senate.gov/public/\\_files/Legislativecalendar100th.pdf](http://www.banking.senate.gov/public/_files/Legislativecalendar100th.pdf)

<sup>7</sup> “The Case for Preserving the Separation between Banking and Commerce,” by Jonathan Brown, Multinational Monitor, (April 1997), available at:

<http://www.multinationalmonitor.org/mm1997/041997/brown.html>

policy.”<sup>8</sup> The National Grocers Association and the National Association of Convenience Stores support separation,<sup>9</sup> as mixing the two can “lead to systemic problems.”<sup>10</sup> The National Association of Realtors observes that banks can become “powerful, concentrated conglomerates” that harm small businesses and consumers.<sup>11</sup>

Many bankers themselves endorse the policy, including the Independent Community Bankers of America, the trade association of smaller banks.<sup>12</sup>

Paul Volcker, when he served as Federal Reserve chairman in 1987, summarized: “Widespread affiliations of commercial firms and banks [carry] the ultimate risk of concentrating banking resources into a very few hands, with decisions affecting these resources influenced by the commercial ownership links, resulting in inevitable conflicts of interest.”<sup>13</sup>

## **Perforating the Wall between Banking & Commerce: Gramm Leach Bliley Act of 1999**

For decades, managers of some of the largest banks have sought to repeal restrictions on the types of firms they can own. In 1999, they succeeded with approval of the Gramm Leach Bliley Financial Modernization Act. Most prominently, the law permitted FDIC-backed depositories to affiliate with the investment banks. The law also included three little noticed changes to the Bank Holding Company Act.

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<sup>8</sup> Testimony of Bridget Kelly, , UFCW, Senate Banking Committee (October 4, 2007), available at: [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=949c6aa8-bab0-4b71-918b-69ddf7aa915b](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=949c6aa8-bab0-4b71-918b-69ddf7aa915b)

<sup>9</sup> Testimony of Thomas Bliley, House Financial Services Committee, (July 12, 2006), available at: <http://democrats.financialservices.house.gov/media/pdf/071206sbc.pdf>

<sup>10</sup> Letter to Sen. Chris Dodd, from Sound Banking Coalition, (Feb 8, 2008), available at: <https://www.icba.org/files/ICBASites/PDFs/ltr020808.pdf>

<sup>11</sup> National Association of Realtors, website, visited Jan. 27, 2014, available at: [http://www.realtor.org/banks\\_and\\_commerce.nsf](http://www.realtor.org/banks_and_commerce.nsf); A letter to Congress expanding on the associatons position is available at: letter from realtors to congress opposing banks in real estate: [http://www.realtor.org/banks\\_and\\_commerce.nsf/docfiles/L\\_09Jan\\_s356.pdf/\\$FILE/L\\_09Jan\\_s356.pdf](http://www.realtor.org/banks_and_commerce.nsf/docfiles/L_09Jan_s356.pdf/$FILE/L_09Jan_s356.pdf)

<sup>12</sup> Chicago Fed Letter, “The Mixing of Banking and Commerce: A conference summary”, Nisreen H. Darwish, Douglas D. Evanoff, Essays on Issues, The Federal Reserve Bank of Chicago, Number 244a, November 2007, last accessed July 22, 2013, available at: [http://qa.chicagofed.org/digital\\_assets/publications/chicago\\_fed\\_letter/2007/cflnovember2007\\_244a.pdf](http://qa.chicagofed.org/digital_assets/publications/chicago_fed_letter/2007/cflnovember2007_244a.pdf)

<sup>13</sup> “Business Forum: Does The U.S. Need Superbanks? Why Bigger Isn’t Better in Banking”, Thomas Olson, The New York Times, June 28,1987 available at: <http://www.nytimes.com/1987/06/28/business/business-forum-does-the-us-need-superbanks-why-bigger-isn-t-better-in-banking.html>

First, section 4(k)(1)(B)<sup>14</sup> permits the bank holding company to engage in any activity that the Federal Reserve Board finds to be “complementary to a financial activity.” Congress did not define what was meant by “complementary.” Legal scholar Saule Omarova noted the clause is “an open-ended” excuse to engage in activities that may be profitable.<sup>15</sup> In the hearings before passage of the changes to the Bank Holding Company Act, lobbyists did not mention commodities or mainstream commercial activity. Instead, one bank lobbyist referred to American Express publishing leisure magazine to complement its credit card business.<sup>16</sup>

Second, under section 4(k)(4)(H), a holding company may engage in “merchant” banking. Again, the term is not defined.<sup>17</sup> Merchant banking generally refers to providing capital to a company in the form of investment ownership, as opposed to a loan. The statute limits ownership of a non-banking firm to 10 years, and forbids active management.

Third, there is a “grandfather” clause.<sup>18</sup> Section 4(o) provides that a firm that was not a bank holding company in 1999 (when Congress approved Gramm Leach Bliley), but becomes one thereafter with Federal Reserve approval, may continue to engage in activities “related to the trading, sale, or investment in commodities.” To be “grandfathered,” the firm needed to be engaged in such activities as of September 30, 1997, and the aggregate value of its commodities must be less than 5 percent of its total assets.<sup>19</sup> As Congress debated Gramm Leach Bliley, Goldman Sachs owned J. Aron, a commodity trading company. This commodity grandfathering provision was widely viewed as the Goldman exception,<sup>20</sup> an inducement for the firm to enter traditional banking without having to shed other businesses. As a sidenote, Goldman’s current CEO Lloyd Blankfein joined the company through J. Aron.

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<sup>14</sup> 12 USC 1843(j)(2)

<sup>15</sup> Saule Omarova, “The Merchants of Wall Street,” *Minnesota Law Review* (2013), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2180647&download=yes](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647&download=yes)

<sup>16</sup> Saule Omarova, “The Merchants of Wall Street,” *Minnesota Law Review* (2013), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2180647&download=yes](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647&download=yes)

<sup>17</sup> Saule Omarova, “The Merchants of Wall Street,” *Minnesota Law Review* (2013), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2180647&download=yes](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647&download=yes)

<sup>18</sup> 12 USC 1843(o).

<sup>19</sup> 12 USC 1843(o).

<sup>20</sup> See Testimony, Saule Omarova, Senate Banking Committee, (July 13, 2004), available at: [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=6d49a599-f7dc-4c1f-9455-fa8d891f04c6](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=6d49a599-f7dc-4c1f-9455-fa8d891f04c6). Omarova testimony cites: Martin E. Lybecker, *Financial Holding Companies and New Financial Activities Provisions of the Gramm-Leach-Bliley Act*, in “Back To The Fundamentals: Insurance Regulation, Broker-Dealer Regulation, And Investment Adviser Regulation” (ABA Center For Cle Nat’l Institute, Nov. 8-10, 2001), fn. 11.

## The Problem of Size, Complexity and Opacity

If Americans became enlightened to one fact during the financial crash of 2008, it was that some financial institutions had become enormous—too big to fail. Paradoxically, federal officials responded to the systemic tremors by intensifying the too-big-to-fail problem. For example, the government arranged for the sale of Bear Stearns and Washington Mutual to JP Morgan

Largely overlooked amid this concentration of goliath banks were the powers these large institutions might use to control commodities. In 2003, the Federal Reserve began permitting bank holding companies to engage in commodity ownership as a “complementary” activity. In 2005, it granted this authority to JP Morgan, which was a bank holding company at the time.<sup>21</sup>

But at the peak of the financial crisis in 2008, the Federal Reserve Board granted bank holding company status to Goldman Sachs and Morgan Stanley. The Board’s decision came during an unusual Sunday meeting of the Federal Reserve Board.<sup>22</sup> The previous Monday — Sept. 15, 2008 — giant investment bank Lehman Brothers Inc. declared bankruptcy. The Lehman bankruptcy released contagion throughout the global system. Confidence in financial pillars such as JP Morgan, Citigroup and Bank of America also plummeted. The Federal Reserve could provide emergency support for these firms as bank holding companies. But other pillars required help as well, notably investment banks Goldman Sachs and Morgan Stanley. Normally, an application for status as bank holding company absorbs months of review. Firms are required to sell certain assets, pledge to structural changes, even change management. Even after tentative approval, the Board requires a 30-day period to hear “views and recommendations.” The Board’s order noted that Goldman held “total consolidated assets of approximately \$1.1 trillion” but dismissed concerns about concentration. Absent from this expedited document was any reference to Section 4(0), the grandfather provision.

“It is highly unlikely that ... the Board focused on these firms’ extensive physical commodities assets and activities—or gave full consideration to the question of how to deal with such activities in the long run,” speculates Prof. Omarova.<sup>23</sup> Former House Financial Services Committee Chairman Jim Leach, an Iowa Republican, was “shocked” to hear in 2014 that regulators had pointed to merchant banking and grandfather sections in the bill

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<sup>21</sup> JP Morgan Chase & Co., Federal Reserve Order, (2005), available at:

<http://www.federalreserve.gov/boarddocs/press/orders/2005/20051118/attachment.pdf>

<sup>22</sup> Federal Reserve Board “Order approving formation of bank holding companies,” (Sept. 21, 2008) Available at: <http://www.federalreserve.gov/newsevents/press/orders/orders20080922a1.pdf>

<sup>23</sup> Saule Omarova, “The Merchants of Wall Street,” *Minnesota Law Review* (2013), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2180647&download=yes](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647&download=yes)

bearing his name as the legal authority allowing banks to retain or gain control over physical-commodities markets. “I assume no one at the time would have thought it would apply to commodities brokering of a nature that has recently been reported.”<sup>24</sup>

How far into commerce and commodities have Goldman and Morgan Stanley invested? Goldman Sachs and Morgan Stanley are the largest investment banks in the United States. Goldman Sachs’ roughly \$1 trillion in assets and Morgan Stanley’s \$780 billion in assets are each more than the assets of General Electric, Exxon Mobil, and Royal Dutch Shell.<sup>25</sup> The “grandfather” provision limits a bank holding company’s commodity ownership to 5 percent of total assets, meaning that such a firm certainly doesn’t own more oil than Exxon, but may own a substantial amount. And certainly among financial institutions, Goldman and Morgan Stanley were and “remain the top players in both derivatives and physical commodity markets,” according to industry reports.<sup>26</sup>

Enormous as their commercial holdings must be, there is no single, definitive description of these assets with names of properties and values. The firms’ public shareholder reports offer minimalist descriptions. For energy holdings, firms file extensive reports with the Federal Energy Regulatory Commission (FERC). Media reports are another source, usually dealing with a current transaction. Nor is the Federal Reserve a source. Summarized Sen. Sherrod Brown (D-Ohio) chairman of a committee probing the issue, “These institutions are so complex, dense, and opaque that they are impossible to fully understand – the six largest U.S. bank holding companies have 14,420 subsidiaries, only 19 of which are traditional banks.”<sup>27</sup>

One example of this problem of size, complexity and opacity is Goldman Sachs. In Goldman Sachs’ 2007 annual report, before it faced policy scrutiny for its commodity holdings, the firm reported that it owned 19 power plants. It also explained that it owned “a wide variety” of commodities and commodity derivatives, including oil and oil products, metals,

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<sup>24</sup> “The Mega Banks’ Most Devious Scam Yet,” by Matt Taibbi, Rolling Stone, (Feb. 12, 2014), available at: <http://www.rollingstone.com/politics/news/the-vampire-squid-strikes-again-the-mega-banks-most-devious-scam-yet-20140212?print=true>

<sup>25</sup> The World’s Biggest Public Companies, Forbes, (2013), (website visited Feb. 17, 2014), available at: <http://www.forbes.com/global2000/>

<sup>26</sup> See, e.g., Greenwich Associates, 2012 Greenwich Leaders: Otc Commodities Derivatives (2012); Alexander Osipovich, *Risk and Energy Risk—2012 Commodity Rankings—Energy*, RISK.NET (Feb. 9, 2012), <http://www.risk.net/energy-risk/research/2144918/risk-energy-commodity-rankings-2012-energy>., take from Omariva, “Merchants of Banking,” p. 313.

<sup>27</sup> Statement, Sen. Sherrod Brown, (July 23, 2013) available at: <http://www.brown.senate.gov/newsroom/press/release/at-senate-banking-hearing-brown-presses-regulators-on-bank-holding-companies-controlling-price-and-supply-of-physical-commodities-effect-on-consumers-and-manufacturers>

natural gas and electricity, and forest products.<sup>28</sup> That report did not identify the power plants nor itemize the value of specific holdings in forest products, or metals, or other commodities. In 2013, Goldman's annual report didn't number its power plants.<sup>29</sup> Firms supplying energy file reports with FERC. For example, Goldman Sachs provides a "power market analysis for the Southeast region," in one filing.<sup>30</sup> This contains facilities and power levels.

Another example of a firm summarizing what may be considerable ownership of commodities with little specificity is Morgan Stanley: "We engage in the production, storage, transportation, marketing and trading of several commodities, including metals (base and precious), agricultural products, crude oil, oil products, natural gas, electric power, emission credits, coal, freight, liquefied natural gas and related products and indices."<sup>31</sup> None of these properties is identified by name or value. The company's most recent annual report makes reference to ownership of TransMontaigne twice, only in reference to risks. TransMontaigne was the 17<sup>th</sup> largest privately owned firm in the nation before Morgan Stanley bought it.<sup>32</sup> Morgan Stanley's FERC filings contain other details.<sup>33</sup>

Media reports contain additional detail, although they are naturally dependent on company press releases and sources outside the firm. For example, Goldman Sachs purchased a coal mine in Columbia in 2012, according to one story.<sup>34</sup> Goldman has made claims on Nevada land presumably to erect solar panels.<sup>35</sup> Goldman owns a metals warehouse facility in

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<sup>28</sup> Goldman Sachs, annual report (2007), p. 7, available at:

<http://www.sec.gov/Archives/edgar/data/886982/000095012307001332/y29219e10vk.htm#102>

<sup>29</sup> Goldman Sachs annual report (2012), available at:

[http://www.sec.gov/Archives/edgar/data/886982/000119312513085474/d446679d10k.htm#toc446679\\_2](http://www.sec.gov/Archives/edgar/data/886982/000119312513085474/d446679d10k.htm#toc446679_2)

<sup>30</sup> Letter to FERC, from VanNess Feldman, on behalf of J. Aron & Co., a subsidiary of Goldman Sachs, (December 29, 2011), available at: <http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=12851528>

<sup>31</sup> Morgan Stanley annual report (2012) available at:

[http://www.sec.gov/Archives/edgar/data/895421/000119312513077191/d484822d10k.htm#rom484822\\_5](http://www.sec.gov/Archives/edgar/data/895421/000119312513077191/d484822d10k.htm#rom484822_5)

<sup>32</sup> "Morgan Stanley's Transmontaigne: What they own, what they do," Reuters, (Dec 11, 2013) available at: <http://www.reuters.com/article/2013/12/11/us-morganstanley-transmontaigne-idUSBRE9BA16T20131211>

<sup>33</sup> Letter from Cadwalader, Wickersham & Taft, on behalf of Morgan Stanley, (June 30, 2011), available at: <http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=12697647>

<sup>34</sup> "Vale sells Colombia coal mines to Goldman Sachs-led group," Reuters, (May 29, 2012), available at: <http://uk.reuters.com/article/2012/05/29/uk-vale-coal-idUKBRE84S00M20120529>

<sup>35</sup> "Wall Street firms behind slow solar pace on federal lands," NBC News (2010), available at:

[http://www.nbcnews.com/id/38956835/ns/us\\_news-environment/t/wall-st-firm-behind-slow-solar-pace-federal-lands/](http://www.nbcnews.com/id/38956835/ns/us_news-environment/t/wall-st-firm-behind-slow-solar-pace-federal-lands/)

Detroit, according to another press report.<sup>36</sup> Goldman “has grown from a small presence to be a top 10 physical gas trader in North America since 2010,” according to Reuters.<sup>37</sup>

Morgan Stanley has “built its own power plants in Nevada, Alabama and Georgia,” according to a media report.<sup>38</sup>

JP Morgan, according to one news account, “spent billions of dollars over the past five years to build JPMorgan's oil, power, gas and metals business into the biggest on Wall Street.”<sup>39</sup>

Even combining media , company and FERC reports, it is difficult to understand with any precision the identity or scope of commodity holdings of these bank holding companies, other than that they are substantial.

## A Record of Abuse

Does substantial ownership breed abuse, as defenders of the banking/commerce wall warn? A number of examples dramatize the core fears when large banks enter commerce and the commodity business. Goldman Sachs, Morgan Stanley and JP Morgan each have run afoul of customers and regulators with their commodity-related businesses.

Goldman Sachs has drawn criticism for a Detroit metals warehouse it owns. In July 2013, the New York Times reported: “Hundreds of millions of times a day, thirsty Americans open a can of soda, beer or juice. And every time they do it, they pay a fraction of a penny more because of a shrewd maneuver by Goldman Sachs and other financial players that ultimately costs consumers billions of dollars.” In this case, a Goldman subsidiary owns 27 industrial warehouses in the Detroit area to store customers’ aluminum. But it seems that the warehouse workers simply shuffle the metal, without delivering it to customers. “They load in one warehouse. They unload in another. And then they do it again.” Since Goldman bought the warehouses, the wait time has grown more than tenfold.<sup>40</sup> U.S. regulators and

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<sup>36</sup> “A Shuffle of Aluminum,” by David Kocieniewski, New York Times (July 20, 2013), Available at: <http://www.nytimes.com/2013/07/21/business/a-shuffle-of-aluminum-but-to-banks-pure-gold.html>

<sup>37</sup> “It’ll Be Way Harder For Goldman Sachs And Morgan Stanley To Get Out Of The Physical Commodities Business Than JP Morgan,” Reuters, (July 29, 2013), available at: <http://www.businessinsider.com/morgan-and-goldman-on-physical-commodities-2013-7>

<sup>38</sup> “Morgan Stanley and Goldman Sachs to survive Fed revamp better than others,” the Economic Times, (Feb 12, 2014), available at: [http://articles.economictimes.indiatimes.com/2014-02-12/news/47270155\\_1\\_trade-raw-materials-commodities-trading-foreign-banks/2](http://articles.economictimes.indiatimes.com/2014-02-12/news/47270155_1_trade-raw-materials-commodities-trading-foreign-banks/2)

<sup>39</sup> JP Morgan to pay \$410 million to settle rate case,” Reuters (July 30, 2013) Available at: <http://www.reuters.com/article/2013/07/30/us-jpmorgan-ferc-idUSBRE96T0NA20130730>

<sup>40</sup> “A Shuffle of Aluminum,” by David Kocieniewski, New York Times (July 20, 2013), Available at: <http://www.nytimes.com/2013/07/21/business/a-shuffle-of-aluminum-but-to-banks-pure-gold.html>

the Department of Justice have reportedly launched initial investigations into the metals warehousing business.<sup>41</sup>

In a parallel case, in 2009, Morgan Stanley hired a supertanker to store oil at sea presumably as a means to remove supply and profit from higher prices later. Noted one observer, “Investment banks like Morgan Stanley . . . were the leaders in keeping 80 million barrels of oil in storage in tankers at sea—nearly enough oil to supply the world for a day.”<sup>42</sup>

Meanwhile, JP Morgan Chase was fined \$410 million in an energy rate-manipulation case, the largest penalty since Enron.<sup>43</sup> “JPMorgan’s brazen, Enron-style market manipulation cost California ratepayers over \$120 million,” said Rep. Henry Waxman (D-Calif).<sup>44</sup>

British authorities also questioned JP Morgan’s control of metals business, calling it “restrictive” and “manipulative.”<sup>45</sup>

Mega-banks, of course, aren’t the only abusers in commodities markets. Enron’s energy manipulations and frauds harmed electricity consumers. However, unlike any other industry, bank funding for its assets enjoys the backing of the federal government. Insurance from the FDIC means depositors can be less concerned about management integrity at the bank. The Federal Reserve provides low cost abundant funding, especially in times of peril. These legal backstops exist for no other industry. In Glass Steagall and the Bank Holding Company Act, Congress made explicit that these bank privileges should be used for specific goals, namely impartial loan-making. These laws were not licenses to exploit these privileges to sprawl into commodities, let alone manipulate these markets.

Joshua Rosner, a finance expert with Graham Fisher & Co., testified before the Senate Banking Committee, the experiment of allowing banking into commerce “has gone better for the banks than it has for consumers. Electricity users appear to pay more because of

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<sup>41</sup> “It’ll Be Way Harder For Goldman Sachs And Morgan Stanley To Get Out Of The Physical Commodities Business Than JP Morgan,” Reuters (July 29, 2013), available at: <http://www.businessinsider.com/morgan-and-goldman-on-physical-commodities-2013-7>

<sup>42</sup> Tyson Slocum, “Testimony, US Senate Permanent Subcommittee on Investigations, (Nov. 3, 2011; and Alaric Nightingale, “Morgan Stanley Hires Supertanker to Store Oil in Gulf,” January 19, 2009, [www.bloomberg.com/apps/news?pid=newsarchive&sid=albVHft2R3SE](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=albVHft2R3SE)

<sup>43</sup> Federal Energy Regulatory Commission, “Order Approving Stipulation and Consent Agreement,” (July 30, 2013) Available at: <http://ferc.gov/EventCalendar/Files/20130730080931-IN11-8-000.pdf>. Since this penalty, JP Morgan has said it intends to exit the commodities business

<sup>44</sup> “JP Morgan to pay \$410 million in FERC settlement,” Bloomberg, (July 30, 2013) Available at: <http://www.bloomberg.com/news/2013-07-30/jpmorgan-to-pay-410-million-in-u-s-ferc-settlement.html>

<sup>45</sup> House of Commons of the United Kingdom, Select Committee on Science and Technology, “Strategically important metals - Science and Technology Committee”, “Examination of Witnesses (Question Numbers 70-107)”, February 16, 2011, available at: <http://www.publications.parliament.uk/pa/cm201012/cmselect/cmsctech/726/11021602.htm>

Wall Street involvement, aluminum for airplanes and soda cans costs more, and some say gasoline at the pump costs more -- without any measurable benefit to anyone but the banks."<sup>46</sup>

Summarized Sen. Brown, allowing banks into commerce has led to "a host of anti-competitive activities."<sup>47</sup>

## **Can the Federal Reserve Order Banks to Shed their Commodities Businesses?**

If the experiment of allowing banks to own commodities has not served American consumers perfectly, can the Federal Reserve reverse these permissions? Perhaps. The Board can apply at least two tests: whether bank ownership of commodities yields a public benefit, and whether commodity ownership poses problems for the safety and soundness of the financial institution.

In the case of JP Morgan, (which was a bank holding company in 1999 and cannot avail itself of the grandfather loophole,) the Federal Reserve can apply a public benefits test to energy and other commercial enterprises the firm owns or proposes to purchase.

Episodes of market abuse hardly argue for a universal public benefit.

Even outside such episodes, it is difficult to understand how a profit-maximizing bank will generate public benefits through commodity ownership. On its face, public benefit means that bank ownership generates better prices or overall economic efficiency. But a bank cannot simultaneously sacrifice prices for the benefit of consumers and oblige its shareholders by maximizing profits. The conflicts between the public and shareholders "are not rare," understated Rosner before the Senate Banking Committee.<sup>48</sup>

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<sup>46</sup> Statement of Joshua Rosner, managing director, Graham Fisher & Co., before the U.S. Senate Committee on Banking, Housing and Urban Affairs, (July 23, 2013); available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=5d268a77-d49f-4807-9edd-de59483aee7f](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5d268a77-d49f-4807-9edd-de59483aee7f)

<sup>47</sup> Statement, Sen. Sherrod Brown, (July 23, 2013) available at: <http://www.brown.senate.gov/newsroom/press/release/at-senate-banking-hearing-brown-presses-regulators-on-bank-holding-companies-controlling-price-and-supply-of-physical-commodities-effect-on-consumers-and-manufacturers>

<sup>48</sup> Statement of Joshua Rosner, managing director, Graham Fisher & Co., before the U.S. Senate Committee on Banking, Housing and Urban Affairs, (July 23, 2013); available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=5d268a77-d49f-4807-9edd-de59483aee7f](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5d268a77-d49f-4807-9edd-de59483aee7f)

Nor does bank participation in commodities businesses yield greater economic gain. Identifying empirical evidence for this thesis has proven “difficult,” concluded a survey by the FDIC.<sup>49</sup>

Nor is it necessary for commodity firms to have bank parents. Most commodity firms already exist outside of banks. There are also cases where such firms have operated under bank control and then independently, with no apparent detriment. For example, Freeport Commodities has operated under a variety of owners, including JP Morgan (as Sempra Energy<sup>50</sup>) and also independently. The senior management has been the same.<sup>51</sup>

Commodity ownership may not even provide a benefit to the bank. In the summer of 2013, JP Morgan announced it would sell its entire commodities business.

Perhaps most troubling, the Federal Reserve is not positioned to determine the public benefits of bank ownership of commodities. The agency has no direct role in the supervision of the commodities markets generally, acknowledged a Board official.<sup>52</sup> The Commodity Futures Trading Commission (CFTC) regulates commodity futures and option markets.<sup>53</sup> The existence of an alphabet soup of financial regulators, marked by overlaps as well as gaps, doesn’t help either. In a letter to the Senate Banking Committee, CFTC Commissioner Bart Chilton wrote, “There is zero interest in ... information sharing on the part of the professional staff at the CFTC [with the Federal Reserve].”<sup>54</sup>

Federal Reserve official Michael Gibson acknowledged that determining the public benefit of bank ownership of commodities is “subjective.”<sup>55</sup>

With the existence of commodity market abuse by banks, the absence of clear public benefits, and the lack even of a rigorous regime to measure these benefits, the Federal Reserve can and should reverse its permissions for commodity ownership by apply a strict

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<sup>49</sup> “The Future of Banking in America,” by Christine Blair, FDIC Banking Review, (2004, Vol. 16, No. 4), available at: <http://www.fdic.gov/bank/analytical/banking/2005jan/article3.pdf>

<sup>50</sup> “JP Morgan will buy Sempra Business from RBS,” by Jeffrey McCracken, Wall Street Journal, (Feb. 16, 2010), available at <http://online.wsj.com/news/articles/SB10001424052748703562404575067982178809878>

<sup>51</sup> See company website at: <http://www.freepoint.com/about-us/> Also, “Sempra Reborn as Freeport Commodities,” by David Sheppard, Reuters, (Jan 13, 2013) Available at: <http://www.reuters.com/article/2012/01/13/us-freepoint-messer-idUSTRE80C2FA20120113>

<sup>52</sup> Testimony of Michael Gibson before the Senate Banking Committee, (Jan 15, 2014), available at: <http://www.federalreserve.gov/newsevents/testimony/gibson20140114a.htm#f10>

<sup>53</sup> Testimony of Michael Gibson before the Senate Banking Committee, (Jan 15, 2014), available at: <http://www.federalreserve.gov/newsevents/testimony/gibson20140114a.htm#f10>

<sup>54</sup> Letter, from CFTC Commissioner Chilton, to the Honorable Sherrod Brown, chair, Subcommittee on Financial Institutions, (Jan 15, 2014).

<sup>55</sup> Testimony: FOOTNOTE.

public benefits test. Subjectively, the Board can conclude that it cannot identify a public benefit.

Such a position can answer the issue of commodities ownership by JP Morgan and other firms that were bank holding companies as of 1999.

There remains the problem of the “merchant” banking and “grandfather” loopholes where banks need not meet a public benefit tests. These are the loopholes through which Morgan Stanley and Goldman Sachs have retained commodities businesses.

What the Federal Reserve can and must do in these cases is apply its responsibility to govern the safety and soundness of the institution. As a regulator, the Federal Reserve’s powers to uphold safety and soundness are broad and potent. Under the statute 12 USC 1818 (b), if “in the opinion of” the Federal Reserve, a firm it oversees engages in “an unsafe or unsound practice,” the Board may terminate this activity.<sup>56</sup> Under the Federal Reserve’s Regulation Y, “Whenever the Board believes an activity ... constitutes a serious risk to financial safety, soundness, or stability ... the Board may require the bank holding company to terminate the activity or to terminate control of the subsidiary.”<sup>57</sup>

The commodities business can be prone to costly problems. Examples include the explosion at British Petroleum’s Deepwater Horizon oil platform;<sup>58</sup> ruptures in gas transmission pipelines at Pacific Gas and Electric Company (PG&E), which led to \$1 billion in penalties and another \$1 billion in new investment;<sup>59</sup> an armed attack by “very highly trained individuals” at a PG&E substation near San Jose, Ca.,<sup>60</sup> the historic Exxon Valdez oil spill of 1989; and the Three Mile Island nuclear power incident of 1979.

Consider the oil spill from Deepwater Horizon—just one platform. This resulted in cumulative losses of \$42.2 billion, including liabilities for clean-up and compensation for affected fishing

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<sup>56</sup> The Board’s powers are described as those of any relevant banking agency, under 12 USC 1818 (b)-(n), available at: <http://www.law.cornell.edu/uscode/text/12/1818>

<sup>57</sup> Regulation Y, available at: <http://www.law.cornell.edu/cfr/text/12/225.4> . See Sec. 225.4 Corporate practices

<sup>58</sup> “Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities,” Federal Reserve, (January 2014), available at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140114a1.pdf>

<sup>59</sup> “Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities,” Federal Reserve, (January 2014), available at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140114a1.pdf>

<sup>60</sup> “Sniper Attack on PG&E,” by Steve Johnson, San Jose Mercury News, (Feb. 5, 2014) Available at: [http://www.mercurynews.com/crime-courts/ci\\_25072628/attack-pg-e-substation-sparks-concerns-about-possible](http://www.mercurynews.com/crime-courts/ci_25072628/attack-pg-e-substation-sparks-concerns-about-possible)

businesses.<sup>61</sup> That's a far larger loss than the value of the platform, which was arguably worth less than \$1 billion.<sup>62</sup> In conventional banking, losses can be no more than the value of a loan. Had a bank extended a loan for the construction of the platform that its owner could not repay, the bank's loss would be restricted to the loan value, not the \$42 billion in losses due to liability of the platform's owner for the oil spill.

Importantly, when banks do own commodities, they do so largely with borrowed funds. Banks are highly leveraged. Borrowed money from deposits, bonds and other financing accounts for more than 90 percent of the value of the property banks control. In its latest quarterly report, Goldman reported assets of \$923 billion. But its liabilities were \$845 billion. Total shareholder equity at Goldman stood at \$75 billion.<sup>63</sup> By contrast, British Petroleum reported \$300 billion in assets, \$181 billion in liabilities, and shareholder equity of \$118 billion.<sup>64</sup> In other words, even though BP is smaller than Goldman Sachs in assets, its equity buffer could better withstand the \$42 billion loss from the Deepwater disaster than could Goldman.

Morgan Stanley acknowledges these risks: "Our commodities business ... exposes us to the risk of unforeseen and catastrophic events, including natural disasters, leaks, spills, explosions, release of toxic substances, fires, accidents on land and at sea, wars, and terrorist attacks that could result in personal injuries, loss of life, property damage, and suspension of operations. As a result, our financial condition, results of operations and cash flows may be adversely affected by these events."<sup>65</sup>

The Federal Reserve should exercise its broad authority to protect the safety and soundness of the financial system from the potential catastrophes from commodity ownership. The Federal Reserve recognizes these risks and many of the episodes of costly problems recited above are taken from the Board's own proposed review of its policy of bank ownership of commodities. Particularly because the public benefit test isn't available, the grandfathered firms should be held to a strict safety and soundness test so that catastrophes do not cascade through the system.

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<sup>61</sup> "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities," Federal Reserve, (January 2014), available at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140114a1.pdf>

<sup>62</sup> A list of losses from other oil rigs shows values of \$200 million to \$1.1 billion.

<http://www.oilrigdisasters.co.uk/> Exxon reports that it's entire plant and equipment is valued at \$226 billion. See Exxon annual report (2012), available at:

<http://www.sec.gov/Archives/edgar/data/34088/000003408813000011/xom10k2012.htm>

<sup>63</sup> Goldman Sachs quarterly report, (fourth quarter, 2013), available at:

<http://www.sec.gov/Archives/edgar/data/886982/000119312513430752/d590232d10q.htm>

<sup>64</sup> British Petroleum, financial statement, contained here:

<http://finance.yahoo.com/q/bs?s=BP+Balance+Sheet&annual>

<sup>65</sup> Morgan Stanley annual report (2012), available at:

[http://www.sec.gov/Archives/edgar/data/895421/000119312513077191/d484822d10k.htm#rom484822\\_5](http://www.sec.gov/Archives/edgar/data/895421/000119312513077191/d484822d10k.htm#rom484822_5)

## Is the Problem Abating?

Recently, major banking firms such as JP Morgan have announced sales of commodities businesses, evidence that the Federal Reserve may be applying some or all of the above tests to bank control of commodities, and that the problem of bank control of commodities is abating. Precisely what the Federal Reserve has ordered remains unclear, not subject to public meetings or published releases.

As noted, JP Morgan has declared it would exit the commodities business. One media outlet speculated that the decision came “under rising regulatory and political pressure.”<sup>66</sup>

Morgan Stanley reportedly is selling its TransMontaigne subsidiary.<sup>67</sup> Morgan Stanley also explained in a recent shareholder report that it was engaged in “discussions” with the Federal Reserve regarding its commodities activities. “If the Federal Reserve were to determine that any of our commodities activities did not qualify for the BHC Act grandfather exemption, then we would likely be required to divest.”<sup>68</sup>

Goldman has shed many of the physical trading assets it owned in 2008. Its U.S. power sales have fallen to less than one sixth of their peak in 2005, according to regulatory filings with the Federal Energy Regulatory Commission.<sup>69</sup> A Federal Reserve letter to the Goldman Sachs in 2012, obtained through the Freedom of Information Act by a news service, said that “specifically, Goldman Sachs continues to engage in commodity-related activities and indirectly controls (redacted) impermissible non-real-estate investments that the Board has not authorized.”<sup>70</sup>

These are welcome developments. But do they represent a transitory policy by the current governors of Federal Reserve Board? In January, 2014 the Federal Reserve published an invitation for public comment on its entire approach to the three perforations in the

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<sup>66</sup> “JPMorgan in talks with Mercuria on commodities unit sale,” Reuters, (Feb. 5, 2014), available at: <http://www.reuters.com/article/2014/02/05/us-jpmorgan-commodities-mercuria-idUSBREA140PT20140205>

<sup>67</sup> “As Fed looms, Morgan Stanley sets sale of its US oil terminal business,” Reuters, (Dec. 11, 2013), available at: <http://www.reuters.com/article/2013/12/11/us-morganstanley-transmontaigne-sale-idUSBRE9BA16320131211>

<sup>68</sup> Morgan Stanley annual report (2012), available at: [http://www.sec.gov/Archives/edgar/data/895421/000119312513077191/d484822d10k.htm#rom484822\\_5](http://www.sec.gov/Archives/edgar/data/895421/000119312513077191/d484822d10k.htm#rom484822_5)

<sup>69</sup> “It’ll Be Way Harder For Goldman Sachs And Morgan Stanley To Get Out Of The Physical Commodities Business Than JP Morgan,” Reuters, (July 29, 2013), available at: <http://www.businessinsider.com/morgan-and-goldman-on-physical-commodities-2013-7>

<sup>70</sup> “It’ll Be Way Harder For Goldman Sachs And Morgan Stanley To Get Out Of The Physical Commodities Business Than JP Morgan,” Reuters, (July 29, 2013), available at: <http://www.businessinsider.com/morgan-and-goldman-on-physical-commodities-2013-7>

banking/commerce role. The invitation for comment did not accompany a proposed new rule. Fundamentally, the process should be public and transparent. Permissions to own commodities under any existing statute should be subject to public comment. Ownership of commodities should be subject to a rebuttable presumption that they meet neither a public benefits nor a safety and soundness test.

## Speculation Intelligence

In a newly recognized problem, commodity trading remains vulnerable to exploitation through the emergence of sophisticated speculation intelligence. This problem stems from the fact that there is no legal prohibition on trading with insider information in commodity markets.<sup>71</sup> This allows commodity producers and users to hedge without concern that their insider understanding can expose them to criminal or civil liability.

While commodity ownership by banks remains a policy challenge, the 2010 Wall Street Reform Act barred proprietary trading in derivatives related to commodities by banks and their affiliates. The Volcker Rule permits banks to engage in market-making in the service of customers. Bank profits, however, must not derive from information-based speculation, simply the spread between the purchase and re-sale price.

But commodity producers, users, and other traders remain free to use any information, including non-public information, for proprietary trading.

When a firm obtains market information before anyone else, they are able to trade contracts with other parties who lack adequate price discovery. The firm enjoys a price advantage over other market participants not armed with the same information. As a result, the advantaged trader is able to charge a “premium.” Ultimately, a market subject to trader information advantages can translate into costs for consumers.

The ability to gain information to compete as traders with commodity producers themselves can involve expensive sources of speculation intelligence. Firms such as Genscape with extraordinary investments in energy supply surveillance sell near real-time intelligence to those traders large enough to afford such services. Such firms may deploy helicopters equipped with infrared cameras to measure oil supply in Cushing Oklahoma, or monitor generation from nuclear power plants. This information can be more precise than that obtained by government information agencies that is subsequently reported during scheduled releases. Genscape figures in a growing industry that employs sophisticated surveillance to supply traders with “nonpublic information” about oil supplies and electric-

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<sup>71</sup> See, for example, the CFTC’s rule on manipulation, Federal Register, Vol. 76, (July 14, 2011) p. 41403, Available at: <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-17549a.pdf>

power production, explained one news account.<sup>72</sup> Surveillance and analysis of the oil, electricity and natural-gas sectors can run Genscape clients more than \$300,000 a year.<sup>73</sup> Another example is Remote Sensing Metrics, which can count cars in shopping mall parking lots. Clients include unnamed retailers and Wall Street investment firms.<sup>74</sup> A third example is DigitalGlobe, which can assess crop damage at disaster sites.<sup>75</sup> Customers include financial industry firms, though the firm doesn't name them.<sup>76</sup>

In securities markets, some large institutional investors have surveyed analysts about their forthcoming ratings on companies they cover. New York Attorney General Eric Schneiderman deemed the practice "Insider trading 2.0." Gleaning such information by "certain elite, technologically sophisticated clients" comes at "the expense of others—a practice that can put the market at large at an unfair disadvantage." Schneiderman recently announced an agreement whereby 18 Wall Street firms agreed to cease participating in the surveys.<sup>77</sup>

In the case of Genscape, the government is a subscriber. DigitalGlobe is registered with the Securities and Exchange Commission as a public company. As a fuller safeguard, speculation intelligence firms should register with an appropriate government agency such as the CFTC. This can allow government supervisors to reverse engineer suspicious trading. Regulation of this type of speculation intelligence requires efforts beyond the Federal Reserve's purview, and we encourage multiple agencies to begin to examine this new frontier in speculation based on "insider commodities information."

## Conclusion

Separating banking and commerce has served the American economy well, as evidenced by problems when this wall has been violated. And as institutions seem to push boundaries as with speculation intelligence, it underscores the need for vigilance in this arena.

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<sup>72</sup> "Traders Seek and Edge with High-Tech Snooping," by Michael Rothfeld, Wall Street Journal, (Dec. 18, 2013), available at:

<http://online.wsj.com/news/articles/SB10001424052702303497804579240182187225264>

<sup>73</sup> "Traders Seek and Edge with High-Tech Snooping," by Michael Rothfeld, Wall Street Journal, (Dec. 18, 2013), available at:

<http://online.wsj.com/news/articles/SB10001424052702303497804579240182187225264>

<sup>74</sup> Company website visited Feb. 17, 2014, available at: <https://www.rsmetrics.com/about-us/who-we-are/>

<sup>75</sup> "Traders Seek and Edge with High-Tech Snooping," by Michael Rothfeld, Wall Street Journal, (Dec. 18, 2013), available at:

<http://online.wsj.com/news/articles/SB10001424052702303497804579240182187225264>

<sup>76</sup> DigitalGlobe annual report (2012) available at:

<http://www.sec.gov/Archives/edgar/data/1208208/000119312513077044/d446164d10k.htm>

<sup>77</sup> Press release, Office of AG Schneiderman (Feb. 26, 2014), available at: <http://www.ag.ny.gov/press-release/ag-schneiderman-announces-far-reaching-agreements-wall-street-firms-stop-cooperating>

The three perforations introduced by Gramm Leach Bliley in 1999 can be repaired to varying degrees by willing governors of the Federal Reserve Board. Firms such as JP Morgan that cite a commercial activity as “complementary” to banking should be held to a strict “public benefits” test. Such a test should include a rebuttable presumption that ownership of commercial assets harms the public. A record of abuse should disqualify the bank. For firms such as Goldman and Morgan Stanley that might rely on the grandfather or merchant banking provisions, the Board should determine that inherent risks of commodities business constitute too great a challenge for the Board’s overriding responsibility to protect the safety and soundness of the financial system.

The American public, however, shouldn’t depend on the individual, transitory policy choices of board members who will come and go with succeeding Presidents. Congress should provide for a more secure wall. The 21<sup>st</sup> Century Glass Steagall Act and similar measures now under consideration in Congress provide such surety.<sup>78</sup> This bill erases the three perforations contained in Gramm Leach Bliley.

For the broader commodity markets, the Commodity Futures Trading Commission should require that speculation intelligence firms register with the agency, and that their reports be made available to government supervisors. After a suitable period, these reports should be made public to allow for independent analysis of whether such reports contributed to unfair advantages or manipulation.

Rationally functioning commodities markets serve at the core of a stable economy. Producers can source material in a predictable manner and market competition leads to fair prices. Interference from banker abuse or speculation intelligence should be carefully controlled.

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<sup>78</sup> The 21<sup>st</sup> Century Glass Steagall Act, (introduced July 11, 2013), available at: <http://beta.congress.gov/bill/113th-congress/senate-bill/1282?q=%7B%22search%22%3A%5B%22sen.+warren+21st+century%22%5D%7D>